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The Invest

One of the critical problems confronting management and the board of Pioneer was the determination of a minimum acceptable rate of return on new capital investments.

The company's basic capital budgeting approach was to accept all proposed investments with a positive net present value when discounted at the appropriate cost of capital.

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pioneer petroleum

Pioneer Petroleum had been formed in 1924 through the merger of several for merely independent firms operating in the oil refining, pipeline transportation, and industrial chemicals.

Over the next 60 years, the company integrated vertically into exploration and production of crude oil and marketing refined petroleum products, and horizontally into plastics, agricultural chemicals, and real estate development. It was restructured in 1985 as a hydrocarbons-based company, concentrating on oil, gas, coal and petrochemicals.

Pioneer was one of the primary producers of Alaskan crude, and in 1990, Alaska provided 60% of Pioneer's domestic petroleum liquids production. Pioneer was also one of the lowest-cost refiners on the West Coast and had an extensive West Coast marketing network.

In 1990 total revenues exceeded $15.6 billion and net income was over $1.5 billion.

Volatility in crude oil prices was a major concern:

In 1990, for example, the price of West Texas Intermediate crude during the first quarter was $21.80 per barrel, and it reached a low of about $15.50 in mid-June. With the Iraqi invasion of Kuwait, crude prices rose to more than $40 per barrel, but they fell to about $25 per barrel as the year ended. The average price of West Texas Intermediate crude during 1990 was about $24.50 per barrel.

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Investment Details

Pioneer spent about $3.1 billion on capital expenditures in 1990 and forecasted capital expenditures of almost $4.5 billion in 1991. Some of these expenditures, like the addition of a sulfur recovery facility and the improvement of a coker, allowed the refineries to process the heavy Alaskan crude oil more efficiently.
Advantage: The light product yield in Pioneer's refineries was substantially higher than the industry average

Investment was made in exploration and development, as it replaced all its 1990 production with new reserves. Most of this exploration was in the lower 48 states and the Gulf of Mexico.
Investments were also directed to environmental projects, and Pioneer anticipated spending an additional $3 billion in the next 5 years to meet the new standards of the 1990 Clean Air Act amendments and the California Air Resources Board's regulations.
Advantage: Pioneer's gasoline were among the cleanest burning in the industry, and its chemical unit produced about one-third of the world's supply of methyl tertiary butyl ether (MTBE), which was used to make cleaner-burning gasoline.

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A single cutoff rate based on the company's overall WACC

A system of multiple cutoff rates that reflect the risk-profit characteristics of the several businesses

The suggestion was that these multiple cutoff rates would determine the minimum acceptable rate of return on proposed capital investments in each of the main operating areas of the company and would represent the rate charged to each of the various profit centers for capital employed.

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