

Apache case study

Business



Their initial investor's capital of \$250, 000 in 1954 rose to over a billion dollars in acquisitions by 2001. Acquisitions over a billion included Repose in Egypt Western desert and a partnership with Shell Overseas Holdings to acquire Fletcher Challenge Energy.

During this period, Apache had a plethora of their resources in the United States, which some view as a disadvantage if the oil price was to rise, changing the focus to exploration of other regions around the world at lower prices.

Even as the company increased profits, Apaches management was faced with many questions regarding risk and if the company should continue to hedge revenues from acquisitions. They wanted to chart a well-defined risk management strategy to track measures in alleviating transfer risk to their shareholders to any other company or investor at a market-determined price in creating value to the shareholders.

We will seek to answer questions regarding the risks Apaches faces, how and should they manage risk, is risk management valuable, what are the potential hazards to manage risk, how could Apache manage risk, and what is the goal of hedging. Major risks that Apache faces. Price Volatility Risk: * When the price of oil decrease cause production shifts away from the US, due to he high cost of producing oil.

. * Apache had 80% of its proved reserves in the US. US, deep-water drilling in the Gulf to Mexico and major interests, b had large fixed costs and the risks were considerably higher.

The oil prices also affected the costs and the availability of drilling rigs. When prices were low, the oil companies cut their capital expenditures, leaving many rigs tied up at the docks to rust. * The Reservoir engineers and geologists, who had the “ institutional knowledge” about particular reservoirs could be lost due to the layoff programs that need to be executed under low-oil price scenarios.

The company’s asset/liability situation can see unpredictable moves *
Uncertainty about future profits and losses occurring from selling UN-hedged oil & gas in the market.

Field Risk: * This area became a risk as Apaches strategy and size as a firm had gone on longer than in most areas of the world, making oil fields in the US the most mature fields in the world. * When field matured from continuous usage the cost of oil extraction exponentially increases cause Apache to lower their production costs and seek out other technological advancements to extract the oils. * Under these impasses like Apache disregard hedging its oil output as losses in their ability to produce expected output targets.

Hedging Risk * Liquid and at reasonable prices are not accessible * Long term hedging became very expensive causing continuous balancing * Risk in price movement as hedge do not cover market Jumps and back flow of contracts * Logistical transport became costly since they could not ship gas to delivery location as required, which hedging does not cover the full front to back flow on contracts Other extenuating risks: * Economic Risk: risk caused due to the overall economy operates on a whole.

Firms with strong reliance on one or two economies tend to have risk derived based on the state of the economy.

Geopolitical risk could also be clubbed into this category. * Operational Risks: servicing a multi million-dollar business with Investments in fields/oil wells and extraction processes taunting task with many government regulations they must meet. As an oil producer of this kind the operational risks are very high. How is Apache managing risk now? Apaches primary tool in the risk management was the implementation of the limited hedging program.

Initially the executive board wanted to know if the program should be extended beyond hedging the revenues from the acquisition.

There are quite a few variations to the application and also belief system that can be observed and they are: Apache had begun the practice of hedging the expected production from its new acquisitions. Apaches view was that the current environment offered the company the opportunity to negotiate the purchase of excellent properties, on potentially attractive prices. Through hedging, Apaches managers locked in these high gas prices.

The hedges concentrated on the expected production over the next 2 or 3 years, while the markets showed liquidity to up to 5 years or even more sometimes. Apaches risk managers had strongly believed that their hedging strategy aligns and is well grounded with the market's view. Apaches near term view was quoted as “bullish”.

I. E. The prices would go up due to strong demand and shortage of supply. Apache used collar strategy and as per the CUFF, it provided good protection

against a potential downturn, but they left upside potential consistent Ninth Apaches view on the market.

Apache believed that they were able to buy high- quality properties at low cash flow multiples.

Also, that the hedging had benefited the firm in a subtle way by increasing the firm's credibility in the acquisition process. Should Apache manage risk? Is risk management valuable to Apache? Some companies view risk management as an essential element of their business strategy. Risk management is valuable to Apache and below is a theoretical argument to support risk management activity at Apache. 998 Price levels/volatility: ere oil price had hit pernicious levels in 1998 when it bottomed out at \$11 per barrel. And in 2001, the prices had come up to \$27 a barrel (which at that point in time was rated as relatively ' high'). Throughout the reference document, there is evidence to prove that the industry on a whole wasn't very clear on the future price direction of oil ; gas.

Each and every firm had their own view (like Apaches bullish view) and constructed risk management strategies in handling the exposures even though some were unsure if transferring risk created value.

The biggest risk that the Industry players faced during low prices included: * Going out of business * Shutting down of wells/fields * Heavy prices to restart previously shutdown fields Closing the fields permanently or reselling at poor prices * Retrenchment of its intellectual labor forces and thus losing people with the institutional knowledge on TTS fields. * Risk reduction is costly iris strategy was also found valuable by other industries. Airlines <https://assignbuster.com/apache-case-study/>

adopted hedging strategies that resembled some of Apaches option based hedging practices.

Therefore, theoretically, there is enough evidence to prove the exposure due to price Laterality; Apache needs a risk management strategy for handling the downside, and the risk management strategy is indeed valuable. What are the potential hazards problems) Apache faces if it manages risk? When oil prices rise, production tends to shift away from domestic sources, as oil is relatively expensive to extract in the US as compared to elsewhere in the world.

Apache has also purchased a number of mature oil fields from larger producer, which are more expensive to extract from, since production falls and extraction cost rise as fields mature. Apache strategy is to maximize production and minimize cost through increasing exploration, development and acquisitions. Apache has also attempted to increase its non-domestic holding wrought international holdings, they may be less costly to develop, but are riskier in respect that reserves are not proven and they bring additional risk in political uncertainty.

Low prices could lead to cutbacks whereas higher prices could create more spending in areas such as technology research and development. Other problems they are faced with: Systematic Risk – Insecurity arising from daily operating activities, such as product delivery and oil drilling; as well as its financing activities, such as issuance of bonds and shares. Price Risk – Uncertainty about future refits and losses occurring from selling UN-hedged oil and gas in the market.

Hedging Risk – The Chance of foregoing any additional profits if prices were to increase dramatically under the collar strategy.

Political Risk – Uncertainty stemming from investing internationally and the associated foreign policies in different countries. How could Apache manage risk? To manage risk Apache should hedge against oil price volatility to protect investment in newly acquired oil fields, and to acquire when oil price is high (buyers' market). Hedging enables Apache to reduce equity needed to support operations. Hedging price risk can reduce the net cost of capital, also increases the capital markets and improve the terms on which they raise the capital thus creating value for their firm.

Reducing price volatility removes noise created by fluctuating prices, and makes evaluation of managers easier to execute. This also creates value for the firm by being able to identify managers who are performing poorly and those who are performing well. This also ensures effective bonus distribution because incentives are dispersed fairly, and investors can get a better idea of the firm's performance and an make more informed decisions. What is the goal of hedging? ere goal of hedging is to ensure that corporations would have the capital to support risky operations.

Any other resource of support would not be as significantly efficient enough to guarantee the amount of equity necessary to function and operate within the capital markets.

For instance, Henry Hub could not suffice on their own without hedging. Instead, basis risk was necessary through third party vendors to assist in Obtaining deliverables solidified within their contracts. Using hedging
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techniques is an essential strategy when doing so for major corporations to leverage specific risks while making good use of their intellectual capital.

Hedging also facilitates better performance evaluations, allowing investors to evaluate the firm's overall performance. Conclusion Apache corporation was able to manage its risk in order to provide opportunities to develop other resources and increase profitability. The use of hedging techniques allowed company bonuses to be maximized by removing from consideration the price volatility of oil and focusing on production in order to fairly gauge the performance of its managers.

This technique also allowed the company to lock down higher gas prices and enabled Apache to take advantage of opportunities when oil prices were down. So, the use of a hedging strategy to manage risk was beneficial to Apache in the sense that they were able to offset the inherent risk of the oil business' pricing shifts by hedging against future increases in the cost of operations and allowing the near term goals of the company to continue to be met, even when the level of oil prices would normally have been prohibitive to growth and acquisitions.