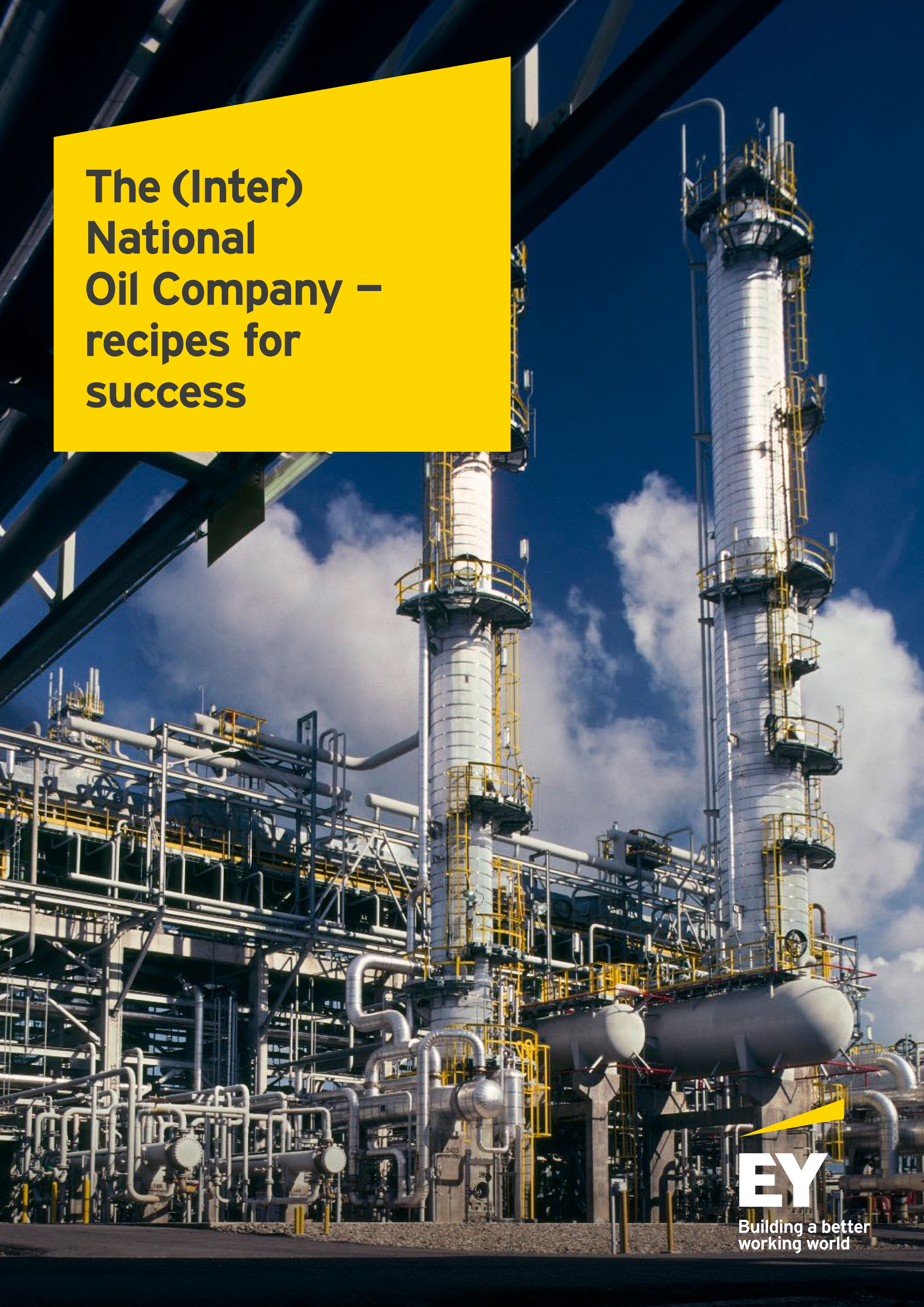
The (Inter) National Oil Company – recipes for success



Building a better working world

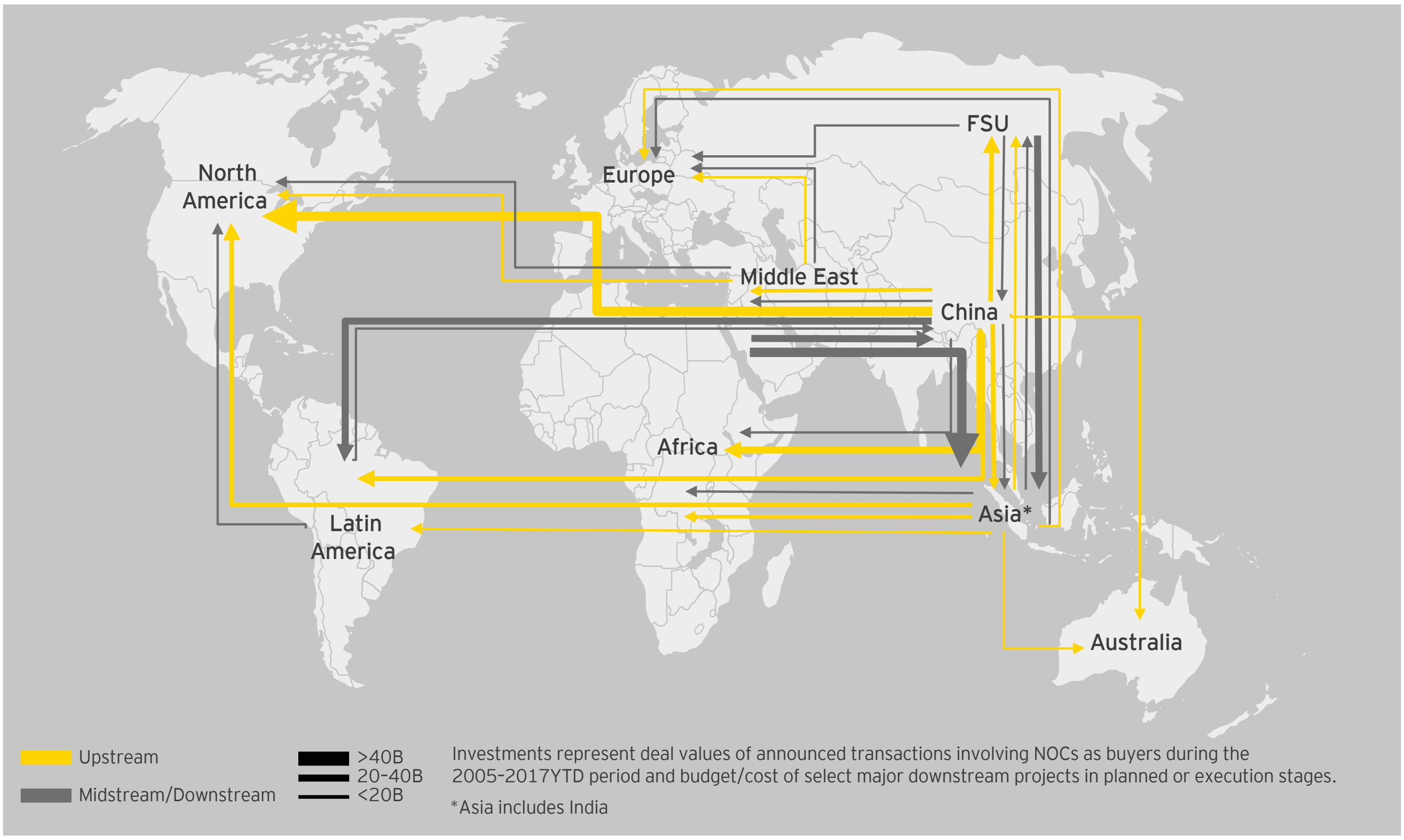
An internationalization strategy presents National Oil Companies (NOCs) with opportunities to diversify, grow their businesses, improve returns and benefit their owner governments. To exploit these opportunities, NOCs need to shift their approach toward more autonomous decision-making with standardized operations and governance.

Since oil was first discovered, internationalization has been the engine of growth and big returns, spawning the creation of "International Oil Companies" (IOCs) with the "majors" developing extensive portfolios across the globe. The NOCs started operations much later, but since the beginning of this millennium, they have emerged with international investments of over US$500 billion till end of 2017.[1] NOC internationalization (either investment in international assets or partnering with international companies on domestic assets) has been motivated by a variety of factors, some economic, some political and some social. These factors have driven — and will continue to drive — their international ambitions.

Changing market conditions are forcing more NOCs to internationalize their operations, to grow and to be more efficient in a lower oil price environment that is increasingly seen as the new normal.[2] Different NOCs are at different stages in their internationalization journey, with resource-seeking NOCs active in acquiring reserves, and producing NOCs active in securing demand.

The NOCs' government owners depend on oil revenue, and NOC executives understand that maintaining those dividends in the face of low oil prices and (in some cases declining reserves) will require them to expand their businesses and change their approach. Oil price declines have resulted in a dramatic reduction of net income for NOCs, especially those that generate a high proportion of their revenues (and profit) from upstream activities. In other words, most of them.

The common thread in NOC internationalization is capital. That is by attracting investment in native resources by partnering with international companies, or by making investments in overseas resources that have better returns or serve long-term strategic objectives.



Source: EY analysis of data from Derrick, BMI and other sources

[1] Source: EY analysis of data from Derrick Petroleum Services

[2] Source: EY analysis of various data sources and media reports

Low oil prices have limited NOCs' access to capital and the focus on capital allocation has increased. It has become imperative for NOCs to review international investments with an eye toward near-term returns, long-term strategic objectives and their organization's ability to execute and add value.

Approach to internationalization	Strategic rationale
Securing supply by investing in overseas reserves and downstream assets	Replacing domestic reserves, avoiding dependence on imports, building share in emerging markets and increasing size, scope and enterprise value
Investing in technology through international acquisitions, joint ventures, partnership with IOCs and service providers	The shale revolution, digital technologies and the push toward decarbonization has disrupted global oil and gas markets
Changing domestic legislation and fiscal regimes to attract international investment	Lower revenue from oil and gas. Lower access to capital due to cuts in capex spending and lower appetite from equity and bond investors

Driving successful internationalization

Internationalization is a multi-year journey, and NOCs at varying stages of transformation can take measures to ensure success. In countries that open up the domestic oil and gas sector to foreign companies, the local NOCs can learn from their partners and build required skills in areas of technology, operatorship and project management. Key success factors for international diversification include:

- **Aligning corporate strategy and core competency:** The NOC should establish clear goals and be open about the purpose and the outcome of internationalization. It is imperative for the NOC to have an in-depth understanding of its core competencies – and those of the partner – so they can leverage the capabilities of the partner. This will also enable the NOC to identify and close gaps in its competencies when transitioning toward majority ownership.
- **Choosing the right entry strategy for each overseas investment:** Different locations and assets will require different entry strategies. The NOC should undertake a detailed feasibility study of the target market, the competitive landscape and the core competencies that will provide a competitive edge in the particular market. For instance, an integrated NOC has multiple options to choose where to invest in upstream/downstream refining/LNG liquefaction/LNG regasification.
- **Investing in relationships:** Building relationships with host governments is critical for long-term success. Continued dialogue with non-market players such as NGOs and other government agencies besides the oil and gas ministry/regulator will ensure the NOC is able to demonstrate the value it brings to the host country.
- **Partnering with the domestic NOC or strong local partner by offering access to technology or capital:** When an NOC decides to invest for the first time in an overseas market, it should choose a partner with an established track record. This enables the NOC to acquire local expertise (approvals, regulatory compliance etc.), particularly for large projects.
- **Close portfolio monitoring:** An NOC should have effective systems in place to continuously track the performance of its various investments. It should also have a system in place to review its portfolio in relation to the broader NOC business strategy. We have observed that while NOCs have a strong appetite for investments, they can be reluctant to divest assets, unless they are strapped for cash. NOCs should regularly evaluate their positions, take corrective actions, and execute appropriate exit strategies.
- **Strict controls on HSE and ethical practices:** Most NOCs have to bolster their controls. In this era of integrated markets and information, even a minor lapse in one area can have an adverse impact on an NOC's global brand.

Pitfall: political goals

In the past, the decision to enter into international investments was often driven by the state, with the intent of strengthening government to government relationships. The NOC had responsibility for executing those deals, leading to:

- NOC management taking a passive role in the investment
- Opaque goals, leading to unclear expectations and accountability

Overseas investments should be driven by the specific transformation objectives of the NOC. When it comes to NOC transformation, autonomy is critical. Autonomy is especially critical for successful internationalization. There are two aspects to autonomy:

- **Strategic autonomy** – the ability to independently balance commercial objectives and strategic objectives in the context of national priorities
- **Operational autonomy** – the capacity of the NOC to make day-to-day decisions on how to execute on those objectives

Today, we see a significantly improved balance, with NOCs taking a greater role in managing international investments.

Moving toward a concrete internationalization strategy will require NOCs to work with their respective governments to establish clear rules, roles and responsibilities, which will be more conducive to maximizing the benefit of an NOC internationalization strategy.

Pitfall: minority interest

NOCs have typically acquired minority stakes in international assets and have had limited influence on operations and management, and limited control over commercial outcomes.

NOCs do have several levers, however. For example, in the case of a refinery, the exporting NOC can negotiate with the partner on the design, to ensure maximum usage of the crude slate. By appointing an EPC company that they have used for previous projects, the NOC can use that relationship and negotiate better prices for other projects. In the case of an upstream investment, the domestic NOC can insist on using more local content to increase in-country value and meet political objectives. Another example would be the right to pre-empt any dilution of the stake of a joint venture partner by having the right of first refusal; this will ensure the NOC can exclude partners whose objectives are not aligned to the NOC.

Of course, the NOC will have to grant concessions to the partner, for instance operatorship to the NOC of the host country. While this does increase the risks, the investing NOC can reduce these by arranging partial funding for the projects, and maintaining visibility and control through taking critical roles in the management of the asset, from investment through to operation. This will allow the investing NOC to exert indirect influence and closely monitor the progress and performance of the project.

The NOC can maximize the benefit of internationalization by:

- Establishing clear governance structures to evaluate international investment opportunities to maximize value
- Looking for opportunities to influence decisions in their business ventures – i.e., actively influencing those elements that will enhance the NOC's profitability and commercial positioning
- Developing skills and competencies to become a more committed investor, majority owner or operator – Saudi Aramco's acquisition of majority stakes in oil refineries in South Korea and the US is a good example

Pitfall: governance

Effective corporate governance is essential to successful internationalization initiatives. According to Transparency International's *Promoting Revenue Transparency: 2011 report on oil and gas companies*, NOCs lag behind IOCs in reporting on anti-corruption programs, organizational information and meaningful country-level reporting on international operations. However, NOCs that support the Extractive Industries Transparency Initiative (EITI) and operate in multiple countries tend to have better defined transparency and reporting practices.[3]

Home jurisdiction plays an important role in shaping corporate governance and reporting standards. Notably, most of the NOC-dominated regions also happen to be emerging countries (Middle East, Latin America and Asia) with lesser developed reporting practices. Therefore, NOCs (especially those with operations limited to their home country) with significant internationalization ambitions, will need to focus time and effort on developing high standards of corporate governance before acquiring assets and businesses or raising capital in overseas markets.

Conclusion: integrate for successful internalization

An internationalization strategy presents NOCs with opportunities to diversify, grow their businesses, improve returns and benefit their owner governments. To exploit these opportunities, NOCs need to shift their approach towards more autonomous decision-making with standardized operations and governance.

Many of the benefits of internationalization are synergistic. In order to tap into these benefits, NOCs need to integrate their international assets into their overall portfolio. A simple expansion of their international footprint may yield limited synergies, while the initiative may require significant investment of resources, including capital.

In order to maximize value, synergies and efficiency, NOCs must integrate global assets and activities – an action which may be all the more demanding given their government-centric structures and goals. However, if NOCs are to compete effectively, they must consider reconfiguring their approach, so as to ensure the transfer of knowledge and best practices across diverse holdings and geographies.

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[3] *"Promoting Revenue Transparency: 2011 report on oil and gas companies," Transparency International and Revenue Watch Institute, 9 March 2011, ©Transparency International.*

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