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READERS’ FORUM - Shifting Business Models and Changing Relationship Expectations of IOCs, NOCs and OFSCs

This commentary has been prepared by Ali Aissaoui, Senior Consultant at APICORP. The author wishes to thank, while absolving from responsibility, the many readers who contributed ideas, comments and feedback. For privacy purposes, the names of those quoted have been abbreviated to their initials.

1. The relationship between International Oil Companies (IOCs) and National Oil Companies (NOCs) has been a good caption for conferences for some years. These gatherings have generally followed each other with only slight variations in their basic theme of how to ensure cooperative partnerships in the face of global business challenges. The relationship has also been a recurrent feature of studies by management consulting firms. In contrast to open debate, however, most such firms have focused their in-house research on the increasing threats IOCs face as NOCs upgrade their technology and human capital and extend their reach beyond national borders.

2. To better explore the changing landscape of the oil and gas industry in this regard we have reframed the debate by raising greater awareness of the role and importance of a third industry player: the oilfield service companies (OFSCs). More specifically, we have asked informed readers how they perceive the shift in the business models and relationships of the three players taken together. While all respondents have kept to our terms of reference, some have additionally taken stock of progress achieved by the International Energy Forum (IEF) during its last NOC-IOC Summit and offered forward-looking and viable proposals. They have also suggested, in support of their arguments, a comprehensive typology of the different players which, unfortunately, could not be included in this commentary, because of editorial limit.

3. Accordingly, the commentary is organized in two main parts. The first reviews our contributors’ perception of shifting business models; the second discusses changing relationship expectations and requirements. But before that, the following is a reminder of how we reframed the debate.

Reframing the debate

4. In a context, where NOCs are arguably gaining prominence (increasing self-confidence and enhanced competence in dealing with large project portfolios, project management and operatorship) and where project financing constraints have loosened (thanks to higher oil prices and improved capacity to generate growth capital), we have tentatively reframed the issue around three points. First, the traditional debate about NOC-IOC relationship and its premises (securing equity oil in exchange for access to capital, advanced technology and managerial expertise) would be incomplete without an examination of the role and contribution of the OFSCs. Second, some NOCs may perhaps prefer collaborating directly with OFSCs, avoiding as a result contentious policy issues that are political in nature such as resource conservation and depletion, modulation of production (in OPEC member countries) and partners’ strategies and rent-sharing. Third, OFSCs seem to have found a way around IOCs in dealing with NOCs. They have been developing and offering new upstream services (seismic, exploration, drilling, engineering and construction) and extending their business models to include consulting and project management. At the same time, they have adopted more creative strategies geared towards dealing with NOCs on a long-term win-win basis.

5. In this context, the key question we put to our readers is: Can IOCs still differentiate themselves from OFSCs in their dealings with NOCs and business offerings (adding more value to their services and lowering their expectations on returns) in order to book more reserves on their balance sheets? Or are they facing a losing competitive battle?

Shifting business models

6. Most contributors among our readers have expressed the conviction that the NOCs and, to a lesser extent, the OFSCs are gaining increasing power and influence, whilst the IOCs’ importance is being progressively reduced in terms of both technical skills and reserves booking.

Diminishing technical skills

7. The diminishing skills of IOCs may have their roots in the outsourcing phenomenon that has accompanied globalization and the search for more productive and profitable models of entrepreneurship. In this context, PW, a Paris-based policy analyst and formerly an executive with a leading IOC, observes that IOCs made the fateful mistake of stopping investment in R & D in the 1980s. He contends that:

This space has been taken over by OFSCs which have provided much of the science and engineering behind many of the most important innovations of the last 30 years or so: horizontal drilling, 3D seismic, hydraulic fracturing, reservoir simulation, etc. Holding the keys to these technologies has allowed OFSCs to establish strong relationships with NOCs, which fit much better for an NOC that wants to be seen as being in charge – managing an OFSC contract looks better than having an IOC doing the work by actually hiring an OFSC and adding a markup.

8. The view of growing doubts over the IOCs’ role in technology is supported by PS, a London-based senior energy policy researcher:

It is becoming apparent that much of the command in the technology lies in the OFSCs. If you need horizontal drilling you don’t have to go to the IOCs.

9. However, even though the argument about diminishing technical skills is relevant it needs to be nuanced. PW for instance make a case that, after all, IOCs have still niche competitive advantage and, accordingly, a part to play:
10. This argument is further supported by PS who sees geoscience as a key field where IOCs have retained their dominance.

Drilling horizontal wells is fine and dandy but someone has to decide where to spud the wildcat. It is interesting to observe that the really successful NOCs such as Saudi Aramco, Petrobras, Petronas and Statoil for example have all put huge resources into training up their geo-scientists.

11. However, at the same time as adding further weight to the argument, PS remains somewhat cynical:

[...] while individual hard technologies lie in the OFSCs, the IOCs are still excellent at managing very large projects. Thus they command the soft technologies of managing risk on projects. However, such a view received a very unfavorable response in Kazakhstan following their experiences with large-scale field developments (or rather the lack of them!).

Lower booked reserves

12. Instead of catching up with R & D, IOCs have worked their way up through long-standing relationships. Ultimately they ended up taking risk service contracts with little oil price upside and limited reserves booking compared to other contractual and fiscal regimes. As elaborated by GL, a Geneva-based academic in the area of industrial and energy economics:

While in the 1990s there was a widespread expectation that IOCs would be able to continue to expand their reserve base, it is now clear that they are fighting an uphill battle. Reserve expansion is limited to creep and venturing into remote, extremely difficult plays such as the Arctic. For smaller reserves located in new producing countries, it is frequently the independents that get there first.

13. But booked reserves may no longer be presented to investors and credit rating agencies as relevant. A point taken by PS who expects that:

[...] progressively IOCs will start telling analysts that booking reserves is not so important after all - helped in this by the increasingly blurred line between conventional and unconventional oil - see what Venezuela just did with their reserves. If you start including non conventional reserves, you can easily book very large volumes - although the exploitation rate may be very slow.

* Editor’s note: PS refers here to PDVSA’s booking of part of the Orinoco’s large extra heavy oil deposits (oil sands).

Lower returns

14. Rather, the key challenge IOCs face is in relation to creating value for their shareholders. According to PS:

IOCs are still dominated by a financial strategy that first emerged in the early 1990s anchored in what is known as “value-based management”. Put simply this says if the company cannot earn a rate of return on its investment projects at least as good as projects in the same sector, they must give the money back to the shareholders and this they have been doing in bucketsful. The reason they are struggling to get the required return is that [...] they can hardly get access to low cost reserves.

Running out of options

15. Few options are left to IOCs. Because the downstream is inherently incapable of generating profits, IOCs have come under growing pressure to divest related assets, many of which are likely to be bought by the NOCs. The remaining options can typically be narrowed down to natural gas, unconventional oil, and deep-water operations. This notwithstanding, PS offers a pessimistic view:

Gas is currently uncertain because of the uncertain outcome of the “shale gas revolution”, even though IOCs have been moving into US shale gas in ever-greater numbers. Unconventional oil has the potential to cause serious damage to corporate green credentials and deep-water is still struggling under the aftermath of the Macondo spill. Thus the prospects for IOCs are not good. [...] Further mega-mergers with current corporate structures are unlikely given concerns over competition issues. It is therefore unlikely that the IOCs will be able to survive in their current form.

16. If IOCs are not expected to survive in their current form, what further options are left to them? PW briefly conjectures that:

IOCs are fighting an up-hill struggle as NOCs’ competencies increase and the importance of providing capital diminishes. So you see more emphasis on IOC’s R & D budgets increasing in recent years and some partnering with OFSCs - if you cannot beat them, join them!

17. But GL has a more nuanced view. While contending that IOCs could hardly stand a chance of differentiating themselves from OFSCs, he argues that:

There is nothing that prevents OFSCs from signing contracts with a risk element and an upside [reward] linked to performance, and/or to ally themselves with financial intermediaries to offer complex packages including financing, which they actually already do. In fact, I fully expect that IOCs will move and more look like OFSCs. To make just one example of a company that is at the same time an IOC and an OFSC, the future of ENI may well be SAIPEM (to some extent it is already). In fact, the only value added that IOCs can offer to [host] governments is a plurality of interlocutors. That is, one may wish to have the IOCs around in order not to depend exclusively on the local NOC - for fear that it might end up controlling the government rather than the other way around.
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18. The fact that not all NOCs are competent leaves some space for IOCs. Lack of sufficient managerial capacity is sometimes coupled with financial weakness due to bad governance of the state and/or of the company. In this context, managerially and financially weak NOCs would rather seek the support of IOCs to implement projects. This, however, may not stand up the changes anticipated by PS:

The NOCs will come under increasing pressure to improve their performance. This will force them into greater use of the OFSCs. It will also increase commercial pressures. All this suggests that the national mission of the NOCs may become a thing of the past as producer governments grow in confidence (and capacity) to provide the national mission operations by other means.

19. The shifting business models reviewed previously are aptly summed up by JVM, a London-based independent energy policy consultant, who concludes a comprehensive contribution by stating that:

[The business models and relationships of] the IOCs, NOCs and OFSCs are changing as the OFSCs offer more and more services, sometimes specialized, sometimes aggregative. The OFSCs’ advantages lie in their access to global experiences and their ability to offer this, without the conflicts which would occur if they themselves were also explorers and developers. At the same time many NOCs and some smaller private sector companies are gaining competence and the confidence to manage contracts directly with OFSCOs, without using the integrative capacity of the IOCs. Some NOCs, at a mature stage of development with strong cash flows, do not require the finance IOCs bring.

Changing relationship expectations

20. Shifting business models of IOCs, NOCs and OFSCs may spur changes in relationship expectations, a point highlighted by JVM, who capitalizes on the outcome of the IEF’s NOC-IOC Summit to offer guidance. The Forum debate, which took place within the framework provided by the IEF’s background paper, pondered over the new challenges facing the industry and came up with far-reaching ideas of cooperation. The tone was set by Khalid al-Falih, Saudi Aramco’s CEO, in an opening statement titled “Addressing the Real Sustainability Challenge”. Al-Falih pointed to the “emergence of a third-generation of social expectations” and a new paradigm of cooperation to address the corresponding challenge. What he hinted at is that IOCs and OFSCs should accept sharing responsibility which NOCs carry for promoting the socio-economic development of the countries in which they operate.

21. The Forum’s concluding statement could not ignore this. In instructing the IEF Secretariat to work with the IEF Industry Advisory Committee (which contains NOCs and IOCs but not explicitly the OFSCs) “to formulate a set of general principles or best practices defining successful cooperative schemes between NOCs and IOCs”, emphasis was put on the “need to explore new models of cooperation that go beyond simple resource development, and integrate host nation’s expectations”. According to JVM:

[These principles] are likely to include commitments to host countries’ economic development and diversification, access to markets and all segments of the value chain, stable tax regimes and use of negotiation to resolve regulatory and tax issues. Through this process the IEF is engaging IOCs and NOCs in the development of a system of global governance for the oil industry which is broadly based, including government of both producing and consuming countries, and which develops by a “soft” process of consensus, principles, and specific co-operative projects.

22. IOCs, NOCs, and OFSCs need to pay attention to this process, which is transparent and open to their contributions. In this regard, JVM contends that achieving the objectives so set requires political commitment. It may also be helped by attention to the procedures and practices which are addressed in the wider fields of international business, i.e.

- Balancing sovereignty against arbitration or investor protection agreements which may limit sovereign risk to foreign investors such as the IOCs;
- Using the WTO as a platform for ensuring most favored nation treatment for IOCs, NOCs, and OFSCOs;
- Using the GATS as the framework for developing the service sector in producing countries, reducing the cost of development for NOCs and IOCs, and developing technical capacities of the host countries outside their NOCs;
- Using and developing international treaties and organizations for environmental protection.

23. Achieving the relevant objectives is therefore feasible. Nevertheless, as cautioned by JVM:

The NOCs and private sector IOCs and OFSCs have different roots: in the economic development of their country and in the rewards to shareholders respectively. Models of relationships which fail to recognize these differences are unlikely to be sustainable.

Conclusions

24. As usual, our readers have managed to offer insightful and thought-provoking viewpoints on a complex and challenging topic. The overall impression from their remarks is that the NOCs and, to a lesser extent, the OFSCs are gaining increasing power and influence and that the traditional competitive position of IOCs has indeed come under threat. IOCs need to change their business models, which in turn may require changes in collaborative, cooperative relationships. The IEF’s NOC-IOC Forum of April 2011 called for the development of “principles and best practices” to further such changes. Well-informed readers contend that achieving the relevant objectives will require political commitment and due attention to international business procedures and practices.

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3 Ibid. IEF’s Forum Proceedings; also published as an OpEd in MEES dated 23 April 2011.