The Impact of Deregulation on the Outlook for the Oil Industry

*by Keith Hamm**

The fundamental shift away from government involvement in industrial activity has had only a limited impact on the oil industry thus far. This shift, driven by changes in political philosophy which now allows a greater degree of choice to the consumer rather than being limited by the structure established by governments, has been most apparent in the developed economies of the Northern Hemisphere where the consumer usually already has a great deal of choice between competing suppliers. In this instance oil has been different from electricity or gas where until recently it was thought there could be little or no competition between suppliers. These industries are now being *deregulated* to give the consumer a choice. In the oil industry, deregulation of the market, such as it is, has been limited largely to consumer pricing issues; designed simply to remove governmental barriers to prices to the consumer (excluding tax) falling to the levels evident in international markets. Even privatization of dominant companies has generally taken place in markets where there was already a competitive environment. However, in these cases, the changes in ownership are at least likely to reduce the extent to which strategic rather than commercial decisions influence the economics of the market.

Perhaps, in the longer term the oil industry will be affected more fundamentally by the impact of reduced government involvement in the upstream sector. By reducing the role of the state in developing the oil resource base of a number of countries, it is likely that oil production capacity will grow much more rapidly than would otherwise have been the case. Moreover, not only will capacity rise but it is likely that the oil will get to market more quickly than hitherto (as a result of commercial decisions, rather than strategic, determining production rates). Indeed the reduced role of governments in production in OPEC member countries may make it more difficult for the organization to "manage the surplus" as effectively as it has done over the last twenty or so years.

Therefore, taken across all phases of the oil industry, deregulation in its broadest sense is likely to bring downward pressure on margins and perhaps even the absolute price of oil.

Downstream Deregulation

When we think of deregulation in the energy industry we tend to concentrate on policies being adopted by governments to protect consumers by mean of increasing competition between suppliers rather than by government regulations or eliminating those designed to protect local companies from being overwhelmed by the large internationals (such as by restrictions on the channels or volumes of imports of products). Underpinning these policies is the general political move away from government intervention in industry but they get specific impetus from a number of features apparent in the energy industries. These include:

- the growth in size of markets which allows for more companies to compete while still retaining a viable scale for their operations;
- the fact that in many developing countries the need to support indigenous industries as part of the overall industrializing process is no longer required;
- technological developments which allow for competition in sectors which had previously been thought of as natural monopolies.

To these general features has been added the fact that the oil industry has been characterized by major structural surpluses in all phases for some twenty years. Although these have been *managed* in the upstream by OPEC there has been no similar organization in the downstream and thus competition between refiners and marketers has been intense. In such circumstances, government intervention to *protect* the consumer is not only unnecessary, it is usually counter productive; government set maximum prices include elements of cost recovery that can not be realized in the open market while also providing a benchmark to which marketers relate their prices, rarely offering sufficient discounts to bring them down to open market levels. Similarly, policies designed to protect local industries have been put under intense pressure by the availability of relatively low cost product on the open market undermining political support.

Therefore, deregulation of the downstream of the oil industry has largely been a matter of governments removing price or import controls or other mechanisms which had been designed to provide protection either to the consumer or the local operator. As such it has generally resulted in a reduction in margins downstream, not necessarily matched by a reduction in consumer prices as some of the savings have been taken by the government in the form of higher excise duties or the like.

In sharp contrast, deregulation has done little to reduce the operating cost of those refining or marketing. In fact the continuously tightening restrictions on refining storage, distillation and marketing operations and the ever changing specifications on product qualities, (in both cases to limit the impact of the oil industry on the environment), are increasing operating costs. Indeed, while a great deal of emphasis has been given to deregulation of the oil markets, in many countries environmental issues (be they Clean Air, Global Warming or the risk of damage from accidents) are resulting in the downstream of the oil industry becoming increasingly regulated.

The Upstream

While Downstream deregulation may be the most apparent, perhaps what is taking place Upstream is of more underlying importance to the oil industry. In particular this refers to the accelerating process in many countries of reducing the restriction on who can explore for and develop the oil resources within their borders. Countries which have previously reserved E&P to their state owned companies are now allowing foreign companies in, while those which had previously insisted on restrictive terms for foreign companies (particularly by not allowing companies any rights to the oil produced) are now offering terms which are attractive to the oil industry.

While this process has been evident for much of the last

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ten years in countries outside of OPEC, in recent times a growing number of countries which are members of OPEC have also begun to adopt such policies. In these cases the purpose of this deregulation is to speed development of a country's resource base which had previously been held back by constraint on expertise and/or finance. By broadening the number of companies able and willing to explore and develop oil, these constraints can be overcome.

Clearly, the result of successful deregulation in this form would be to increase crude oil (and gas) producing capacity on a global scale. There may be some scope, with companies having greater choice of where to explore than hitherto, for this to result in reallocation of E&P budgets rather than these simply being increased in line with the increase in opportunities. However, it is likely that companies will concentrate on the areas with the greatest potential and, therefore, production capacity should still be greater than if opportunities were limited. Moreover, the growth in production capacity is likely to be magnified by the fact that foreign companies now able to explore once again in areas from which they have been excluded for twenty or more years, have developed in that time their expertise and techniques to ensure viable and prolific oil production from areas considered much less prospective. When these techniques and expertise are now applied to the new open, more prospective areas who knows just what their potential will prove to be.

A further feature which could magnify the impact of oil developed in OPEC member countries is that this oil is likely to be fully available to the market much more quickly than most oil developed by OPEC countries in the last twenty years. This is because the oil is being developed by foreign companies (albeit in joint ventures or the like with the state oil company) and they essentially insist on having the right to produce the oil they discover as fast as prudent reservoir management will allow. It is highly unlikely that this oil would be shut in to support, for example, an OPEC agreement to set a production ceiling below capacity in the member country concerned.

One aspect of OPEC's relative success in "managing the surplus" in the upstream which has not been given enough consideration is the fact that in all OPEC member countries, production has been dominated by state owned companies. These companies are able to make strategic decisions, i.e., those the government believe are in the best interest of the country as a whole and not only the commercial interest of the company. With an increasing share of production in the hands of companies which will only make commercial decisions, the ability of OPEC members to restrict output in the future may well be circumscribed.

Corporate Deregulation

Overlaying the developments in the Downstream and Upstream sectors of the oil industry is the fact that reducing government involvement in the oil industry is changing the nature of the businesses involved in the oil industry. Privatization of companies is not only resulting in a change in ownership from state to private shareholders but is also changing their attitude to their business decisions. Once again the strategic interests of the state are no longer a priority, the commercial interests of the company become paramount (unless a country's strategic interest coincides with the company's commercial interests). In the downstream this is evident in the unwillingness of previously state owned companies to maintain uneconomic refining capacity, previously kept open for employment, industrial or prestige reasons. In this respect, privatization is removing a barrier to effective rationalization. Indeed, in a highly competitive market some of the weaker privatized companies may find it difficult to survive without government support and could be swallowed up by others.

However, this is many ways a regional phenomenon, concentrated in markets West of the Suez. The restructuring of state companies is much less evident in the Middle East or the Pacific although even here the nature of the state companies is changing. In particular, in recent years a number of these state companies have become increasingly international, particularly investing in downstream facilities in other countries. This has been apparent in the forward integration of state oil producing companies into refining/marketing in the United States, Europe and the Pacific. Now we are witnessing some of the state owned, or state protected, downstream companies from the Pacific moving into other markets. Often this remains within the Pacific region but increasingly these companies are becoming evident in the West. For these companies operating in foreign markets, commercial factors are likely to become of growing importance, first in relation to their foreign investments and then probably working back to influence the approach to their domestic markets. However, the extent to which they become fully commercial operations is likely to depend on the extent to which their protected position in their home markets is lessened. So far this seems to be happening only slowly. Indeed for a number of countries East of the Suez the flow is all one way - their state companies can go abroad but there remains formidable obstructions for new comers to carve out a share of their own dynamic markets, and where opportunities do exist the traditional international companies face stiff competition from the newly emerging internationals.

In these circumstances it seems quite possible that the structural changes to the industry will intensify the downward pressures on margins which are likely to result from deregulation in the downstream sector. Such a consequence can only be transitory, however, as, in the absence of government support, margins will have to be sufficient on their own to justify investment and, indeed, continued operation. Those companies that cannot stand on their own feet without some form of government protection are likely to disappear. Perhaps, therefore, the longer term consequence of deregulation will be an acceleration in the rate of downstream concentration, with markets increasingly becoming dominated by a limited number of large companies.

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