Is the IOC business model dead?

GLOBAL ENERGY INSTITUTE

The business model of the international oil company (IOC) has not died — but its vital signs are not encouraging. The question now is what steps IOCs need to take to remain competitive in global markets given changing supply/demand profiles, alternative forms of energy and new entrants.

Adjusting to the new normal

IOCs are particularly challenged by current price and demand levels for oil. The general industry consensus is that the world oil price will remain at about USD50 to USD60 per barrel for the foreseeable future. At the same time, innovations such as a changeover to electric vehicles could result in a significant reduction in demand for gasoline, signaling a shift to a new era. In addition, several countries in Europe have announced plans to transition away from the internal combustion engine and many countries are implementing strategies to move away from their dependence on oil and gas by reducing domestic consumption and emphasizing renewables.

The possibility of long-term ‘demand degeneration’ coupled with low prices casts significant doubt on the future viability of traditional business models for IOCs, but perhaps less of a challenge for national oil companies (NOCs). In countries that are heavily dependent on hydrocarbon revenues, the national government represents a full interdependency of interests, which includes but is not limited to NOCs and profitability. In contrast, IOC investors have long expected a steady stream of dividend payments. While the current financial position of the IOCs is such that analysts do not question a short-term ability to pay dividends through a combination of operating cash flows, debt and asset divestments, the ability to meet this requirement could be challenged over the long term.

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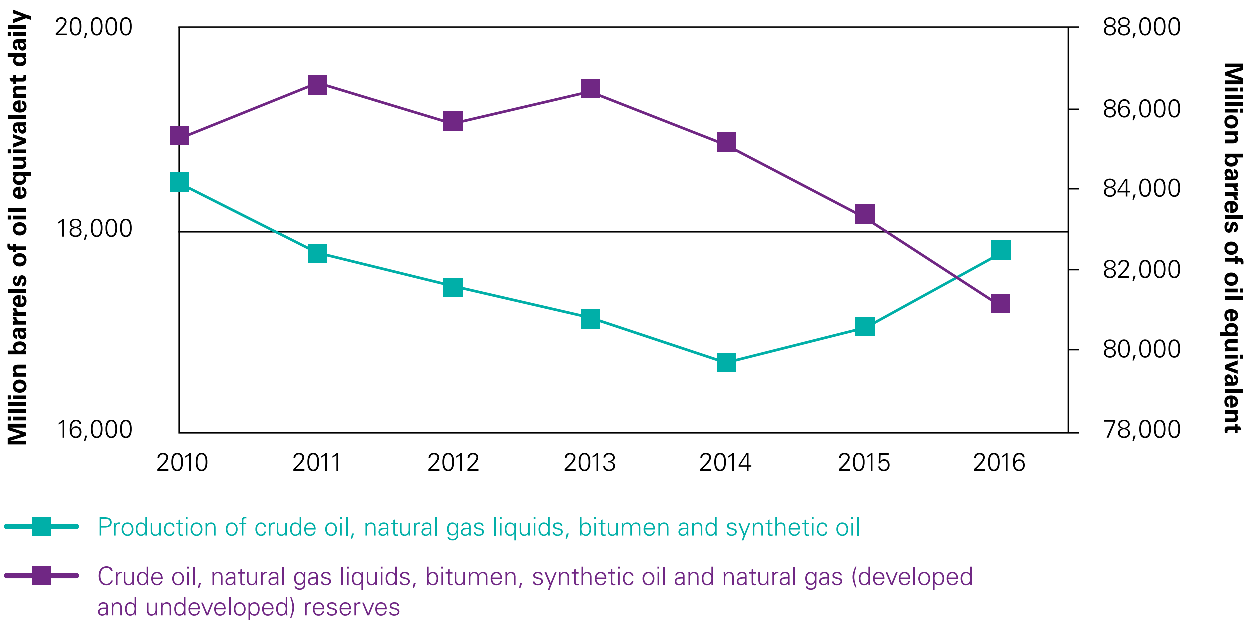
Shrinking production and rising debt

Both the IOC share of global production as well as production in absolute terms have experienced stagnation over recent years, with companies unable to return to 2010 volumes. The declining reserves base reduces the potential of the IOC to increase production. IOC earnings and operating cash flows are also experiencing declines, while the IOC debt level between 2010 and 2016 has increased by over 50 percent.

Compared to the break-even costs associated with asset portfolios of the largest NOCs, those of the IOCs seem to be significantly higher, making sizeable portions of their asset portfolios uneconomical at prices below USD60.

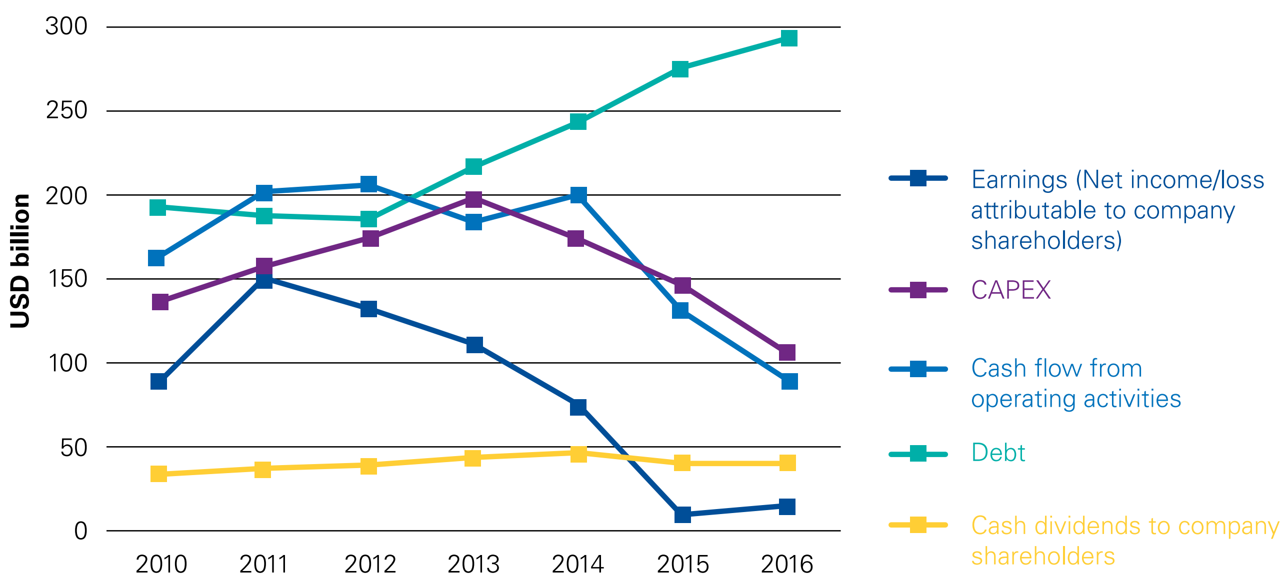
In the meantime, NOCs are becoming ever larger in terms of production levels. Saudi Aramco alone is producing around 13.7 million barrels of oil per day compared to the total IOC production of 17.8 billion barrels. As the largest NOC in the world, Saudi Aramco's recent decision to conduct an IPO would add a major new player in the public investment space for the oil and gas market. In fact, this newcomer might challenge investor appetite for IOC shares worldwide which might affect today's combined IOC market capitalization of over USD1 trillion.

IOC cumulative production and reserves



Source: KPMG International, 2017

IOC key cumulative financial indicators



Source: KPMG International, 2017

The need for new strategies

Since a sustained recovery in the price of oil seems unlikely and future demand is uncertain, IOCs will need to develop convincing long-term strategies for maintaining and increasing shareholder value. It appears that recently announced tactical steps including upstream portfolio rebalancing and expense reduction might no longer be enough to attract investor appetite and ensure their going concern in the coming new era.

As an example of new strategies, several IOCs are continuing to branch into the alternative energy sector. Total in France has acquired battery manufacturer Saft[2] as well as Lampiris, a green energy distributor in Belgium[3]. Shell has created a green energy department to focus on wind farms[4], and ExxonMobil is conducting research on algae-based energy sources, carbon capture and storage and energy-saving materials[5]. These and similar initiatives will help IOCs expand and diversify their portfolios and better position themselves for competitive advantage in tomorrow's changing energy landscape.

IOCs have many strengths they can leverage as large, highly sophisticated companies.

Changes ahead

IOCs have been able to survive for over a century, but their traditional business model is challenged. Global oil markets are going through fundamental structural changes driven by technological revolutions and geopolitical shifts that are only increasing in size and volatility. IOCs still enjoy significant advantages across the global industry, but they must adapt to current changes or face a future of slow but steady decline.

Since a sustained recovery in the price of oil seems unlikely and future demand is uncertain, IOCs will need to develop convincing long-term strategies for maintaining and increasing shareholder value.

IOCs' strengths include:

Fast response and flexibility
IOCs are responsible primarily to their investors, not to any particular government or governmental policy. As such, they can respond quickly to changing markets and adapt new business models to meet changing circumstances.

Technical prowess
IOCs lead the world in developing innovative technology to enhance hydrocarbon finding/extraction activities, field operations, refining and distribution.

Size and reach
IOCs still rank among the largest oil and gas companies in the world.[1] As major players, they can use their market presence, financial strength, expertise and established network of business relationships to compete with NOCs in established and new markets.

What's next

Stay tuned for additional thought leadership from KPMG's Global Energy Institute for ideas on new operating models for IOCs, including how to win in the non-hydrocarbon arena.

1 The World's Largest Oil And Gas Companies 2017: Exxon Reigns Supreme, While Chevron Slips, Forbes, 24 May 2017, https://www.forbes.com/sites/laurengensler/2017/05/24/the-worlds-largest-oil-and-gas-companies-2017-exxon-mobil-reigns-supreme-chevron-slips/#4704b3d14f87

2 Total Completes Billion-Dollar Acquisition Of Saft, CleanTechnica, 19 July 2016, https://cleantechnica.com/2016/07/19/total-completes-billion-dollar-acquisition-saft/

3 Total acquires Lampiris to expand its gas and power distribution activities, Total, 14 June 2016, https://www.total.com/en/media/news/press-releases/total-acquires-lampiris-expand-its-gas-and-power-distribution-activities

4 Shell creates green energy division to invest in wind power, The Guardian, 15 May 2016, https://www.theguardian.com/business/2016/may/15/shell-creates-green-energy-division-to-invest-in-wind-power

5 ExxonMobil Announces Breakthrough In Renewable Energy, Oil Price, 20 June 2017, https://oilprice.com/Latest-Energy-News/World-News/ExxonMobil-Announces-Breakthrough-In-Renewable-Energy.html

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