



Big thinkers

By John Downie, Curt J. Howes and Julie Adams

As the supermajors shift away from the world's maturing oil basins, a group of smaller, upstream independents are moving in. With their value-creating strategies, growth-oriented cultures and focus on operational excellence, a handful of these entrepreneurial companies are posting outstanding performance.

■ It's not exactly like Las Vegas—but there are similarities. Consider this: A major oil find can double a small energy company's market cap overnight—while one poor decision can wipe out another company. Similarly, an oil price shock—like the price crashes in 1986 and 1998—can slash the industry market cap in a matter of months. And these shocks, whether collapses or spikes, are not rare. In the past two decades, there have been at least half a dozen major events that had a dramatic impact on oil and gas prices.

Energy is obviously a high-stakes game, especially in the oil sector, and not a business for the fainthearted.

The industry's reaction to the most recent oil price collapse, in 1998, was consolidation—on a massive scale—and today, the market is led by a handful of so-called supermajors—companies like BP, Chevron-Texaco, ConocoPhillips, ExxonMobil, Shell and Total. These giants have the critical mass and financial resources to drive new opportunities in the frontier regions of the world, such as West Africa, while continuing to serve their rapidly maturing home markets in Europe and the United States.

Does this mean you need to be big if you want to hit the jackpot in oil? Not necessarily.

In an ever-evolving industry, the supermajors' strategic focus is shifting away from the maturing basins in the North Sea and North America, which are no longer as economically attractive for such huge companies. Replacing reserves is the name of the game in oil and gas. A company the size of BP requires a really big find to replenish its reserves, and these areas rarely yield them. As a result, the supermajors are taking

their quest for assets into emerging markets, leaving the mature fields to a different set of players: the so-called independent oil companies.

The independents comprise a distinct group within the oil and gas industry. Mostly North American, the majority tend to focus on the upstream part of the business—exploration and production. Unlike the supermajors, which run refining and marketing operations as well, the independents are small, lean and have more focused operations, which gives them a cost advantage when it comes to making older assets pay.

As part of Accenture's High Performance Business initiative, we looked at the independent energy companies and tried to understand what set the high performers apart. To do this, we looked at a number of key elements of high performance for each company in our international peer set (see "About the research," opposite). This allowed us to identify four high performers that had consistently delivered superior returns to shareholders during the past three, five and seven years, in addition to superior growth, profitability, positioning for the future and consistency of earnings. But what we really wanted to know was what these organizations do differently that enables them to outperform their peers.

Six key attributes

We discovered that there were six key attributes, the unique combination of which, we believe, set these high-performing independents apart. Many of the other companies in their peer group could boast one or more of these attributes, but only the four high performers

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About the research

Accenture defines high performance in the energy business on the basis of both historical and likely future performance, and we give considerable weight to both.

To understand the historical performance of our peer group of 21 independent oil companies, all with revenues in excess of \$1 billion, we used Accenture's six standard elements, including consistency as measured by total return to shareholders over three, five and seven years. We also looked at growth, taking the compound annual growth rate for revenue for these time periods. Because the industry is so capital-intensive, we explored the metric of profitability by looking at the ratio of enterprise value to invested capital in addition to the return on invested capital.

Our metrics for positioning for the future were tailored to the energy industry by extending Accenture's core metric, change in the company's share of total future value in the industry, to include somewhat more subjective criteria:

- The trend for return on invested capital, looking for companies that have improved this measure

- Financial flexibility, defined as available cash coupled with credit rating
- Strategic positioning and management capabilities, which we based on our own qualitative assessments in interviews with executives at the companies

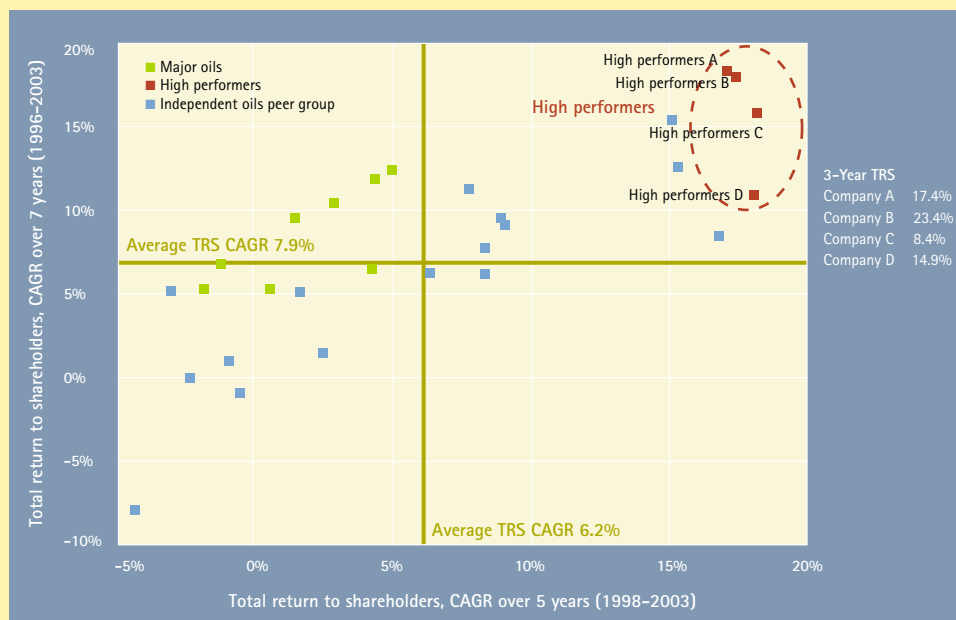
Strategic positioning also examined three subfactors:

- The markets in which the company focuses
- The quality of assets to support that positioning
- The business model and the company's capabilities in support of its market positioning

The measurement of management capabilities, like strategic positioning, is somewhat subjective, but is derived from a structured evaluation of certain key elements. Our assessment of management capabilities is based on our observation of the management team's depth of experience, including outside the industry, the team's willingness to change and take measured risks, and the strength of board oversight.

Based on total return to shareholders, four independent oil companies have emerged as high performers.

5-Year TRS (CAGR) vs. 7-Year TRS (CAGR) (through May 2003)



Ebbs and flows

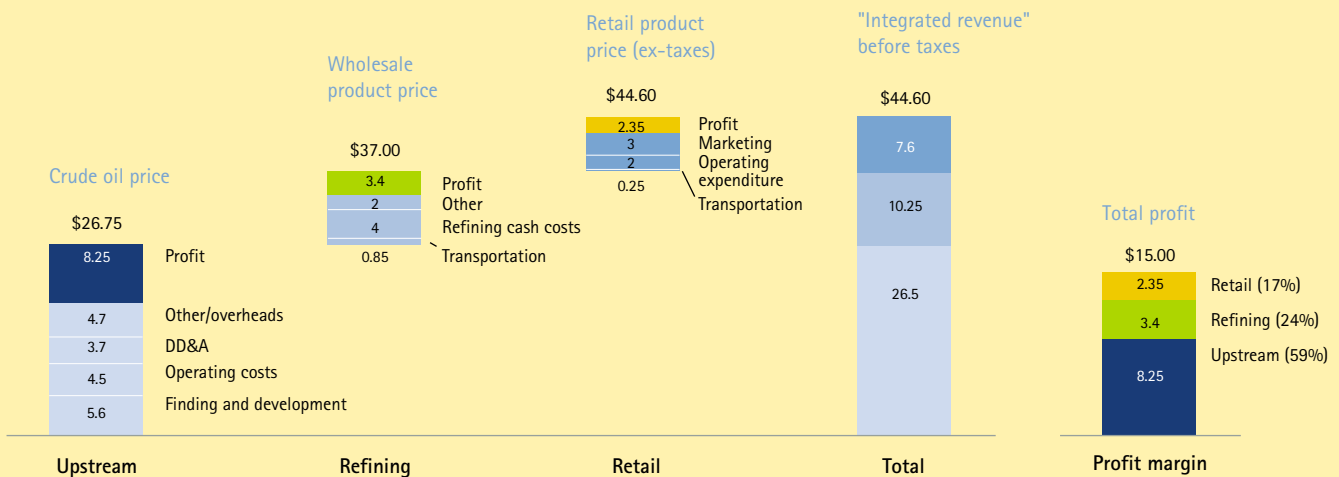
The oil industry has gone through a number of phases, with evolving strategic goals. The most recent priority has been exploration and development.

| | 1882 | 1911 | 1931 | Late 1940s | 1960 | 1973 | 1986 | Late 1990s | 2000 > |
|--|--|------------------------------|--|--|---|-------------|--|---|---|
| | Standard Oil trust formed | Standard Oil trust dissolved | Pro-rationing enforced in Texas | Rise of Middle East production | OPEC formed | Price shock | Price collapse | Price collapse, then rebound | Geopolitics Supply concerns High prices |
| Shaper | Standard Oil | Antitrust regulator | Texas railroad commission | "Seven Sisters" | OPEC | | Saudi Arabia and key OPEC followers | New coalition: OPEC Norway Mexico | OPEC |
| Percent of production controlled by shaper | 85 | n/a | 50 | 30-70 | 60 | | 30 | 40 | 40 |
| Shaper's method of influence | Near total control of purchasing to create price stability | Regulation | Production legally limited to raise prices | 50/50 principle and many interlocking joint ventures | Cooperate on production levels to provide price control | | Act as swing producer to help stabilize market | Act as swing producers to help stabilize market | Act as swing producers to maintain price target |
| Strategic priority | | | Integration | Access | M&A | | Access | M&A and exploration | Exploration and development |

SOURCE: ACCENTURE ANALYSIS

For integrated and most independent oil companies, more than half the profit comes from the upstream.

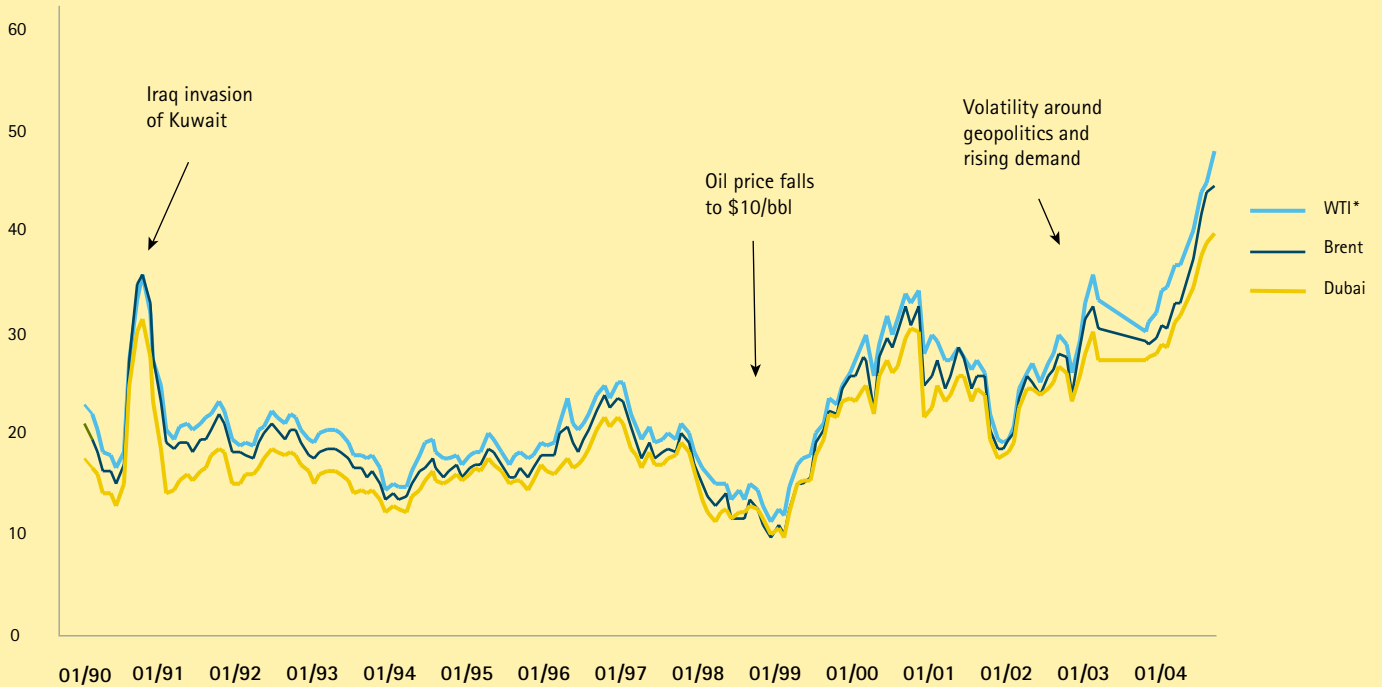
Conversion of one barrel of crude oil to one gallon of gasoline (illustrative oil price)
US \$/bbl



SOURCE: EIA; CSFB ESTIMATES

The oil price has a major effect on oil company profitability.

Crude oil prices 1990-2004
\$/bbl



*West Texas Intermediate
SOURCE: CERA; WTI, BRENT AND DUBAI ARE ALL BENCHMARK CRUDE OIL PRICES

After the oil price fall in 1998, the industry consolidated

Mergers start August 11, 1998

Today

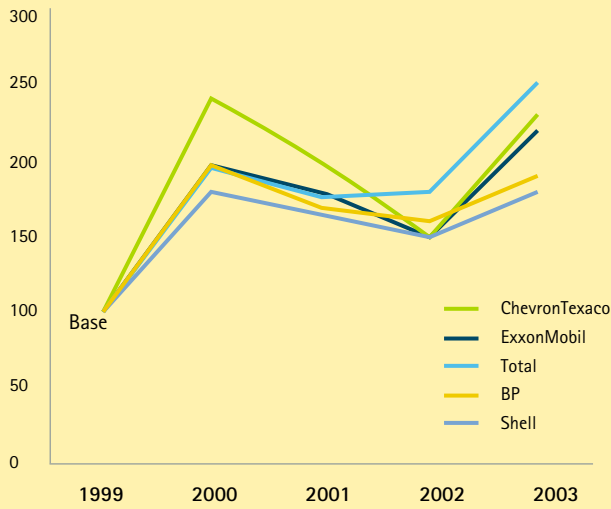
| | Company | Market cap (\$bn) |
|----|----------|-------------------|
| 1 | Exxon | 225 |
| 2 | BP | 130 |
| 3 | RD Shell | 116 |
| 4 | Mobil | 55 |
| 5 | Chevron | 48 |
| 6 | ENI | 46 |
| 7 | Amoco | 40 |
| 8 | Elf | 30 |
| 9 | Texaco | 30 |
| 10 | Total | 24 |



| | Company | Market cap (\$bn) |
|---|----------------|-------------------|
| 1 | ExxonMobil | 290 |
| 2 | BP | 190 |
| 3 | RD Shell | 160 |
| 4 | Total Fina Elf | 115 |
| 5 | ChevronTexaco | 96 |
| 6 | ENI | 75 |
| 7 | ConocoPhillips | 50 |
| 8 | RepsolYPF | 26 |

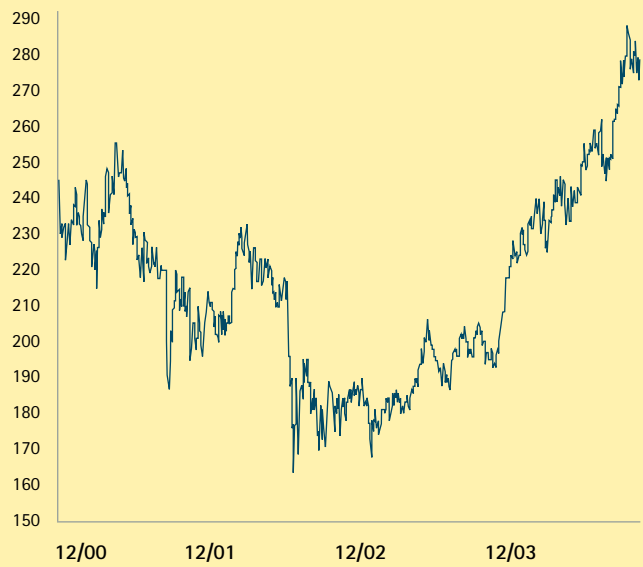
Profitability in the industry has now recovered . . .

Earning per share (\$) for 5 supermajors



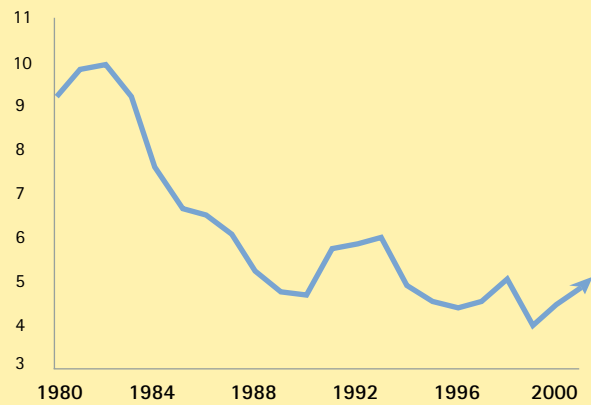
*Adjusted for special items
SOURCE: COMPANY REPORTS

S&P 500 energy price index

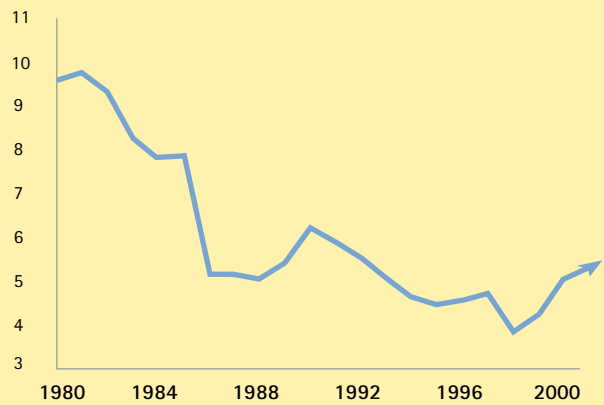


. . . with technology and operational improvements having enabled cost reductions

Worldwide finding and development costs
\$ 1 BOE*



Worldwide production costs
\$ 1 BOE*



Drivers of cost reduction

Technology



- 3D/4D seismic
- Floating production systems
- Horizontal wells

Operational improvements

- Automation
- Outsourcing
- Contractor management

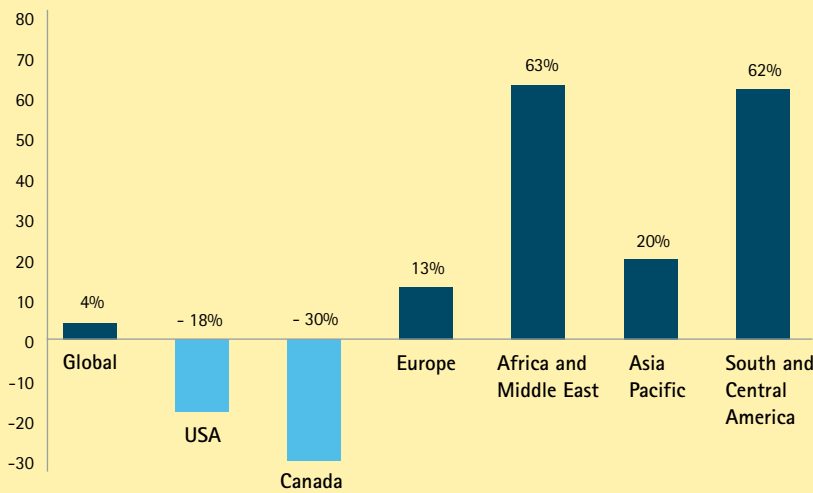
*Barrels of oil equivalent

The focus of the majors is now on growth markets, with the independents concentrating on more mature basins.

Oil & gas growth regions 
 Oil & gas mature regions 



Capital expenditure changes by region 2001-2003



SOURCE: IEA, "WORLD ENERGY INVESTMENT OUTLOOK," 2003

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seemed able to combine all six to consistently deliver high performance year after year.

Surprisingly, perhaps, these high performers do not always boast the lowest global exploration, development or acquisition costs. All, however, manage to achieve very good returns on their investments. The secret to their success: the development of distinctive business models that allow them to excel. These business models are different, but what distinguishes all of them is a coordinated balance of the following six key attributes.

1. A growth-focused strategy

Their growth strategies vary, but all four high performers have been growing aggressively. They've done so by steadily replacing their reserves, either organically, through M&A or by leveraging the undeveloped acreages of their international operations.

When they go the M&A route, these companies are adept at deriving value from the combination. High performers buy assets that offer the best strategic fit, not necessarily the cheapest one.

These companies have achieved growth without sacrificing capital efficiency—a tribute to their financial acumen and flexibility. In fact, one of the high performers has the lowest debt/market-capitalization ratio in the business. By maintaining good credit ratings, the high performers have ensured continued access to cheaper capital. As a result, they can take advantage of growth opportunities as they arise, and retain the financial capacity to fund future acquisitions. (For more on financial mastery as a key element of high-performance business

Existing business models must evolve to accommodate the requirements of larger and more global organizations.

across industries, see “A seat at the table,” *Outlook*, June 2004.)

2. Mastery of niche technologies

Research has shown that since 1980, advances in technology have cut offshore oil exploration and development costs by 80 percent and halved these costs onshore. The independents are well placed to take advantage of these changes.

Technological advances have been greatest upstream, where the independents are primarily focused. And the high performers have been especially swift to recognize that technology is key to optimizing exploration and production. Simply pursuing technology is not enough, however. What distinguishes the high performers is the way they focus their technology strategies—whether by carving a leadership niche in a key basin play like oil sands, or by delivering gas that is technically difficult to extract. The technologies they use may well be generic, but by focusing on a particular technological strategy, the high performers become expert in its use and thus are able to differentiate themselves from their competitors.

3. Operational excellence

High performers in this industry do not appear to be emotionally attached to their assets. They examine the contents of their portfolios continually, assessing the strategic value of their assets to ensure the best allocation of capital. They are also biased toward “operatorship.” For example, a high-performing independent might aim to take a large equity stake in a key asset to hold the most decision-making power (in exchange for assuming more of the risk).

This approach not only builds a company’s core technical skills but also improves cost control. And although

high performers don’t allow cost considerations to get in the way of essential strategic investments—some will spend more on technically difficult exploration to exploit a niche and reap the rewards of higher reserves—they also know their limitations.

4. Strong, involved leadership

The CEOs of high-performance companies in this sector provide hands-on leadership and exceptional clarity of vision. Because the ultimate goal of high-performing independents is to grow into larger, more international companies, where decision-making powers must be delegated, these CEOs also recognize the importance of building effective leadership teams, imbued with common values. A team-based ethos, in which power is successfully delegated while CEOs remain at the core—very often physically located among their employees—motivates staff at all levels.

Because speed of decision making and swiftness of execution are essential elements of competitive advantage for companies of this size, this sense of motivation plainly plays a critical role in the high performers’ success.

5. Organization effectiveness

The organizational structures of high performers are flat and lean, fast and efficient. These companies seem capable of managing both the global and local aspects of their business better than their peers. Thanks to their minimal bureaucracies, they enter new markets with a highly disciplined approach to risk, and they empower local management with a sense of involvement and control.

They also make shrewd and efficient use of their external partnerships and alliances. CEOs of top performers in this industry are very good at managing relationships with all



stakeholders—not only their employees and shareholders but also the governments and alliance partners with which they must do business. And because they bring access to new skills, effective alliances can improve business operations.

6. A culture geared to growth and high performance

The independents are no longer wildcatters, but the free-spirited, entrepreneurial mentality that brought them into existence still prevails. High performers are companies on the go.

There's rarely any downtime at a high-performing independent oil company; a clear sense of individual accountability means that people don't wait for orders. Transparency of decision making, teamwork and a policy of aligning individual performance with corporate growth make for exceptionally effective knowledge-sharing networks and thus a committed workforce.

Doomsday demographic?

The future will be challenging for these high-performing independents. They run tight, lean operations from small bases where every individual counts. They are not immune, however, to the “doomsday demographic”—an aging workforce.

The average age of oil industry workers in OECD countries is climbing steadily (the median age of nearly half the professionals in today's oil industry is 47). And there just aren't enough young professionals to replace them. That's partly because the business has lost some of its attraction as a secure career. Twenty years ago, graduate geologists could look forward to starting work in Houston or Aberdeen; these days, it's more likely to be somewhere considerably less comfortable.

Traditionally reliant on the majors for their source of talent, the independents look especially vulnerable to this problem.

Not surprisingly, however, the companies we've identified as high performers have been swifter and more energetic than their competitors in actively developing recruitment programs designed to address this issue. A specific aim of one company's recent acquisition was to bring on board staff with strong technical expertise.

As the energy industry continues to mature, no high-performing independent oil company can afford to become complacent. Existing business models must evolve to accommodate the requirements of larger and more global organizations in an increasingly competitive environment. Thus far, the high-performing independents are responding to change with positive and value-creating strategies. Flexible and highly adaptable, they show every sign of continuing to do so. ■

About the authors

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