

SCOMM

94:4

TRANSFORMING THE ALASKA BUSINESS

TESTIMONY OF

JULIAN R. DARLEY, PRESIDENT

BP EXPLORATION (ALASKA) INC.

TO THE

SENATE AND HOUSE SPECIAL OIL AND GAS
COMMITTEES

March 2, 1993

Mr. Chairman, Honorable Members of the Oil and Gas Committees, good afternoon.

For the record, my name is Julian Darley, and I am President of BP Exploration (Alaska) Inc. Thank you for this opportunity to appear before you.

I would like to speak to you today about the major transformation that has occurred in our business here in Alaska. It is a transformation that continues even now as I speak, and which will continue to evolve and develop for the foreseeable future.

Let me begin by describing what the outlook was for our Alaskan business just a few years ago. As you will shortly see, it was not very good, so we decided to do something about it. That's the second part of the story. The third part is the results of our actions, which are nothing less than a true transformation of our business and our outlook for Alaska. Finally, I would like to share with you my vision for the future of our business here as we continue to build from our successes. I should caution you now that this vision of the future is very much a "work in progress."

Just three years ago the outlook for BP's Alaskan business was, to be candid about it, decidedly unattractive. Prudhoe Bay production was off plateau and in its inevitable decline, which had commenced in 1988. True, a great deal of creativity and investment had combined to extend the production at 1.5 million barrels a day far longer than anyone, including ourselves, had originally expected. But that was past, and the inevitable had finally begun. The fact is today, we are now working hard to produce at 1.15 million barrels per day from Prudhoe - a nearly 25% decline from peak rates.

At the same time, the costs of operating the field were climbing at an alarming rate -- both in terms of dollars per barrel and in terms of the total amount of money being spent. Why were costs rising? - We were (and are) producing ever more water, more gas: they cost money to handle, and earn us nothing; we were suffering more corrosion; higher maintenance needs. In other words, it looked as if Prudhoe was entering an inexorable upward cost spiral just at the time it was entering its inexorable decline in production.

The combination of spiraling costs and declining production is deadly. The outlook for Prudhoe made our entire Alaskan business look like a faltering business headed for failure -- a grim prospect. I am talking of three years ago. When you are faced with a bleak outlook for the future of your business, you work hard to address the situation, and in those rather dark days, BP considered many options for dealing with this major business problem of our Alaskan enterprise. It appears that we were not quite as poker-faced as we should have been. For it was then that stories started circulating that BP was going to turn over our Prudhoe Bay operatorship to ARCO, that our building in Anchorage was about to be put up for sale, that we were going to pull out of Alaska. Like a lot of rumors, these had a kernel of truth behind them.

It's self-evident that BP did not decide to exit Alaska; we decided to save our Alaskan business by doing business better. A transformation in performance was required. Our efforts have been along four basic lines,

- (i) eliminating duplication by sharing common services with our co-operator, Arco (You will recall that BP operates the West side of Prudhoe Bay field and Arco, the East.);
- (ii) radically increasing the effectiveness of what we in BP are doing;
- (iii) forming business alliances with vendors and contractors, to work together for better performance. 80% of our expenditures (excluding taxes) go to purchase of goods and services;

and

- (iv) looking beyond our existing assets, in active exploration on the North Slope.

With respect to our first line of effort, the sharing of services with Arco has been a considerable success. Beyond elimination of duplication, we share best practices and look for new ways to do the business more effectively, whoever is the operator. This collaboration is supported by exchanges of key staff.

To transform our own performance -- our second effort -- we rigorously reviewed all aspects of our business. Multi-disciplinary teams from our organization challenged and questioned our business practices: Why are we doing this particular task? Do we need to do this task at all? Is it as important as the other things we have to do? Could this task be done more efficiently by someone outside the company? Are the skills required for this task, the type of skills that we need to have in the business for the future? This was a stressful, painful process.

Why painful? It wasn't just the hard work. It was because our answers to such questions led directly to a number of so-called "outsourcing" initiatives to streamline our business. Putting some functions originally handled by BP employees out, for third party service companies to handle.

For example, we discovered -- surprise! -- that we are an oil company, not a communications company. And when we checked with those who are in communications, we found they had developed ways to be efficient, thanks to business competition, that we had not found or could not emulate. The lesson we learned is that Alaskan businesses competing to stay in business could often do for less cost exactly the same things we were doing, and do them at least as well and often better.

We also learned how to make better use of the talents of our people. We are putting great emphasis on looking outward for new and better ways; on teamworking - supported by training - and particularly on the use of multi-discipline teams, often involving suppliers to help us break away from traditional thinking and traditional solutions. We are building an attitude of "continuous

improvement" - that with the knowledge and hindsight of the improvements we create today, we'll find further improvements tomorrow.

Finally, we are improving our effectiveness by drawing the collective goals and objectives of our people into greater alignment with the needs of the business. To support this, we have introduced a program we call "Gainsharing". In Gainsharing, we set specific targets in each of the major measures of our business performance --

such as safety, operating costs, capital expenditures, environmental protection, and production.

If all of the targets are met, employees will receive a modest bonus. But we also set "stretch" targets as challenges for the organization, and if all the "stretch" targets are met, the bonuses can get fairly handsome. This matching of incentives with specific performance targets helps each team and individual in the organization understand how their contribution fits into the overall performance of the business. The result is, we all pull on the oar together.

These initiatives have proven very successful in improving how we do our business. But we recognized at the outset that they would not be enough in themselves. Our internal costs represented only 20 cents on the dollar for what we were spending for operations. Clearly, the other 80 cents are critical. So we have focused on how we do business with vendors and contractors, and on their performance.

Our third area of effort has been with suppliers. For too long our style -- like that of most others in our industry -- had been that of a master and servant in our relationship with suppliers. Typically, we decided what we needed from a contractor or vendor, we said what we wanted, and then the supplier simply delivered what we wanted. This is a very inefficient process. Firstly, by not involving suppliers in our evaluation of what we need to do, we lose their input, ideas and creativity. Secondly, by not involving suppliers in our plans, and our thinking about future requirements, they are unable to set their resources of people or equipment appropriately and incur much higher costs for holding resources "just in case". We and they end up paying for this.

We are therefore working to introduce a new style of working with suppliers which is collaborative, and a "compact" based on transparency in our planning, close working relationships, open and honest communication, and on sharing of benefits. We are seeking *longer term* relationships, so that we benefit next year from the improvements and mutual learning of this year: in short, to achieve continuous performance improvement with our suppliers also.

In all this we try to structure the financial side of the arrangement to be a "win-win" situation for both the contractor and ourselves. For our part, we want to get the job done right, and safely. We also need more bang for our bucks! To the extent a contractor comes up with ways to save money and still do the job right and safely, we share part of that benefit through incentive awards.

This level of involvement with suppliers takes a considerable investment of time and effort on our part, and on theirs, on an on-going basis. To make a reality of this changed style of working and reap the benefits of it, we have had to focus down on fewer contractors and vendors than before.

The contraction in the number of contractors and vendors we do business with has been a difficult process. Difficult for them -- certainly. But difficult for us, too. It is not fun having to choose, when you know that those whom you don't choose may go out of business.

Recognizing this "life or death" aspect to our decisions on contracts, we have striven to make our selection process as objective and fair as we possibly can. We established multi-disciplinary teams to develop selection criteria for each area of business, and these teams conducted the supplier evaluations and made recommendations to management. Before sending out requests for bids on key contracts, we sat down with would-be bidders and explained to them what we were looking for and what our selection criteria would be.

- Cost, of course, is an important consideration.
- So is the ability to do the work expertly, on time, and in a manner safe both for people and the environment.
- It doesn't hurt a bidder to be able to adapt its style of doing business to the new collaborative approach we seek.
- Being Alaskan helps. So does being involved in the Alaskan community -- not only on the civic side, but the political as well.

None of these individually guarantees that a bidder will win the contract. But a bidder without them will lag behind others in the competition for our business.

I know there are those who don't believe we have been completely fair in awarding our contracts. Some have complained to me personally, others to people in my organization. In answering them I could dwell on how we checked internally across our organization to develop selection criteria and the weight for each criterion *before* we received bids, about elaborate "decision matrices" and the processes we used to evaluate and rank competing bids, and so on. But I won't. No selection process will be perceived as completely perfect, and the losers inevitably suffer.

But I hope people will take it as *prima facie* proof of our sincerity in trying to be fair, that some of the winners in the competition for our business have also complained about not winning more business. But our fundamental aim is to spend less: and our contractors and vendors must learn to work smarter, and, with incentives, to earn their rewards by spending less of our money.

So, how are these changes proceeding? What are the effects?

We have made great strides with all these initiatives. On the expense side of the ledger, we proved that it was premature to think Prudhoe Bay had entered an inexorable cost spiral.

- Whereas our operating costs had risen 34 percent between 1989 and '90, our total operating costs were down eight percent in 1992 from the year before.
- Our Anchorage overheads this year will be six percent less than last year and 14 percent less than 1991.
- In late 1991 London set a challenge for BP's upstream business around the world, to reduce production costs by 50 cents a barrel. We met and surpassed that challenge.

These dramatic improvements on the expense side of the ledger have not come at the sacrifice of revenues. We cannot do anything to change oil prices. But we can, and *have*, done a lot to slow down the overall decline of North Slope production.

- Prudhoe Bay production for 1992 was down only six percent from the year before, and we project a decline of about eight percent this year.
- At the same time, Endicott last year averaged 115,000 barrels a day, versus the 100,000 barrels a day initially projected as its peak.
- And while I'm pointing to success on the production front, hats off to ARCO for getting Kuparuk up to 337,000 barrels a day in December 1992 -- over 10 percent higher than the "maximum" production expected when the field went into production.

These improvements have been delivered: firstly, by the efforts of talented people who have assessed actual field performance and identified ways to produce the fields more effectively; secondly, with the vital follow-up of on-going investment in the existing fields. I'll refer to this again, shortly.

So, I am now confident that the changes in the past two years or so are delivering the needed transformation of our business. The processes of change that we have set in motion are designed so improvement will continue to occur. Success becomes the foundation for further success. In fact, we have set ourselves the audacious target of keeping the real operating cost per barrel flat for the next years. We don't know how we will achieve this target, but we are confident of finding a way.

The outcome of all this is, that BP now takes a very positive view of the Alaska business and its future prospects. This confidence will be sustained by our maintaining a successful business here, in partnership with the State, notwithstanding a decline in production rates.

Last year we began telling you and the Alaskan public about this turnabout in our business outlook. Almost exactly a year ago Brian Davies, our Vice President for Endicott and Development Projects, testified to the House Special Oil and Gas Committee that BP is going to stay in Alaska for the long run.

Following that, in April, John Browne -- BP's chief executive for exploration and production worldwide -- told the Chamber of Commerce in Anchorage that Alaska would remain an important part of BP's business for a long time. We have been running on television a serious variation on "Knock, knock. Who's there?" -- saying there is a lot more oil on the North Slope to be produced, and BP will be here to help produce it.

This past January, I announced that BP plans to resume exploratory drilling on the North Slope this year. We intend to drill three wells and participate in a fourth this year. Not only does this program end an unusual hiatus in our activities, but it is the largest exploration program we have had in Alaska since 1985 -- the year before the big crash in oil prices.

Yesterday, we announced an agreement with Conoco and Petrofina under which BP will take over the operatorship for the Badami oil discovery east of Prudhoe Bay and Endicott. We will be starting seismic work later this month, and if that bears out our expectations, we will do additional drilling to delineate the field. I trust this will satisfy any remaining Doubting Thomases skeptical of our resolve to stay in Alaska -- we would not be taking on major new responsibilities like Badami if we were on our way out.

To borrow a slogan from Merrill Lynch, we are bullish on Alaska. We intend to remain here -- as a producer, as an investor, as an explorer, and as an operator. There is a good future, we hope a bright future, for us and for the state. Not the dazzling brilliance of the 1980s, but a bright one nonetheless.

Let me outline for you what we see in the next few years. By the end of this year the second gas handling project for Prudhoe Bay, GHX-2, should be installed and operating. That's a major investment which will help us maximize oil production from this field.

BP is paying half of its \$1.3 billion cost. We expect GHX-2 to increase the capacity to handle the natural gas that comes up with the oil, from 5.3 billion cubic feet a day to 7.5 billion. Since it is the gas-handling capacity that currently limits how much oil we can produce, GHX-2 should add some 100,000 barrels a day to what Prudhoe could otherwise produce.

That's the equivalent of almost a whole year's decline, so production from Prudhoe during 1994 promises to be down only slightly from this year's level. Although production after 1994 will resume its annual decline, the continued operation of GHX-2 will mean that each year's production will be significantly higher than it would have been without this investment.

On-going investment in continued development drilling, workovers of existing wells, and expansion of our secondary and tertiary oil recovery programs will also help slow the decline at Prudhoe in future years.

There will also be production from new fields coming into the picture. We expect production to begin from the Point McIntyre field in the second half of this year. BP has an approximate 33% stake in this development, along with Arco and Exxon.

Point McIntyre will be the largest example of a new generation of oil field development on the Slope. Instead of having its own production facilities to separate the oil from the associated gas and water, Point McIntyre will run its production through unused capacity in the production facilities for the Lisburne field.

Later, we expect to run production from our 100%-owned Niakuk field through the Lisburne facilities as well. This is a natural evolution from our running of production from the Sag Delta North field through the Endicott production facilities, which began in mid 1989.

By using unused capacity in existing facilities, smaller fields in the vicinity can be economically developed and produced. The small fields will pay a fee for using another field's capacity, instead of having to bear the full economic burden of installing their own production facilities. At the same time, the increased volume going through existing facilities should enable those facilities to operate more efficiently and hold down their operating costs per barrel. Plans are under way for additional fields, such as ARCO's West Beach, to follow this new approach to development.

All in all, these and similar activities can materially alter the outlook in the year 2000 and beyond. Here is an illustration of what I mean.

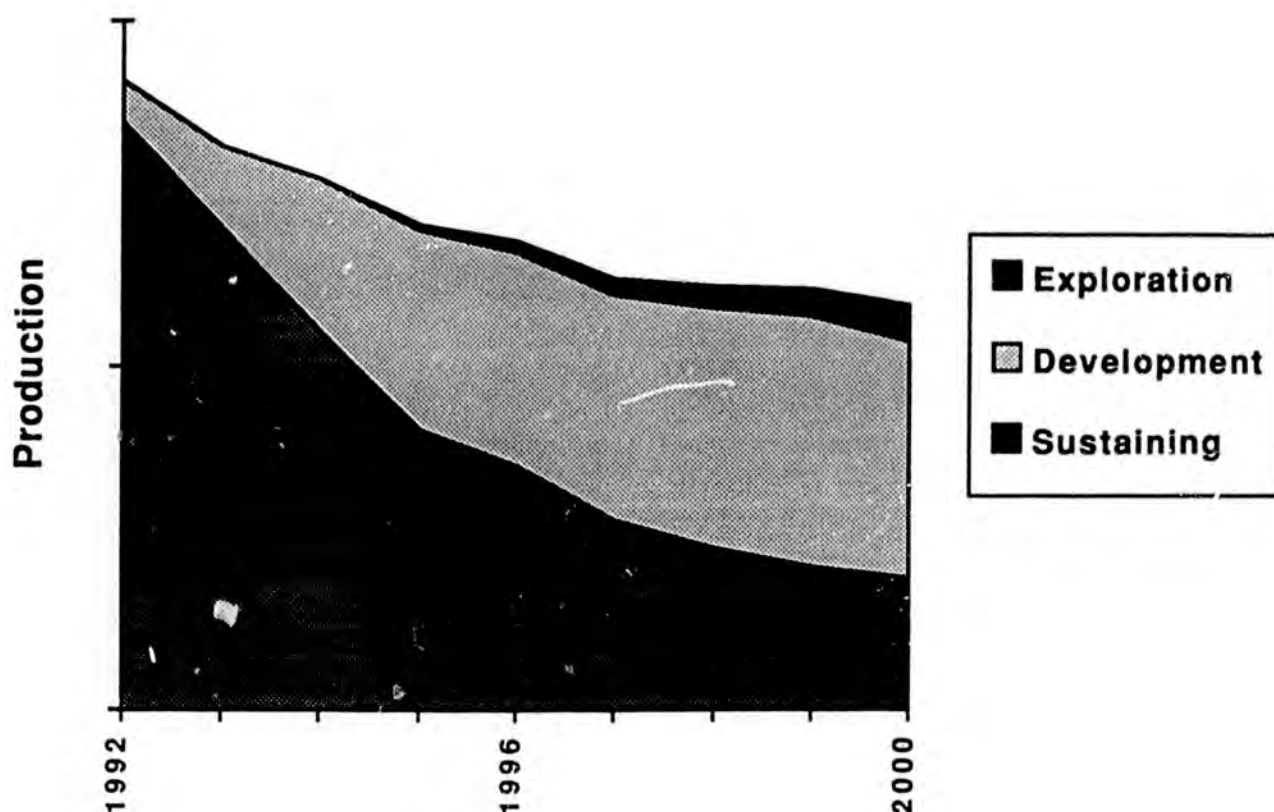


Figure 1. Production Potential from New Investments

This graph is from Brian Davies' testimony last year, but the basic outlook he presented has changed very little since then.

The bottom, or green, area of the graph shows how much production we expect from simply operating and maintaining the existing investments on the Slope. As you can see, it falls off very rapidly -- something like 18 percent a year.

The middle, or yellow, area of the graph shows how much additional production we could have from continuing to make new investments in fields already producing, and in fields such as Niakuk that have been discovered but are not yet in production.

The narrow red band at the top of the graph shows the risk-adjusted expectation of how much production we hope to add as the result of our exploration program. We believe this is a conservative expectation. But, obviously, the actual production could be significantly larger or smaller, depending on what we find. The point I wish to emphasize is that 60% of the production in 2000 will be from investments not yet made and in place. More than there will be from all the investments we currently have on the North Slope.

This graph represents our best guess now about how the future will unfold over the rest of the decade. It is an exciting prospect based on the attractive opportunities we have found, and it presumes an environment in which continuous new investment makes good business sense.

So we are not done looking. This forecast of the future is still very much a "work in progress." As we build upon success, I would hope that more opportunities will come to light that are simply impossible to see today.

----- • -----

Nevertheless, despite all our efforts and despite the successes we and others have had and expect to continue having, there *will* be a decline in Alaskan oil production through the rest of this decade.

Even if ANWR were opened this year -- an unlikely prospect, at best -- we would not see production before 2000 from any discovery that might be found there. If the Sunfish field in Cook Inlet turns out to be as large as the largest field ever found there, its peak production would probably offset only a year's decline in Prudhoe Bay. If the Kuvlum and Badami discoveries prove to be commercial, they won't come into production before the very end of the decade at the earliest. In other words, there is nothing to alter the fact that oil production at the end of the decade will be significantly below today's level, although it will still be handsome!

And this fact means that all of us here in Alaska face a challenge together -- namely, how to get state and local government spending into balance with the revenue that will be available over the long term.

There are two ways we can get from where we are today, to where we will be, even under the best of plausible assumptions, in the year 2000. One is to get there using a plan that gets the budget into balance in an orderly fashion with a minimum of disruption. The other is to stay as we are, and simply hope for the best.

I submit the latter course is most unwise. I note that State spending this year is already almost \$500 million over unrestricted revenues -- \$2.755 billion versus \$2.272 billion. The Department of Revenue has set out forecasts of future revenues; none understand better the patterns of spending than the State Legislature and Administration. There has been much discussion of the fiscal gap: the ISER report was a good starting point for discussions.

There are those who will say (as some have already said) that oil prices are going to rise enough during the remainder of this decade to offset most, if not all, of the effects of declining production. And who knows? They could turn out to be right. I just wouldn't bet the ranch on it. And I say that from experience, not to be flippant. For a while BP was planning its business on the assumption that world oil prices would rise during the early 1990s to the mid \$20s range. Except for a brief blip during the Kuwait crisis, prices never got that high. This miscalculation

created quite a strain on our company. We have learned not to let ourselves get into a situation where an acceptable fiscal outcome depends on oil price increases.

I applaud Governor Hickel for recognizing the seriousness of the fiscal gap that Alaska faces, and for holding the "Economic Summit" earlier this year to examine ways for dealing with that gap. I am pleased to have been a participant in that summit. The most important lesson I learned at the summit is that there is still time for Alaska to choose from a number of options that get to fiscal stability, without a great deal of pain and dislocation.

But the choices need to be made and acted upon. Deferral of decisions won't make the choices easier. Next year is an election year, and that means it will be even tougher to make "tough" decisions. Even the \$630 million that we'll be paying on June 30 won't buy Alaska much time, in relation to the deficits in prospect. Now I am not here to sell you on one plan or another. It really is not appropriate for me, for BP, or any other company to try to tell Alaskans which options to use, and when, in dealing with the State's fiscal dilemma: unless measures the State proposes to take would affect our business here.

"Aha," you are thinking, "now we get to the crux of the matter." And I suppose that's right, in a sense. I would be less than honest with you if I did not admit our real concern about the possibility that Alaska may choose to raise oil taxes instead of taking other measures to balance its budget.

Raising oil taxes would hurt our business and be counterproductive for the State. The oil industry is already paying its way. For those of you who invest in stocks, you will have noticed that the oil industry, for years now, has not been rated well by Wall Street in relation to other business sectors. This is not the rich industry it once was. Those days are past. The early eighties are no more.

Specifically in Alaska, I have illustrated how we have been working very difficult issues -- painful for us in BP as we downsize by 30%, and for our suppliers and their employees -- to reconstruct a successful long-term business out of looming business failure. All this is not done for fun. This is an on-going process: we have to keep ahead of the production decline curve. That's a continuing challenge -- we are climbing up a treadmill.

I have illustrated how our future success in oil production -- for BP and for the State -- also depends on on-going investments not just in exploration, but particularly in the existing producing fields. All this benefits the State.

All my business projections are based on stability in oil taxation. The attractiveness of new investments, which must compete with other opportunities in BP throughout the world, depend critically on the tax regime.

With our track record of successful change over the last three years, BP Exploration Alaska has restored the confidence of Corporate BP in the long term

future of our business here. An increase in oil taxes will shake that confidence fundamentally.

It is the nature of most oil investments that millions of dollars must be committed and spent before a single cent of cash begins flowing back from the investment. Not infrequently, it is years between the first major expenditure and the first cash returns. All through that time, and afterwards, our return on investment is exposed and at risk to changes in technical performance of the project (that's our risk) and to changes in the economic environment, such as oil prices and taxes, that could cripple, or even destroy, the profitability of the project. We take the risk on the oil price -- that's our business.

The State is concerned about what the price of oil will be tomorrow and the next day, because those prices will determine how much revenue the State gets. We share that concern, because oil prices affect the health of our business too, and also affect our capacity to spend and invest. However, in evaluating investment opportunities, we also focus on the long-term trend of prices through the life of a potential investment. Of course, we may reset our long-term expectations as current price movements suggest change may be occurring in long-term trends.

Let me offer the GHX-2 project for Prudhoe Bay as an example. We and the other Prudhoe owners sanctioned GHX-2 to go forward in 1990. We had already spent millions of dollars in designing the project; now we were committing hundreds of millions more to order the materials and build it. After we made that decision to go forward, we have seen oil prices soar to \$40 a barrel during the crisis over Kuwait. We have also seen them fall to \$15. And what has been the effect on the profits we expect to get from GHX-2 by all this soaring and falling in oil prices? Not one cent. GHX-2 is still under construction. There hasn't been any money coming back to us from GHX-2, and there won't be until later this year. In other words, we have gone through one of the most volatile periods of oil prices in history, and it hasn't made a difference to the economics of our investment in GHX-2.

Before moving on, let me address the notion that somehow it would be okay for Alaska to raise oil taxes because the oil companies are still making money from North Slope production. The flaw in this reasoning is in its assumption that sub-standard new investments can be justified by the success of past investments. This is simply not true.

Suppose, for example, you invested money a number of years ago in a 30-year U.S. Treasury bond bearing interest at 10 percent. Today, new 30-year Treasury bonds are paying only seven percent. Does the fact that you are making 10 percent on the bond you already have, mean that you would offer to buy a second bond from the Treasury today at something less than seven percent? Of course not. Your decision to buy a second bond is not affected by the success you are having with your investment in the first bond. Instead, you will buy a second bond only if you will be satisfied with a seven percent return on that money - and you might perhaps not be satisfied that, at seven percent, the market is offering an adequate return.

For us, our past investments in the North Slope are like the first bond. We have already made them. They do not affect our decision to buy a second bond -- that is, to make new investments in the Slope. Each new investment must stand or fall on its own merits; it must compete with other BP investment opportunities world-wide.

So changing the tax rules in the middle of the game, which undermines the long-term returns from our investments, is one of the most destabilizing things Alaska could do. Furthermore, once the State starts to increase the burden of oil taxes as a means of dealing with the fiscal gap, there will doubtless be repeat calls, as fiscal pressures continue to mount. If ever you wanted to chill our renewed and hard-won enthusiasm for Alaska, you could not find a better way to do it than by raising oil taxes.

That's enough about oil taxes! Fortunately, Alaska has a range of options for coping with its fiscal gap. Earlier I commended Governor Hickel for recognizing the seriousness of this situation and for holding the Economic Summit to discuss how to address it. Many proposals were offered at that event.

I cannot let this occasion pass without also acknowledging the sincerity and commitment of the many legislators grappling with this problem. I applaud your work and your dedication. And I respectfully but most urgently ask you and the Governor to agree, *this session*, on a formal plan -- together with some early measures -- for getting Alaska through the transition to a sustainable, balanced budget.

People will, I believe, be much more receptive to the tough decisions you will make regarding the budget, if they see them as part of a greater strategy. In closing, let me repeat that BP has a rejuvenated confidence about the future of Alaska and our business here. We shall continue to strive for ways to work smarter and more effectively, to maintain a successful business in a changing and tough industry, for the long term.

- We intend to explore here.
- We intend to invest here.
- We intend to operate here, both that which we already operate and, we hope, new fields as well.

And if all works out as we plan and intend, we shall produce a great deal more oil for the benefit of the State and all Alaskans, as well as ourselves. There's a bright future out there for all of us. Let us seize it together.

Thank you again for this opportunity to address you.