Fuelled for

For Shell Malaysia, the challenge is to grow its profitable upstream assets while staving off raging competition downstream.

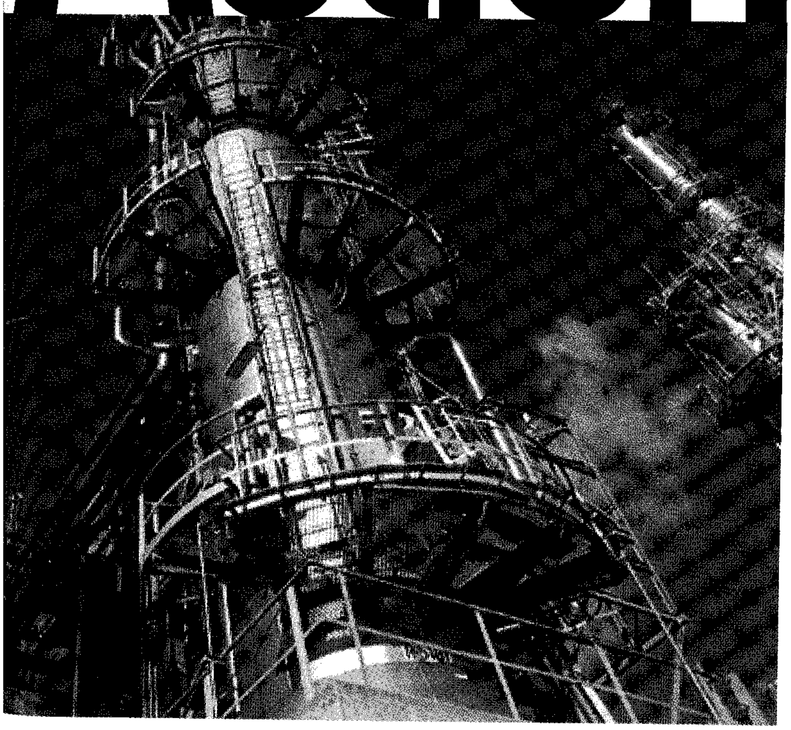
Stories by Bhupinder Singh

IN the last four decades, Shell Malaysia has invested RM70 billion in the country. That makes it the largest foreign investor.

And there's no stopping the oil giant. In its five-year plan from 2003 to 2007, it is investing another RM12 billion. At last count, it had 5,000 Malaysians on its payroll, both at home and abroad.

Shell Malaysia chairman Jon Chadwick is not satisfied. He is looking to further stamp the group's mark on Malaysia. 'We are increasingly looking at Malaysia as a centre of excellence to locate and provide shared services and backroom support to the region and globally,' he says.

Action



This is one area Shell Malaysia may grow the fastest in the next few years. Only in Malaysia has the holding company, Royal Dutch/Shell Group, located nine global shared services hubs.

The largest of them is Shell IT International in Cyberjaya, with over 1,000 young, talented staff. The fastest-growing is Shell Global Solutions, which is also a Multimedia Super Corridor (MSC) company, marketing project consultancy services to the energy industry worldwide.

The other seven perform backroom support services in human resource (HR), finance and payrolls, offshore treasury, technical consultancy, retail dealership training, fleet card services, procurement, and others for Shell worldwide.

'People sometimes say we are here due to the low tax and cheap labour. That's nonsense,' says Chadwick.

'It's about highly trainable, highly talented and multilingual brain power. Malaysia has a talent pipeline of human capital that's very attractive for corporations like Shell and we are going to grow further. The hubs bring our cost lower while our quality improves and all is done by Malaysians.'

In any case, these are good times for the group. Crude oil prices are high, production of oil and gas is at record levels and profits are soaring. Likewise, its oil product business is flourishing with some half a million motorists re-fuelling daily at the company's extensive petrol station network, while its bottled liquefied petroleum gas (LPG) enjoys a 23% market share.

Its association with Malaysia is something the government would like to see for good reason: Shell Malaysia paid RM994.7 million in direct taxes, RM827.1 million in indirect taxes and RM388 million in royalty obligations in 2003 and undertook RM2.9 billion in capital expenditure.

Today, Shell Malaysia is among the 10 most successful Shell companies in the Royal Dutch/Shell Group (RDS), with Malaysia being the growth centre for the region, which is one of the 'heartlands' for the group worldwide.

However, despite such impressive data, Shell Malaysia is not without its challenges, which may became more apparent with the troubles brewing at its headquarters.

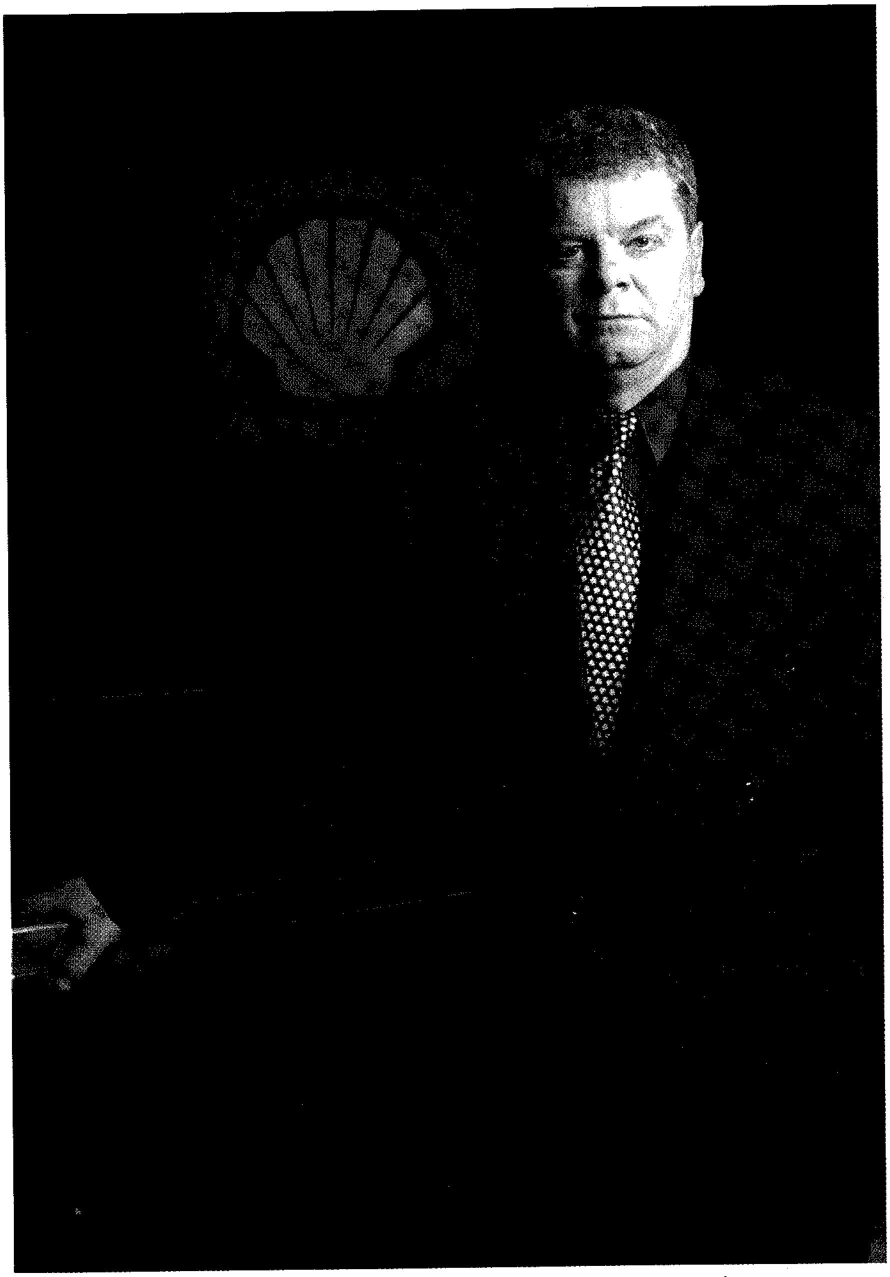
Recent news of the downgrading and re-categorisation of the upstream reserves of the holding company jolted everyone, including many of its senior management.

'I was shocked and saddened by what has happened. It has harmed our reputation,' says Chadwick, who is also the Asia-Pacific production director *(see box story on page 24)*.

Challenging upstream picture

The impact of the problems at headquarters on the operation of the group here is hard to say, as the situation remains fluid. Nevertheless, Shell Malaysia expects to continue to have an aggressive exploration and production (E&P) programme. It has been spending an average of about RM1 billion annually on E&P work over the past two years.

The reserve replacement ratio in Malaysia is reported to be high for oil at 2.5x, as can be seen by the rising national reserve level to 4.5 billion barrels at end-2003, from about 3.4 billion a year earlier, amidst a rise in crude oil production to about 760,000 barrels a day in 2003 from 660,000 barrels previously.



Chadwick: All praise for Malaysia's 'talent pipeline of human capital'

The gas reserve replacement was a negative 0.1x as reserves fell to 14.5 billion barrel oil equivalent (boe) in 2003 from 14.8 billion boe in 2002, according to Petronas statistics. Even though all hydrocarbon reserves belong to Petronas, companies like Shell as contractors get a share according to the production-sharing contract (PSC) terms.

Shell now has 19 PSCs with Petronas. 'Malaysia's reserves are not overbooked as Petronas has a very conservative policy on the issue,' says an industry expert with three decades of experience in the country and abroad with one of the PSCs.

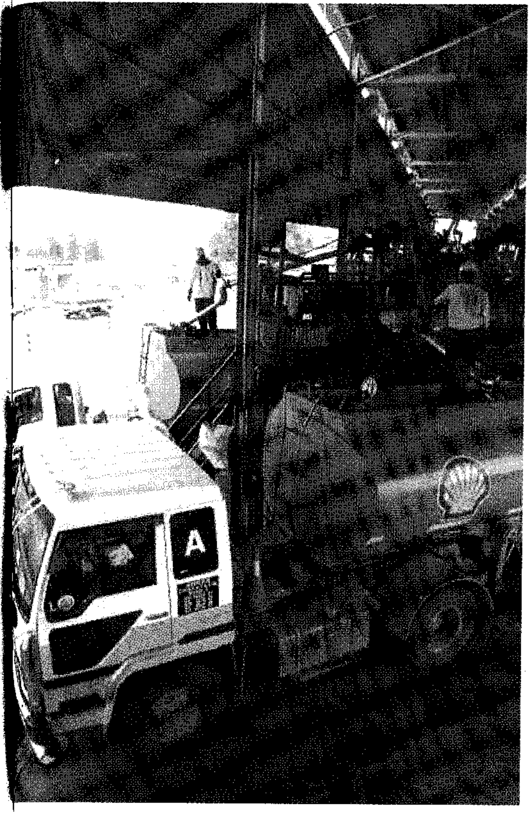
The poor gas replacement ratio however could signal trouble for Shell. The company currently produces 60% of the country's gas (3,000 million cubic feet a day) and 20% of crude oil (250,000 barrels a day). Total oil and gas production of the group is 780,000 boe a day (inclusive of PSC partners' share).

The old fields are being replaced with new smaller ones. Shell has eight fields producing in Sarawak. 'In eight years' time, we will have something like 20-25 fields onstream. Our replacement of reserves ratio in Malaysia is very good. We want to keep growing,' says Chadwick, without disclosing figures.

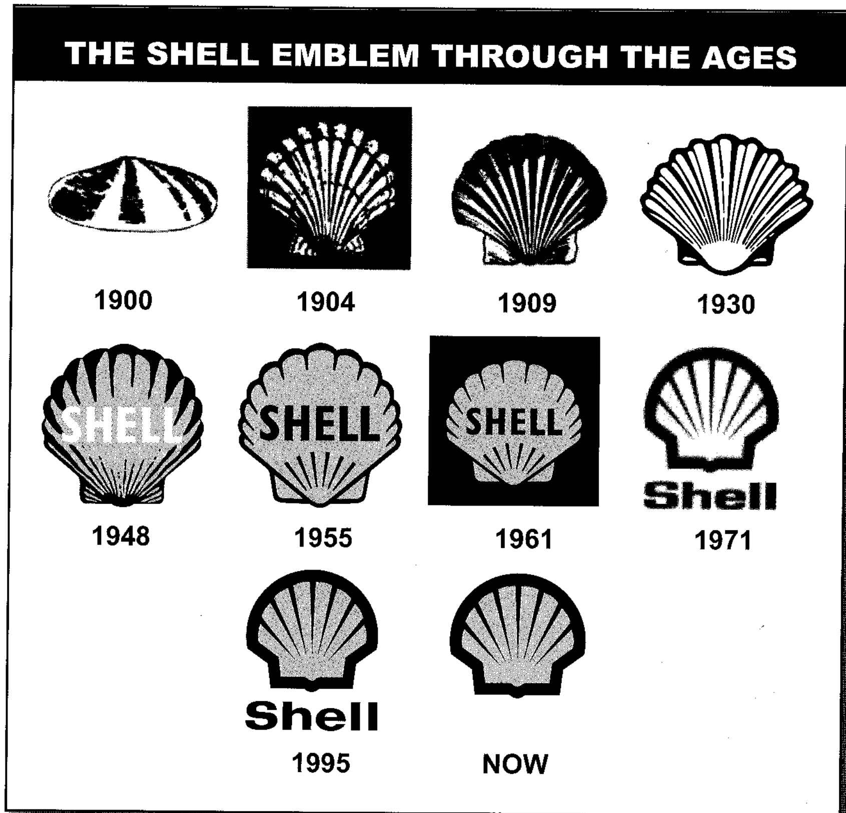
The aggressive E&P programme has made a couple of commercially viable discoveries. Shell and its PSC partners made a gas discovery in the Peninsula last year in Bunga Kamelia and a 'significant' oil discovery early this year at Gumusut-1 in a kilometre of water offshore Sabah.

Opportunity for growth in the upstream business for Shell comes from Petronas' plans to push production of gas to 6.9 billion cubic feet a day by 2008 from about 4.95 billion cubic feet now, and crude oil production by another 3% by 2008. According to local brokerage MIDF Sisma Securities Sdn Bhd, the increase will be from newly discovered fields, rejuvenation of fields and satellite field development.

Shell will play a part. Exploration is moving into deep waters in geologically a very prospective region, but it costs more



A Shell fuel tanker loading at the gantry off the Port Dickson depot



and requires higher technology.

Shell's longstanding commitment to technology differentiates it from its competitors in Malaysia. Many oil and gas exploration and production techniques in the country were pioneered by Shell. Now used by the global industry, Shell pioneered the single buoy mooring system, the twister and the multi-horizontal drilling, which enables better oil recovery and improved cost effectiveness.

As E&P activity in Malaysia moves increasingly towards deepwater and 'ultra' deepwater, Shell's know-how will become more highly prized. 'We like Petronas as a partner, it's two plus two equals five so far,' says Chadwick of Shell's willingness to commit to exploring and developing the country's hydrocarbon potential.

Upstream is where the margins are higher, especially with oil going for over US$30 a barrel and lifting costs in the range of RM6-RM10 a barrel. Shell's global portfolio is extensive. In the Asean region, the company has E&P activities in Malaysia, Brunei and the Philippines as well as Australia. The regional focus of RDS' E&P activities in the Asia Pacific is on China and developing its liquefied natural gas business.

The group regularly reviews its worldwide portfolio. Recently, RDS disposed of its upstream assets in Bangladesh and last year in Thailand. The

SHELL'S MILESTONES IN MALAYSIA

1878 > Marcus Samuel & Company formed in London.

1882 > Cc de Crespigny, the resident of Baram district, Sarawak, records 'earth oil' in Miri.

1889 > First shipment of cased kerosene imported by Marcus Samuel to the Straits Settlements. The Labuan oil mining lease is granted to the Central Borneo Company by the colonial office.

1896 > The first motorcar in Malaya is recorded.

1897 > The Shell Transport & Trading Company Limited is formed.

1902 > Shell Transport & Trading merges with Royal Dutch Petroleum Co to become Shell Transport and Royal Dutch Petroleum Co Ltd.

A 'Crude' Awakening

THE news shocked the oil world. When the Royal Dutch/Shell Group (RDS) announced it had to readjust its upstream reserves, it gave its stakeholders across the group a rude shock.

RDS has undergone a seismic upheaval, triggered by the downgrading of its oil and gas reserves by 23 % or 4.5 billion barrels, equal to Malaysia's current oil reserves, since January.

For the world's third largest international oil company and one of the most profitable in Europe, the re-categorisation of reserves saw the departure of chairman Philip Watts and head of exploration and production (E&P) Walter van de Vijver, both blamed for the fiasco.

The reserve statement problem in itself was a surprise to everyone including many of the senior management of the company and their auditors.

The reassessment was of proven reserves, particularly underdeveloped reserves, within both producing and frontier areas, as well as standard adjustments across the reserve base. The assets were located primarily in Nigeria, Gorgon in Australia and the giant Kashagan field in Kazakhstan.

Recent events have focused attention on the group's internal controls, conduct of management, the inherent judgmental nature of reserve bookings and the cumulative effect on the financial and operating profile of the once-respected group.

The fallout could see more executives go as regulators in Europe and America investigate information disclosure and insider trading. Environmentalists like Friends of the Earth (FoE) attacked the company's sustainable development and environmental policy.

FoE says Shell has for many years overstated its social and environmental performance, much like its reserves.

Fitch Ratings, the international rating agency, downgraded the outlook on RDS' 'AAA' Senior Unsecured to negative from stable.

'The negative outlook reflects the expectation that RDS will incur incremental costs of up to US$6 billion through a combination of organic replacement of reserves or acquisitions, following the unprecedented rebasing of 20% of proven reserves to probable,' explains Isaac Xenitides, senior director, European energy, at Fitch in a written reply.

He adds that the rebooking of reserves rebases much of RDS' cost performance over the years and supports criticism of the business.

Analysts have been pointing out RDS' deteriorating competitiveness in the upstream and downstream business. The group's reserve replacement ratio is a low 0.6x as compared to peers like ExxonMobil, BP and Total that range close to or above 1x.

Shell has also lost its dominant role in the oil product market to ExxonMobil, with Total fast catching up.

RDS is now staggering like a prize fighter after taking blows, waiting for the bell so he can regain his bearings. Shell Malaysia chairman Jon Chadwick believes the group, will come out for the better.

'I believe the changes we make as a result of it will make us stronger and better. This is not an Enron or Worldcom. It has not affected our profitability. It has affected confidence, there's no doubting that,' he says.

The group is determined to catch up with and overtake its peers, explains the 46-year-old Briton who took charge of Shell Malaysia in July 2002.

That may be easier said than done. Says Xenitides: 'The group's near-term upstream and downstream production is anticipated to remain flat over the next two years, which will be at odds with many others within its peer group. It's important to remember that reserves which were rebased may still be exploited by RDS in the future.'

Xenitides says RDS' dual board management structure, highlighted for its stability of purpose and cost control, may need to comprehensively review its business processes and structures across the group. Such an action could adversely affect decision-making and business strategy in the short term.

As for Chadwick, he is clear on what he has to do. 'I have told my staff the one thing that will keep the critics at bay is performance for the benefit of our stakeholders. We are determined to regain the trust and confidence that has been placed in us,' he asserts. mb

1903 > Dr Charles Hose maps 'oil seepages' in the ground in Miri.

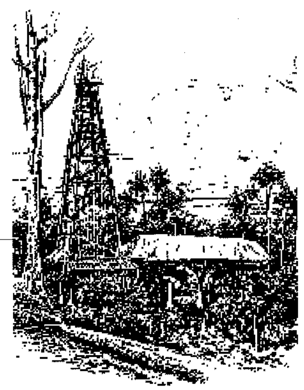
1907 > The British Dutch merger is formally completed to become the Royal Dutch/Shell Group.

1909 > The first oil mining lease for the state of Sarawak is granted.

1910 > Miri's well number one is spudded by cable tool method on Aug 10, completed on Dec 22 and produces 83 barrels per day.

1913 > The first shipment of Sarawak oil is exported.

1914 > Shell builds Malaya's first refinery in Miri.



Malaysia's first oil well was discovered in 1910, located at Canada Hill (now Bukit Telaga) in Miri

Malaysia's First Refinery built at Lutong in 1914

group has announced plans to sell underperforming assets in Peru and the United States. There are no such plans in Malaysia.

'We will continue to be involved in the upstream business here for the length of our licences and there will be hydrocarbon reserves when our licences run out in 25 to 30 years' time. You don't build new platforms if you think the reserves are going to run out,' asserts Chadwick.

Shell pioneered Malaysia's hydrocarbon business in 1910 with its discovery of oil onshore in Miri on Canada Hill, and has been operating in the country for 114 years. Its largest project in E&P in the Asia Pacific is the E-11 in

Sarawak, a RM2 billion capital investment to refurbish some old platforms, build new ones as well as new pipelines, which will one day handle half of the company's gas production.

Shell Sarawak can now produce 4,000 million cubic feet of gas a day, which, according to Chadwick, is 'enough to provide energy for seven Singapores'.

Downstream – seize the day

Downstream is where the margins are lower and competition stronger. While partners in the upstream business, in the downstream commercial and retail business, Shell and Petronas are fierce competitors.

Shell downstream assets consist of its stakes in the MLNG Dua and Tiga trains, the gas-to-liquids Shell MDS plant, a 156,000-barrel-a-day refinery in Port Dickson, seven LPG gas filing stations, six area offices, 16 oil depots, eight aviation depots, two lubricant blending plants and its chain of 825 retail outlets which is the largest in the country.

The theme over the years has been customer, cost, portfolio and operational performance. While Shell has been able to hold to its position as the largest petrol station retailer, competitors are chipping away and taken the lead in LPG and aviation fuel, and steadily gaining on the lubricant business.

'We are determined to stay ahead but it's tough and requires our best management people. I believe we have the people but we are not going to sell products at a loss,' says Chadwick.

Shell takes the lead in having the largest number of retail outlets in the country

The lead in the retail station business will be under increasing pressure. Shell's retail station network will expand, in a calculated manner, at an average of 10-15 stations a year, according to Chadwick. However, competitor Petronas now has 683 stations and is adding 60-70 yearly and expanding its supply and logistics facilities.

At that rate, Petronas could emerge with the biggest network within the next five years. 'Factors like convenience, brand loyalty, promotions, product quality and nationalistic preference play a role with consumers. Whether Petronas' growing retail business will be successful based on parameters like profit will be another issue,' says an analyst from a local brokerage.

As with the upstream business, RDS' active portfolio management has let it to sell 24% of its 75% stake in Shell Refining Co (Federation of Malaya) Bhd, held via Shell Overseas Holdings Ltd, to institutional investors for a reported RM468 million.

RDS has 13 refineries in Asia and it is reported that some are for sale. However, analysts believe the group will not divest totally the profitable Port Dickson refinery as it is needed to service Shell's oil product business in Malaysia.

Since the cyclical and long-term nature of Shell's business does not allow the company to control prices of its raw materials, the focus of the company has been on factors that it can influence and control, such as business processes.

That is why Shell is increasingly looking at Malaysia as a centre to locate and provide shared services and backroom support to the region and globally, says Chadwick.

There is a Chinese saying that goes: 'May you live in interesting times'. The outlook for RDS and Shell Malaysia is set to remain interesting for some time to come. Changes in the corporate structure of RDS may see wide-ranging changes in the business process and structures that will likely impact Shell Malaysia's activities.

For Chadwick, the challenge will be to grow the group's upstream assets whilst fighting off competition in its downstream operations. mb

1916 > Refinery relocates to Lutong.

World's longest sealine (sea-going pipeline) in 1917 was launched at Lutong

1921 > The first Shell petrol pump is installed on Foch Avenue, Kuala Lumpur.

1922 > Imported petrol pumps from America arrive.

1934 > Shell explores British North Borneo after obtaining a concession.

1938 > The Shell Company of British North Borneo is formed.

1945 > The Shell Company of Straits Settlements Limited is formed.

1948 > Shell Company of Federation of Malaya Limited is formed.

1952 > A new oil mining lease for Sarawak is obtained.

1954 > Mining lease is extended to offshore exploration.

1956 > The first mixed marine platform is built.

1958 > Sarawak Shell Oilfields Limited is formed. The search for oil in Sabah goes offshore.