

# A case study for vertical integration commerce essay



The word vertical integration describes a style of management control. The oil industry has always been fertile ground for analysis of the reasons and effects vertical integration. One reason of this popularity is that the stages of production are easily differentiated. The general perception is that integration is a prerequisite for success of the company as the oil industry is populated by large integrated companies that make "excessive" profits.

Vertically integrated businesses in a supply chain are united through a common owner. Vertical integration may also be a merger of two companies that are in various stages of production, (for example, an upstream company (ONGC) and a downstream company (HPCL)). Thereby merger with a company which is at a later stage in the production process (and therefore closer to the consumer end) is known as forward integration.

Vertical integration may be contrasted with horizontal integration, the merger of companies that together are at the same stage of production, for example, merging of two upstream companies or two downstream companies.

Joining further back in the process (if a downstream company merged with an upstream company, for example) is known as backward integration. An example of backward integration in India is of Reliance Industries Limited that started with textiles to polyester to petrochemicals and now refinery and exploration & production.

The integration of two organizations that are in completely different business lines is sometimes referred to as the conglomerate integration.

Companies are downstream or upstream of the other depending on whether they are closer or farther from the end consumer (the “ sea”, so to speak, to the river flowing production). The benefits of vertical integration come from the higher capacity that gives organizations control access to inputs (and to control the cost, quality and delivery of inputs).

Some of the best examples of vertical integration have been in the Oil Industry. In 1970 and 1980, many companies that were principally engaged in the exploration and extraction of crude oil refineries decided to acquire downstream distribution networks. Companies like Shell and BP came to control all the steps involved in bringing a drop of oil from North Sea or Alaska to the fuel tank of the vehicles.

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### **Reliance- A Case Study:**

The Reliance Group, founded by Dhirubhai H. Ambani (1932-2002), is India’s largest private enterprise, with businesses in the energy and materials value chain. Group’s annual Revenues are in excess of U. S. \$66 billion. The flagship company, Reliance Industries Limited, is a Fortune Global 500 company and is the largest private sector company in India.

Backward vertical integration has been the foundation of the evolution and growth of Reliance. Starting with textiles in the late seventies, Reliance pursued a strategy of backward vertical integration – from polyester to fiber intermediates, plastics, petrochemicals to petroleum refining and oil and gas exploration and production – to be fully integrated along the materials and energy value chain.

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The Group's Activities span Exploration and Production of oil and gas, petroleum refining and marketing, petrochemicals (polyester, fiber intermediates, plastics and chemicals), textiles, retail and special economic zones Infotel.

Reliance enjoys its Global Leadership in Businesses, being the largest polyester yarn and fiber producer in the world and among the top five to ten Producers in the world in major petrochemical products.

### **Key Milestones in the history of Reliance Group:**

1958- Dhirubhai Ambani started Reliance Commercial Corporation in Mumbai.

1966- Reliance entered the textile industry and set up a mill at Naroda, Ahmedabad.

1975- World Bank team visits the mill and declares that it is as modern and well-managed as those in the developed countries.

1977- Reliance went public with India's first IPO

1985- Reliance total assets: \$227 million.

1986- Reliance Capital, a merchant bank was created.

1988- Reliance Industrial Infrastructure, a petroleum pipeline provider, came into line.

1988- Reliance sales exceed \$404 million.

1991- Hazira petrochemical plant commissioned.

1992-Reliance became the first Indian corporation to raise capital from international markets through Global Depository Receipts offering, and sets a record with a Reliance issue that received over 1 million investor applications.

1993- Reliance Petroleum went public in India's largest public offering to date. Sales exceeded \$909million, making Reliance Petroleum India's largest publicly traded company. Also Reliance offered the first Euro Convertible bond issue.

1994- Awarded Companion Membership of the Textile Institute (UK). Award is limited to 50 members who have substantially advanced the fiber industry.

1994- Reliance offered the second Euro issue of Global Depository Receipts.

1995- Reliance net profit exceeded \$242 million.

1995- Reliance Mutual Funds, an asset management and mutual fund provider launched.

1997- Reliance became the first corporation in Asia to issue 50 to 100 year bonds in the United States.

1997- World's largest multifeed cracker commissioned in Hazira.

1998- Reliance revenue tops \$3 billion and total assets approach \$8 billion.

1999- World's largest petroleum refinery complex commissioned at Jamnagar.

1999- Reliance Infocomm, a mobile service provider is launched.

2000- Reliance revenues exceed \$4 billion, and total assets are \$11.8 billion.

2002- Reliance Industries Ltd. and Reliance Petroleum Ltd merge into Reliance Industries. The new firm is named to the Forbes Global 500 in 2003, entering at position 306.

## **Backward integration of Reliance Industries**

### **Objectives of the Study**

The objectives of the proposed research are as follows:

To study the various activities that can be successfully integrated in oil and gas companies.

To study the effects of vertical integration on different oil and gas companies.

To analyze the effects of vertical integration on Reliance Industries.

### **Research Methodology**

Collection of Secondary Data

Secondary data will be collected from already integrated oil and gas companies and it will give an insight on the various activities which can be successfully integrated.

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The data would then be simulated to analyze the effect of vertical integration on Reliance Industries.

## **Literature Review:**

Oil companies, both national and multinationals have often adopted a vertically integrated structure. Some of these companies are:

Exxon Mobil: it was formed in 1999 by the merger of two companies- Exxon and Mobil. Before the merger, Exxon was an upstream major while Mobil was a Chemical Company and its chief products included basic olefins and aromatics, ethylene glycol and polyethylene.

After the merger, the company has been operating in the following areas:

### **Upstream**

ExxonMobil Exploration Company

ExxonMobil Development Company

ExxonMobil Production Company

ExxonMobil Gas and Power Marketing Company

ExxonMobil Upstream Research Company

ExxonMobil Upstream Ventures

### **Downstream**

ExxonMobil Refining and Supply Company

Sea River Maritime

ExxonMobil Fuels, Lubricants & Specialties Marketing Company

ExxonMobil Research and Engineering Company

International Marine Transportation

## **Chemical**

ExxonMobil Chemical Company

ExxonMobil is an industry leader in almost every aspect of the energy and petrochemical business. Its activities range from the exploration and production of oil and gas to coal

and copper mining, from the refining of petroleum products to the marketing of fuels

(under the Exxon, Mobil and Esso brands), waxes, asphalt and chemicals. In addition,

ExxonMobil is active in electric power generation.

ExxonMobil Chemical is one of the largest petrochemical companies in the world.

Its products include olefins, aromatics, synthetic rubber, polyethylene, polypropylene

and oriented polypropylene packaging films. The company operates its 54 manufacturing plants in more than 20 countries and markets its products in more than 150



countries.

Shell: Shell has vertically integrated its structure which has helped it develop commercial expertise in all stages of this vertical integration, from the initial search for oil (exploration) through its harvesting (production), transportation, refining and finally trading and marketing established the core competencies in the company was founded. Similar competencies are also developed for natural gas, which has become one of the most important businesses in which Shell is involved, and which contributes a significant proportion of the profits of the company.

Royal Dutch- Petroleum's subsidiary, Shell Oil, acquired Pennzoil-QuakerState, the largest producer of motor oil. The vertical acquisition, which included over 2000 Jiffy Lube oil change centers, was consistent with Shell's parent company's strategy to acquire a company that complements its lubricant and oil-products businesses and Shell's gas station chain.

Royal Dutch-Shell was international from its earliest days. Formed in 1907 as an Anglo-Dutch alliance between Shell Transport and Trading and the Royal Dutch Petroleum Company, the Royal Dutch-Shell group was, at that time, the only serious international rival to Rockefeller's Standard.

By the time that Anglo-Persian was formed in 1909 Rockefeller's Standard and Royal Dutch-Shell had already established powerful positions in the international oil industry. But although Anglo-Persian was a latecomer, it had the unique and crucial competitive advantage that it was the first mover in developing the oil reserves of the Middle East, where its first oil field at

Masjid-i-Suleiman in southern Persia (later Iran) was a giant, containing vast reserves of crude oil which could be produced in great quantities at low cost.

From these different beginnings, the firms that would become international majors, acting at times as rivals, at others as allies, proceeded to establish their mastery of the international oil industry. Each of them set out to produce its own crude oil for processing at its own refineries, and to sell the resultant products to the final consumer through its own market outlets.

Each also sought to achieve, as far as was possible, a balance between these successive stages in its operations. By this policy of operational vertical integration, each major was able to co-ordinate the flow of oil, under its own control, from its oil fields to its markets.

In practice, no major was able to achieve a perfect balance between its upstream (producing) and downstream (marketing and refining) operations. Majors with more markets than production could not find new oil fields at will, while others with more production than markets risked fierce competitive battles with their established rivals if they tried to break into new markets. To rectify the imbalances, and to mitigate the rivalries, the majors adopted a combination of measures – they contracted to sell each other crude and products, sometimes in very large quantities; they joined in market-sharing agreements, most famously the 1928 Achnacarry Agreement to share out markets by a quota system; and they formed regional alliances in which majors with surplus upstream capacity joined forces with others with surplus downstream capacity, so that they could balance their joint operations without engaging in competition. By these arrangements, the

international flow of oil came to be channeled, not through open, transparent markets for crude and products, but through the closed circuits of the majors vertically integrated systems.

There were, both then and later, differences between those who argued that vertical integration was the economically most efficient means of organizing the international flow of oil, and those who saw vertical integration not as an economic necessity, but as a way of suppressing competition and of enabling the majors to control the industry. To a large degree, however, vertical integration was historically determined by Rockefeller's early dominance. Once he had established a high degree of monopolistic control, it became a competitive necessity for later entrants such as Royal Dutch - Shell, and later Anglo- Persian, to integrate vertically in order to avoid having to negotiate on uneven terms with established competitors for purchases and/or sales of oil.