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Big oil faces shrinking prospects

Nick Butler

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The Arctic debacle is a salutary reminder that the old business model is reaching its end



The Polar Pioneer, seen here on its way to the Arctic, found results that were not 'sufficient to warrant further exploration'

One hundred and fifty miles from the Alaskan coast lies what must be the most expensive oil well ever drilled. Shell's decision to abandon the Burger J prospect, along with its entire Arctic exploration campaign, marks an outcome that many at the oil major must have dreaded since it bought the leases in 2008.

That is not because of the cost — enormous though it is — of setting up remote platforms and drilling into rock that lies beneath 140ft of water. Shell is reckoned to have spent about \$7bn on the exploration effort; some estimates put the figure even higher. But its balance sheet is strong enough to absorb the loss.

Nor will the public ill-will generated by years of exploration in

pristine Arctic waters last for ever. Indeed, for some senior executives at Shell, the prospect of success in the Arctic was more worrying than the possibility of failure. Building the permanent facilities needed for actual production would have been far more contentious than the limited (if sometimes hapless) exploration work. Among the people on record as opposing Arctic drilling is Hillary Clinton, the frontrunner for the Democratic nomination for president. That is a battle that Shell will no longer have to fight.

More worrying, from Shell's point of view, is the prospect of a declining reserves base. In common with several of the other oil majors, it is pumping oil faster than it can book new reserves of bankable assets. This was the reason for pushing on in the Arctic against public criticism and deteriorating economic prospects for so long. If, as some of the company's executives believed, the Chukchi Sea blocks held about 35bn barrels of oil, Shell's reserve base would have been secured and much effort would have been devoted to winning hearts and minds and pushing down costs. As it stands, the reserve base will continue to decline. Shell's \$70bn purchase of BG Group, if completed, will bring access to some identified resources — for instance off the coast of Brazil — but the cost of development is high and success is very uncertain.

In the long run, this is little short of an existential challenge. Can the existing reserves base be replaced with resources that can be developed commercially? Or is a period of corporate decline inevitable? For the past three years Shell has failed to find sufficient resources to replace production despite heavy exploration expenditure. In 2014 it replaced only 26 per cent of its oil and gas production. Over the past three years the figure is just 67 per cent.

The problem is not a shortage of oil and gas. The problem is access. Over the past decade, according to the BP Statistical Review, global oil reserves rose 24 per cent, despite 10 years of growing production, and gas reserves climbed 20 per cent. But the majors do not have access to much of it. Saudi Arabia and Venezuela are closed to foreign ownership. Much of Iraq is a war zone and politics limits access in areas such as Kurdistan even for the boldest independents. Libya is in a state of civil war. Iran is walled off by sanctions, which the nuclear deal only partially removes. Russia is also subject to sanctions. There are significant volumes of oil and gas to be developed from shale rocks in the US and elsewhere but the economics do not look good at \$50 a barrel.

For understandable reasons companies do not like the idea of shrinkage and decline. So acquisition becomes a powerful temptation. Those in the sector with cash and the ability to raise capital will now be in predatory mode. No doubt there are bargains — even if BG at the offered price is not one of them. But many are cheap for good reasons.

For all these reasons, some will wonder whether Shell's retreat from the Arctic was premature. Exploration is a risky business, and first impressions can be misleading. Oil and gas might never have been developed in Iran, Alaska or the North Sea if the industry had given up after initial wells drilled were unsuccessful. A single hole in the ground tells you only about a narrow slice of geology within an area of thousands of square miles. The success of Eni, the Italian group, in the Barents Sea shows that the Arctic does contain resources. Were it not for the political uncertainty

surrounding Arctic drilling, Shell might well have carried on.

Still, the Arctic debacle is a salutary reminder to oil majors that their old business model is reaching the end of its life. Change might mean a different energy mix — taking the lead in the global transition away from hydrocarbons. Or it might mean accepting new relationships with the state-owned companies that control the world's remaining resources. Only one thing is certain — the oil majors will have to change, or accept decline.

The writer, formerly an executive at BP, is a visiting professor at King's College London. He writes an FT.com blog

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