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Big Oil's Big Shift

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BY VIREN DOSHI, HEGE NORDAHL, AND ADRIAN DEL MAESTRO

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Now that the oil spill in the Gulf of Mexico has been mostly capped, there will be many efforts to catalog its impact: the damage to local (and perhaps global) ecologies, the lost income for tourism and fishing businesses, the increased litigation, and the political fallout. But in the clamor surrounding the crisis, the effect of the accident on the energy industry itself is often overlooked. The oil sector, not just in the U.S. but also around the world, will almost certainly undergo a profound evolution as part of the aftermath. The types of companies that thrive and the types that fail, and the way they do business, will permanently change in the years to come.

To understand why, we have to look past the emotions of the moment and focus on the specific aspects of the oil business that the spill will affect most. Risk has always been inherent in the extraordinarily complex projects that extract oil from the ground or sea. During the past few years, industry trends have added to this risk. The most accessible and productive oil fields, including those in the Middle East and Russia, are now owned and operated solely by national oil companies (NOCs). Leading international oil companies (IOCs) such as BP, ExxonMobil, and Shell — also known as the oil majors — therefore find their access to “easy” reserves rapidly shrinking.

Indeed, it is the need for better equity positions in

oil exploration and production that has driven the oil majors to look farther afield to higher-risk, more remote, more difficult-to-reach places, such as the deep sea, central Africa, and the Arctic. And as the availability of “bookable” reserves continues to diminish, the pace of growth and the earnings of the major oil companies will likely suffer even more.

Put simply, the IOCs will have to get used to placing more expensive bets and relying on ever more challenging technologies to tap reserves. Drilling at 5,000 feet below sea level, or in the Arctic, requires levels of investment and technical skill equivalent to those needed for space travel. That’s why the repair of the Gulf leak was so difficult; it was like fixing a space shuttle in orbit.

Before the recent crisis, the major oil companies managed the risks of these challenging drilling environments in two ways. On the one hand, they implemented a series of checks and balances to minimize unsafe practices. People and plant safety is the number one overall priority at all the oil companies we know. At the same time, in their day-to-day practice over the years, many of the same companies have adopted a “mitigation”-style behavior. Assuming that some level of risk would always exist, they have managed it within their cost constraints and time pressures, mainly by allowing frontline contractors or managers to make the necessary trade-offs within each situation as it arose.

Viren Doshi

viren.doshi@booz.com
is a senior partner at Booz & Company based in Paris. He has 30 years of industry experience, primarily in the oil and gas sectors. He is the leader of the firm's global energy practice and the author of *s+b* articles on energy, infrastructure, and customer relationship management.

Hege Nordahl

hege.nordahl@booz.com
is a principal with Booz & Company based in London. She is a member of the firm's global energy practice and focuses on the upstream oil and gas industry.

Adrian del Maestro

adrian.delmaestro@booz.com
is a principal with Booz & Company based in London. He leads the firm's global energy research team.

This latter approach will no longer fly. The oil spill has accelerated concerns about safety and environmental quality that had already been growing. Henceforth, access to global reserves — for all oil companies, the oil majors and the NOCs alike — will be constrained by heightened regulatory requirements. In deep water, oil companies will increasingly have to guarantee enhanced safety and environmental safeguards or forfeit their license to operate.

In the West, the regulatory penalties for missteps have already become harsher and will be more rigorously enforced. After the Piper Alpha offshore rig explosion in the North Sea in 1988 that killed 167 people, the United Kingdom introduced one of the strongest oil and gas safety regimes in the world. Recently, the U.K. announced that it will double the number of inspections of offshore platforms. The restructuring of the U.S. Minerals Management Service to strengthen oversight of the oil and gas industry is likely to be replicated in many other countries. Even in Asia, Africa, and the Middle East, where regulations have been relatively lax, the emerging middle classes are pressing politicians to be more stringent. When a pipeline in the Xingang harbor in Dalian, China, exploded on July 16, triggering a large oil spill, the government responded rapidly with stricter environmental standards for port operations throughout China.

Moreover, regardless of the outcome of the civil lawsuits rising from the Gulf spill, their visibility and virulence will make any oil company think twice before risking the same sort of liability again. Companies will need impeccable safety and environmental records to attract investment. Less competent upstream oil companies will have a much more difficult time keeping their operations well funded.

In the face of all this, the cost of oil production will increase considerably. The most vulnerable category of businesses will probably be the smaller independent oil companies that are directly engaged in exploration and production. Some of them will now find it so expensive to work in deep water that their operations there will be threatened. They may reallocate their capital elsewhere, perhaps selling their interests in deepwater operations to the oil majors. As for oil-field services companies, which generally provide technology, expertise, and ancillary operations to the sector, they will now be able to charge higher prices to cover their costs, including the wages of more experienced workers expert in rigorous environmental and safety practices. Insurance premiums will also rise, as will investment costs for maintenance, contingency planning, and the infrastructure needed to provide safeguards, such as blowout prevention devices, sensors, and oil-spill-response vehicles and equipment.

All these cost increases, many of them made in

direct response to the Gulf spill, will probably drive up oil prices. Adam Sieminski, chief energy economist for Deutsche Bank AG, has forecast a price rise of US\$5 to \$10 per barrel over the next few years due to the accident.

Ironically, these developments could represent an advantage for the oil majors in the long run. Two things that they will have going for them will be their expertise across the value chain and their appetite for risk. Using their long experience in the oil patch, the majors will increasingly have to pull together and oversee networks of independent companies to take on the challenges of the next wave of drilling. Some critics have called for the majors to stop partnering with contractors, but this won't happen; the expertise and technology necessary to handle more complex drilling activities is scattered among too many different companies.

But the oil majors will have to manage their contractors differently, working more closely in teams with business partners that earn their trust over a long period of time, and in some cases taking stakes in third-party providers to better control their performance. This partnership model must be built on interdependence and mutual respect — a significant change from long-standing practices in some parts of the sector. The oil majors will also need to revise their operating models, sorting out a different mix of activities to outsource, and bringing some of the most critical oversight functions back in-house — so they can address quality issues and place employees on the front line to better oversee the growing situational risk in oil drilling.

Some new types of partnerships in the industry will emerge between national oil companies and the oil majors. NOCs operating in more and more complex environments will seek partners that can manage both risk and liability. Oil majors may have to wholeheartedly embrace this role (and the skill set that goes with it) to survive. Of course, sooner or later, some NOCs will concentrate on building their own capabilities to own and manage risk and liability, thus cutting the majors out of even this part of the business. By that point, some NOCs may be moving into international waters and becoming, in effect, oil majors themselves. Meanwhile, there will be entrepreneurial opportunities for new firms that can provide services for oil-spill prevention and cleanup, emergency response, and operational safety, as well as companies that develop new oil-field technology.

Perhaps the biggest uncertainty in this new and challenging business environment is the ability of the

major oil companies to change as conditions shift measurably. Most large oil companies — including both international oil majors and state-owned NOCs — have rigid management cultures and adversarial, penny-pinching relationships with suppliers and partners. Historically, they have tended to focus on short-term cost cutting without sufficient consideration for collaborative operations that could benefit themselves and their partners.

These practices will be far less feasible now, as oil-field operations become more complex and interdependent. Major oil companies will have to give their staff and suppliers more supervision, but also more trust and support; they will have to encourage everyone at every level to fearlessly point out potential safety and operational flaws; and they will need to fix more problems at early stages, even under immense pressure to deliver.

Many people in the oil industry have foreseen these types of changes, but they haven't been forced to act. Now they will be. Those who figure out how to move beyond their past practices, troubled contractor relationships, and rigid management structures will lead the next generation in the oil sector — on land, in shallow waters, and in deep and remote locations. The time for these changes could come surprisingly soon. +

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