



Telephone: (212) 867-0052

**Petroleum Industry Research Foundation, Inc.**

**122 EAST 42nd STREET**

**New York, N. Y. 10168**

**OIL COMPANY MERGERS AND COMPETITION**

Statement before the  
Fossil and Synthetic Fuels Subcommittee  
and the Commerce, Transportation and Tourism Subcommittee  
of the  
U.S. House of Representatives  
Committee on Energy and Commerce

by

**John H. Lichtblau**  
**President**

**March 21, 1984**

Thank you for inviting me to testify at the joint hearings of your two subcommittees on the subject of oil industry mergers.

In my testimony I would like to address three of the most frequently asked questions on this issue: (1) Are there compelling structural factors underlying the recent trend of oil company mergers? (2) Will mergers have an effect on oil and gas prices? and, (3) Will mergers affect domestic exploration activities and, hence, our dependency on foreign oil supplies?

As we all know, in the current heated debate a variety of fiercely controversial answers have been given to these questions. Let me therefore start out by briefly summarizing our conclusions, so that you know where we stand.

(1) In our view, clearly visible structural changes in the U.S. petroleum industry, some starting in 1979 and some considerably earlier, have created a compelling logic for this industry to move towards consolidation in the form of mergers and acquisitions. We recognize that if this trend were to continue unabated at its current rate it could eventually conflict with the public interest but we believe countervailing corrective economic forces, together with existing anti-trust regulation, will curb the merger trend well before then.

(2) Given current and expected world market conditions for crude oil and refined products and the near certainty that the U.S. will remain a substantial net oil importer for the foreseeable future, a change in the number and size of U.S. oil companies through mergers or acquisitions would not measurably

change the determinants of U.S. crude and refined products prices. These determinants will continue to be located outside the U.S.

(3) We disagree with the view that a large share of the capital spent on mergers and acquisitions could or would otherwise be channelled into exploration activities, thereby increasing the stock of U.S. oil and gas reserves. We recognize the possibility, but not the inevitability, that the immediate financial requirements of a merger could bring about some short-term reduction in a company's exploration expenditures. However, this would represent a delay in exploration activity for the company, but not a long-term loss in production. (In the short term, of course, no production loss will occur). The underlying incentives to replace declining reserves and the industry-wide response to them will not be affected by mergers or acquisitions. However, the same cannot be said about such devices as royalty trusts which could very well have a longer term negative impact on the replacement of domestic reserves.

#### Structural Changes in the U.S. Oil Industry

The U.S. oil industry has been characterized by two basic structural changes: a decline of its domestic resource base and a reduction of its products market. The first has been underway since the late 1960's, the second since the late 1970's. Both trends are well known and require little elaboration. U.S. crude oil reserves have declined in every year but one since 1968. The exception was 1971 when Prudhoe Bay reserves were included in the U.S. total. From then until 1982 U.S. crude oil reserves dropped by nearly 14 billion barrels. Production also

dropped during this period but reserves dropped faster so that in 1982 U.S. crude reserves were equal to only 9.4 years of production, compared to 11.4 years in 1972. Approximately the same development took place in the natural gas sector where the reserve/production ratio dropped from 11.5 to 10.8 years despite a 21% drop in production during this period.

Thus, the U.S. oil industry has clearly been unable to replace its domestic reserves. A recent study by the accounting firm Arthur Anderson & Co. of 300 publicly owned U.S. oil and gas companies shows that during the 3-year period 1980-82 they replaced only 53% of their domestic crude oil reserves and 81% of their gas reserves. Our own calculations of the 23 largest integrated oil companies show a similar result: they replaced 68% of their combined oil and gas production during this period.

Yet, these dismal results were certainly not due to reduced expenditures or activities for finding oil and gas. From 1973 to 1981 U.S. exploration expenditures rose from \$5.4 billion to \$30.7 billion, an annual growth rate of 24%. During about the same period (1973-82) the annual number of exploratory wells rose from 7,500 to 16,500, with an increase registered in every single year. Furthermore, the average depth of these wells more than doubled during this period.

If expenditures and efforts of this magnitude were unable to arrest the decline in domestic reserves the reason must be sought in geological and technical limitations to oil exploration, given the existing state of the art, rather than in insufficient

investment. In fact, conventional oil exploration continues to be a very attractive investment in the U.S. and so will gas exploration once the current surplus has been absorbed. However, the exploration prospects have been steadily declining and no reversal of this trend is expected.

The Alaskan North Slope is a case in point. In 1968/69 two super giant fields, Prudhoe Bay and Kuparuk, were discovered there. In the 15 years since then vast sums have been expended on the assumption the area must contain other giants. Yet, so far, only a few relatively much smaller fields have been discovered, and even these are just now being commercially developed.

Clearly, if an oil company cannot come close to replacing its reserve base through exploration, supplementing its exploration activities by purchases of existing reserves makes commercial sense. It is not a question for these companies of either exploring or purchasing but of doing both in the hope that the combined effect will slow down the depletion of its resource base.

The other structural change has taken place in the downstream market. U.S. oil demand has been declining regularly over the past five years for all major products. In 1983 total demand of 15.2 million B/D was 20% below the 1978 peak. This has of course caused a substantial underutilization of the industry's refining, distribution and retailing capacity which had been built on the general expectation that by 1983 consumption would be significantly higher than in 1978. Consumption is now beginning

to rise again. But the current view in the industry is that by 1990 demand will not differ significantly from this year's level.

The decline in consumption has been reflected in the closing of some 80 refineries since 1980 and 25,000-30,000 service stations since 1978. But there is clearly still substantial excess capacity in the entire downstream sector. Thus, U.S. refinery distillation is still utilized at less than 75% of capacity. Consolidation of capacity to improve the efficiency of operating equipment is a logical, rational response to this development and is economically beneficial as long as it does not violate anti-trust restrictions.

We recognize of course that the current reason for oil company mergers and acquisitions is access to reserves in the ground and not consolidation of downstream equipment. However, the latter, as a by-product of the former, serves the need to reduce obsolete excess downstream capacity.

A concern has been expressed that this development may lead to undue market concentration. On a national level this is quite unlikely, since the oil industry is among the least concentrated U.S. industries. Neither the Chevron-Gulf nor the Mobil-Superior merger would significantly change this. The so-called Herfindahl-Hirschman Index (HHI) used by the Department of Justice and the Federal Trade Commission to calculate concentration levels in U.S. industries shows the 1982 concentration levels for the domestic petroleum industry (after adjustment for the Texaco-Getty merger) at 270 points for liquid petroleum production, 329 points for liquid petroleum reserves

and 410 points for refining capacity. According to the Justice Department's merger guidelines, "a challenge (to a merger) is unlikely under any facts when the HHI value after the merger is below 1000 points." The two new mergers would not move the HHI even remotely close to 1000 in any category.

The situation may of course be different regionally or locally, particularly in the downstream sector where a merger may create an undesirably high market concentration ratio in a given area. The Justice Department and the FTC have the authority and the duty to prevent such concentration by requiring the merged companies to dispose of the overlapping part of their facilities. As we know, the FTC has done so in a number of cases.

Such required sales can actually benefit the independent sector of the market. Following the recent Texaco-Getty merger virtually all of Getty's marketing facilities in the Northeast and Middle Atlantic states were sold to Power Test Corporation, an independent regional gasoline marketer whose market share increased vastly, while Getty, a major integrated oil company, disappeared from the scene.

#### Mergers and Oil Prices

The principal consumer interest in the current merger debate is what mergers would do to the retail price of gasoline, heating oil and other products. Currently, these prices (excl. excise taxes) are determined by two factors: the cost of crude oil to refiners and market competition among refiners and distributors. The cost of crude oil has been unilaterally determined by OPEC since 1973 and it appears this will continue to be the case in the foreseeable future. But regardless of how the world oil

price is set, as long as the U.S. remains a substantial net importer of crude oil, the U.S. price will continue to be determined by the landed cost of imported oil which will remain the marginal supply source for U.S. refiners and thus determine the price for all U.S. crudes. Thus, the price of U.S. or imported crude oil will be unaffected by the concentration ratio of U.S. crude oil producers.

Of course, there could be local exceptions to this. However, there is a mechanism in place to deal with such situations--the FTC's case-by-case review of the impact of mergers on competition.

Regarding products prices, these will continue to be determined by market factors. Since most U.S. refining companies are likely to have excess capacity and ready access to incremental crude oil volumes in the foreseeable future, products price competition should remain strong. Furthermore, given the relatively insignificant tariff levels on imported products, foreign competition will continue to play an active role in setting U.S. products price ceilings, particularly when the OPEC export refineries currently under construction are completed.

#### Merger Payments and Exploration Expenditures

The first point I would like to make on this subject is that the acquisition of additional reserves through merger or acquisition does not lower a company's incentive to look for new reserves. The reason is that the old reserves and the acquired reserves will both be produced at the maximum efficient rate and will therefore deplete just as fast as before the merger. The



company will produce at that rate to repay the loan it received for the acquisition, to maximize the profitability of its investment and because royalty agreements, field unitizations and other factors would likely prevent it from arbitrarily shutting in production for which there is a ready market. The almost complete absence of shut-in crude oil producing capacity in the U.S. since 1971 is a reflection of these factors.

It is of course possible that the financial strain of a merger will cause a company to temporarily reduce all expenditures to improve its debt-equity ratio. However, most of the money required to pay for merger or acquisition does not come from a company's own operating funds but is borrowed for the purpose of acquiring the property. While the repayment of this loan could temporarily reduce funds available for exploration, the need to replace the depleting reserves is as strong as before. Therefore companies can be expected to restore any such temporary reduction in their exploration expenditures. We would like to recall in this connection our earlier point that increasingly, the limit to U.S. exploration is not access to funds but access to prospects. One must also consider the possibility that the cost of exploration could actually be reduced somewhat by mergers, thus leaving the industry more funds for exploration activities. The reduction would result from fewer companies bidding for acreage, thereby tending to lower lease bonus payments.

Finally, I would like to make a brief comment on the frequent assertion that it currently costs much less to acquire

oil and gas reserves in the stock market than through exploration.

The assertion can be correct and, no doubt, some oil has actually been acquired more favorably through stock transactions than through drilling. However, the comparisons are often distorted. For instance, the cash flow, particularly in the early years, could be substantially higher for a property brought on through exploration and development drilling than one purchased subsequent to this stage because of tax treatment of exploration activities which is not available to the purchaser of a developed property. Another factor which can distort the comparison is the production phase of the two properties. Most oil fields produce at a relatively high rate in the first few years and at a progressively declining rate for many years thereafter. However, the life cycle phase of a company's production is often not considered or not known when calculations of the share value of its reserves are made. Still another factor is that newly discovered reserves have not been as extensively delineated as older ones and are thus more likely to be revised upward. This also affects the comparability between the finding cost and the acquisition cost of petroleum reserves.

This ends my prepared statement. I would be happy to answer any questions you may have.