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Supermajors seek the right balance

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As the 20th century drew to a close, the US oil and gas industry went on a buying spree, forming supermajors such as **ExxonMobil**, **ChevronTexaco** and **ConocoPhillips**.

The idea was to gain economies of scale and hedge against tough times and costs associated with exploration, production and refining. By 2008, rising oil and natural gas prices rewarded them with strong profits.

"That increase in oil prices camouflaged or distracted attention away from the structural changes taking place,'" says Praveen Kumar, director of the global energy management institute at the University of Houston.

Resources were harder to come by, with maturing fields and the rise of resource nationalism and competition from national oil companies. The supermajors scrambled to buy what they could – Canada's oil sands, global deepwater, and US shale – all of which were more expensive to develop than conventional resources.

"Even if you now have a promising find, the amount of money needed to exploit is higher than in the past,'' Mr Kumar adds.

To fund these projects, companies are now selling non-core, mature or politically risky assets. Several companies have aggressively pursued a shrink to grow strategy. At Exxon's annual shareholders' meeting on May 25, investors pressed the company, as they have in the past, for clarity on its future direction.

Devon Energy and ConocoPhillips have been rewarded with a rise in their share prices since the start of the year. Even **BP**, forced by the Macondo disaster in the Gulf of Mexico to sell assets to raise cash, has been rewarded by investors.

"We had more opportunities than we could reasonably develop,'' says John Richels, Devon's chief executive. "We decided to focus on the biggest piece – 90 per cent of our portfolio was onshore North America."

In November 2009, Devon began selling its international and deepwater assets, hoping to gain up to $7.5bn before taxes; it brought in $10.1bn before taxes. Yet some investors questioned selling oil assets prized in the market.

"If you don't have some sort of competitive advantage, you shouldn't compete in that area," Mr Richels says.

It is a lesson sometimes forgotten as companies strive to grow. For Paul Sankey, analyst at Deutsche Bank, it raises the question for others in the industry: "Why are you holding on to non-core assets worth more to other companies?"

Jim Mulva, Conoco chief executive, admits he was late taking stock. This was driven home when commodity prices fell off their record highs with the downturn in late 2008.

In early 2009, Conoco, the third-biggest oil and gas company in the US by production and market capitalisation, disclosed a 2008 fourth-quarter net loss of $31.8bn; a $34bn writedown; 1,300 job cuts and a $2.8bn cut in capital spending.

"We did an assessment of the business environment, opportunities, risk reward and value creation, but not as quickly as we could have," he says. "We could and should have done it sooner. We were spending more capital than we had cash flow on opportunities that were not value creating."

Putting an end to that yielded such a positive response by investors that in March **Conoco said it would shed** an additional $5bn-$10bn in assets during the next two years on top of $7bn sold last year.

However, Mr Kumar warns any strategy carries risks. By shrinking too much, companies lose the hedges provided by diversified portfolios.

This is especially important for the exploration and production segment, which is exposed to multiple risks, such as high commodity price volatility, environmental accidents and expropriation of assets by foreign governments.

For example, Seahawk Drilling filed for bankruptcy this year after the drilling moratorium following BP's spill brought its Gulf of Mexico-focused business to a standstill.

Devon is maintaining diversification, with its oil sands business in Canada and shale and conventional oil and gas exploration and production in the US. Conoco is holding on to refining with its exploration and production. In

addition, Conoco says it may spend an additional $2.5bn this year on capital expenditures if the right opportunities arise in deepwater or shale.

“You need to use a certain amount of money to invest for returns,” Mr Mulva says. “We have found the right balance.”

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