

WORLD ENERGY

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Storm Still Building on Oil Company Cash

by Stephen V. Arbogast

A political storm is building and headed toward the large cash piles accumulating at the major oil companies. Whether the storm makes landfall next year or shortly before the 2008 presidential election will depend on whether people think the major companies are putting their resources to effective use. The test of effectiveness will be whether this cash is used to create more secure energy supplies for the U.S. economy at more stable prices.

How large and conspicuous are the cash portfolios being amassed by the majors? The absolute numbers in Figure 1 tell part of the story.

\$ Billion Cash & Marketable Securities	2000	2001	2002	2003	2004	2005	% CAGR
ExxonMobil	7.1	6.5	7.2	10.6	18.5	32.0**	35.1
BP	1.8	1.8	1.7	2.1	1.4	2.2*	3.1
Shell	11.4	6.7	1.6	1.9	8.5	16.0*	5.8
Chevron	2.3	2.1	2.9	4.3	9.3	9.8*†	27.1
4 Majors	12.6					60.0	36.6

** Estimated based upon first two quarters and third-quarter earnings

* Cumulative based upon first three quarters

† Does not include purchase of Unocal

Figure 1

In many cases this cash build has occurred in the face of plans and forecasts that predicted portfolios would plateau and then decline.

These mounting cash balances take on an added dimension when viewed in the context of capital investment trends (Figure 2).

\$ Billion Capital Investments	2000	2001	2002	2003	2004	2005†	% CAGR
ExxonMobil	11.2	12.3	13.9	15.6	14.9	16.5	6.7
BP	10.9	13.2	13.3	13.6	13.8	12.5	2.2
Shell	8.5	11.8	24.6	14.3	14.9	15.3	10.2
Chevron	9.5	12.0	9.2	7.4	8.3	9.5	0.0
4 Majors	40.2					53.8	6.0

† Annualized based upon first three quarters

Figure 2

While this capital spending is massive in aggregate, its impact on the production of oil and natural gas has not been material. As a group, the four super-majors produce less than 1 percent additional oil-equivalent barrels today than they did in 2000.

Why is this happening? Why has the industry's peak profitability coincided with modest increases in capital spending and flat oil/gas production? Some have argued the industry is "opportunity limited" in an era where the most prospective upstream plays are controlled by governments. These observers also note the long development period required to commercialize major upstream plays. Others have noted that large sectors, such as refining, exhibit unattractive industry structures; until recently, refining has been characterized by spare capacity and poor returns that lasted for decades.



These explanations all contain important grains of truth. However, they are missing a central thread of the explanation: The majors' top management remains haunted by memories of the oil price bust of the 1980s.

Today's company leaders lived through that experience. In some cases, current leaders witnessed or personally closed down earlier alternative-energy projects. They remember projects like Battlement Mesa, Colorado, where a multibillion-dollar oil shale facility was abandoned before startup. They remember, too, that oil is a commodity given to price volatility measured in hundreds of percents. In 1980, one major firm forecasted \$200-per-barrel crude oil prices for the year 2000. Being wrong "on the high side" about oil prices can be devastating to investment returns. Today's leaders recognize that for years their firms were wrong by a factor of 10. In their determination not to repeat the mistake, they now see the next bust to be as close as the next warm winter.

With considerable effort, these leaders confronted the unexpectedly low oil price environment and still achieved a more stable financial foundation for their companies. They did this by emphasizing high returns, "hi-grading" their opportunities, consolidating the industry and relentlessly controlling costs. Consequently, they fear calls to grow more rapidly, believing them to be subversive to good discipline and encouraging to the very behavior that carries the seeds of the next price bust.

The problem with this approach is its conflict with political expectations, which are increasingly influenced by concern regarding the physical security of energy supplies for the countries of the Organisation for Economic Co-operation and Development (OECD). Moreover, where supplies are considered vulnerable to disruption, large risk premiums enter into pricing. In this way, tight energy supply chains threaten both physical disruption and the price stability of OECD economies.

Consumers and their governments increasingly expect the major companies, who are perceived to be principal beneficiaries of the price "run-up," to work with urgency to provide remedies. Mounting cash piles juxtaposed with relatively flat investment and production amount to a yellow light flashing, "This is not happening yet." Whether this is a fair judgment is beside the point. Fairness scruples did not spare the majors from public condemnation and punitive taxation during the 1970s.

How, then, to respond to the building political pressures without sacrificing the discipline painfully acquired during the lean years? Companies must begin with a careful reconsideration of their energy outlook planning bases and their implications to key client customers and governments.

Recently, one of the major companies presented its energy outlook to a global supply conference in Houston, reminding listeners the global hydrocarbon resource base remains ample. The company noted, however, that in 2030 the global supply balance will be achieved by increasing the "call on OPEC" by 19 million barrels per day (MMbd), to 47 MMbd. This is an astonishing assumption around which to formulate investment strategy. For one thing, such an assumption must be connected to a low oil price assumption. For another, it implies a large increase in energy dependence upon a small group of countries characterized by political vulnerability and/or open hostility to the United States. For this vulnerability not to matter and for the forecast to make sense, the assumption must be that political conditions will drastically improve in the Middle East. Is this a firm foundation upon which to base either company planning or national energy policy?

Such assumptions may make sense to managements guarding against overbuilding and the next price bust, but they will receive an increasingly hostile reception from political leaders concerned with the security of OECD economies. These now understand the entire oil/gas supply chain has bottlenecks, and that restoration of adequate and stable reserve capacity is in the national interest.

For these reasons, the major companies would be well advised to begin factoring some "political risk credits" into their strategy development and planning assumptions. This means assigning some additional value to projects and programs that better protect the OECD economies and their governments' ability to conduct foreign policy. The market is already "pricing this in" as risk premiums in current and forward energy prices. Indeed, the forward price curve is signaling oil prices near current levels out as far as 10 years.

At the margin of decision making, this approach should result in some changes:

- Some economically justified projects still in development because of efforts to maximize returns will acquire new momentum toward approval.
- Viable projects that respond to specific political concerns, such as refining bottlenecks, will merit more intangible credit, receiving a large urgency boost to accelerate final approval.
- Viable projects with near-term impacts will get some priority for internal resource allocation.

Collectively, these changes should result in some near-term acceleration in capital spending and in the ability of the majors to make high-visibility project announcements. The concern will be a potential deterioration in terms and execution quality, but if the process is carried out as another "hi-grading" exercise, this time taking political risk into account, this execution risk can be managed within a disciplined framework. To the extent projects come onstream faster, they may also participate more

fully in a favorable price environment, thereby boosting returns.

What about long-run supply security? The temptation will be to recite the "let the market work" mantra. While this perspective is valid, here again the majors need to recognize the "political risk" blind spot encased in this argument. Companies' market-oriented pursuit of high returns has embedded far greater political risk into the energy supply chain. When supplies were ample, this could be justified by the virtue of diversification. When supplies became tight, this amounted to exposing the health of OECD economies to the interests and whims of Vladimir Putin, Hugo Chávez, Nigerian oil unions and whoever happens to be running Angola and Kazakhstan.

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In this environment, long-term maximization of shareholder wealth involves the restoration of conditions that will leave OECD economies less exposed to political risk and restore more upstream bargaining power to the majors. To accomplish this, the majors will need to work harder to recreate adequate capacity at the front, the production end, of the supply chain. They must explicitly accept into their planning the objective of restoring supply security for consuming nations. This can be accomplished by giving more emphasis to energy production in politically safe locations such that sufficient spare capacity backs into risky supply sources; in this way diversification can reemerge as an adequate safeguard. In the 1970s this was accomplished by bringing on Alaska and the North Sea. This time, it may involve replicable projects based upon tar sands, shale, biofuels and coal in consuming locations. Public policy that provides adequate downside price protections, such as has been incorporated into financing for the Alaska gas pipeline, may form part of this solution.

Some such projects are gaining momentum. For the moment, however, the companies' urgency factor still appears to be missing. The majors' mindset still subordinates all else to return maximization within an expected return to much lower prices. This perspective assumes the majors must chart their course only with regard to the market. Would that this were so. They'd best get a move on, or less sympathetic minds will find other uses for their idle cash. ♦

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