

The National Oil Company – Transforming the competitive landscape for global energy



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As International Oil Companies (IOCs) work ever harder to build business with resource-holding governments, a number of high profile foreign deals have recently underlined National Oil Companies' (NOCs) ambitions outside their own borders. How can IOCs balance the challenges of growing business on NOCs' home turf while competing with them internationally in an increasingly competitive landscape?

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International Oil Companies historically have been the partner of choice for many major resource holders when facing large, complex or groundbreaking oil and gas development challenges.

However, times are changing. Technology ownership has shifted dramatically from operators toward the oil service sector over the last decade, while the capabilities of many National Oil Companies (NOCs) have grown. In addition, for many governments, a buoyant oil price has removed the need for external financing of some major projects. These factors are combining to place the role of – and business dealings with – IOCs under close scrutiny by some major resource holders.

In parallel, a wave of aggressive international acquisition activity and “super-bidding” by NOCs has raised eyebrows across the industry. China National Offshore Oil Corporation’s (CNOOC’s) ultimately unsuccessful \$18.5 billion move for Unocal dramatically shifted the competitive landscape for mergers

and acquisitions.¹ Additionally, the emergence of NOC consortia, and creative dealmaking by previously conservative NOCs has created a stir in the industry. China National Petroleum Corporation (CNPC), Lukoil, Uzbekneftegaz, Korea National Oil Corporation (KNOC) and Petronas have set-up a consortium to develop gas fields in northwestern Uzbekistan².

Against this backdrop, in conversation with senior leaders from 10 NOCs, Accenture has investigated these companies’ objectives and the role they see for IOCs in that future. Accenture focused on 10 NOCs, each wholly or partially owned/managed by their respective governments. Interviewees tended to be high-level executives with awareness of the company’s long-term business strategies and current

business dealings. A standardized questionnaire was used with each interviewee. In this briefing, we present some of our findings.

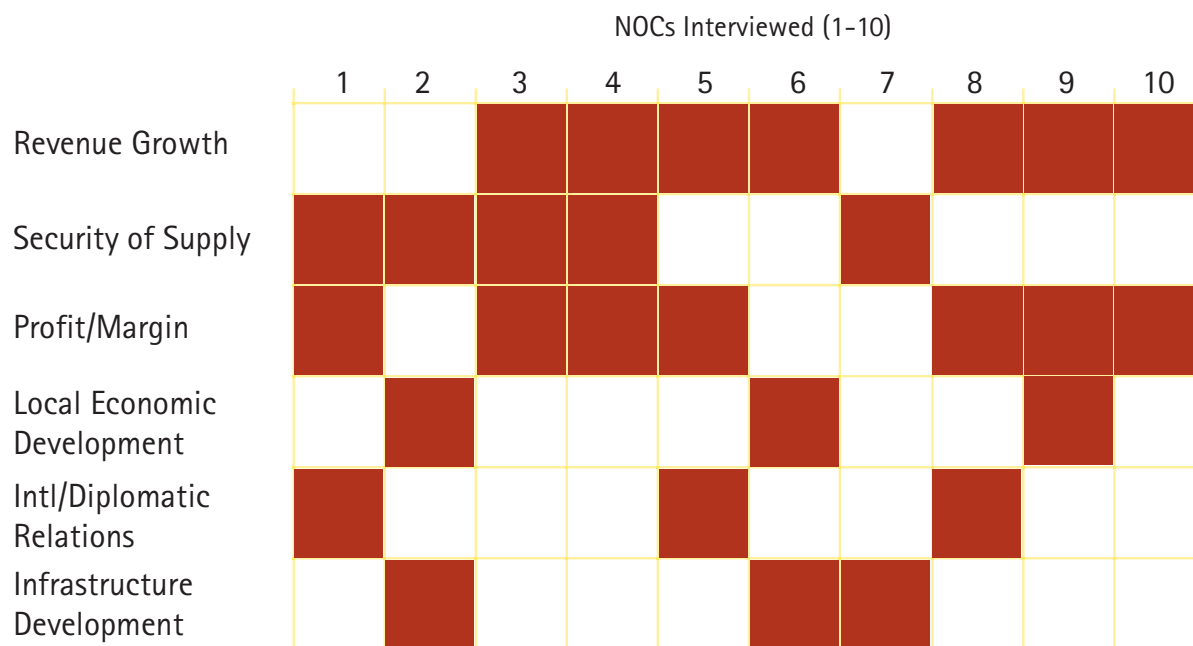
Priorities Differ Widely

Just as governments use NOCs for different national objectives – be it custodian of resource, securer of supply, revenue collector or engine of national development – so NOC priorities vary widely.

All seek the growth opportunities offered by globalization and technology, but each also balances these desires with other priorities.

Figure 1 illustrates the top two to three priorities of the 10 NOCs interviewed. Although all the priorities (revenue growth, security of supply, profit/margin, local economic development, international/

Figure 1. Top 2-3 NOC Priorities



diplomatic relations and infrastructure development) are relevant to all the NOCs, when asked to name the top two or three, the responses were very different. No single priority made the top three in all 10 NOCs Accenture interviewed. This variation means that for the IOCs, there is no substitute for detailed knowledge, intimacy and on-the-ground insight, understanding not only the NOC but the government that it serves.

The Deal Remains King

NOC executives tend to be reluctant to distinguish preferred characteristics for a business partner, instead citing the deal-specific nature of any relationship. Relationships between NOCs are becoming longer term and more strategic. Relationships between NOCs and IOCs, however, appear to be becoming increasingly transactional. BP's and Statoil's relationship is now much more project based compared

to the strategic alliances they enjoyed in the 1990s.³ This deal-by-deal mindset may be troubling for IOCs who aspire to create longer-term relationships with NOCs, hence avoiding diverting and time-consuming cycles of bid and deal-making activity. The recent signing of a Memorandum of Understanding (MOU) between Shell and Oil and Natural Gas Corporation Ltd. (ONGC) for joint cooperation in the energy supply chain in India and globally is a positive sign.⁴

All of our NOC interviewees indicated openness to new deal types and relationships beyond the traditional Joint Venture (JV) or Production Sharing Contract (PSC). When asked about preferred partnership structures, one representative we interviewed said it best: "No fixed way as long as there are benefits."

Definitions:

NOC or National Oil Company
A company which is wholly or partially owned by the Government

IOC or International Oil Company
A company which is fully private and shares are held by private entities

MOU or Memorandum of Understanding
A legal document which is signed as a precursor to negotiations for a full contract

Oil Value Chain
All sectors of the oil and gas industry – upstream, downstream and gas

Resource Holder
Government or National Oil Company which owns the country's oil and gas reserves

Integrating & Internationalizing

Every NOC executive with whom we spoke had clear ambitions to both internationalize and broaden across the oil and gas value chain. In 2005, NOC deal activity reached an all time high. Figure 2 illustrates NOC merger and acquisition deals from 2000 to 2005.

CNOOC and CNPC, for example, already derive around one-third of their revenues from overseas, and based on recent signals that figure is likely to grow substantially.⁵

This internationalization suggests that IOCs now will come face to face with NOCs more often, not only as customers, partners or custodians in developing a host country's resources, but as commercial competitors on the world stage. And these demand-side NOCs are formidable competitors, changing the "currency" of competition by making deals with a wider and

longer-term strategic value compared to the traditional standalone project net present value analysis.

For example, India has offered lines of credit up to \$1 billion on a government to government basis to West African nations for infrastructure projects in exchange for oil exploration rights⁶. CNPC committed to the local economic development in Kazakhstan through investment in power stations, chemicals, plants, railways and gas pipelines.⁷

IOCs Still Have a Role

Encouragingly, most NOCs do still see a clear role for their international cousins. A number of executives we interviewed cited both IOCs' downstream assets and technology capabilities – in particular LNG, GtL, secondary recovery, unconventional oil, ultra deep-water and alternative energy/fuels.

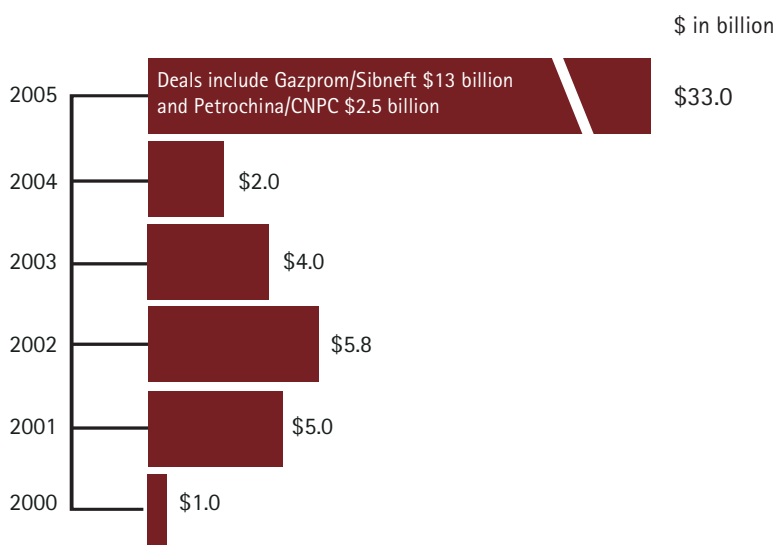
In addition to these types of hard-edged capabilities, IOCs'

tough-to-replicate market, trading and infrastructure linkages continue to present an appealing strategic offer to many hosts.

Firstly, the presence of a large IOC can send a signal to the international community that a country or market is really opening up, which is vital when emerging from a period of isolation. Such has been the case in Libya, where companies like BG, Chevron and Occidental, were all successful in recent licensing rounds.⁸

Secondly, partnering with IOCs can get NOCs access to assets or deals an NOC might not be able to access alone. This is particularly true of LNG deals which are viewed as being complex and technically challenging. For those NOCs which are inexperienced in this area, an IOC partner is very valuable. This particular point was highlighted in our interviews.

Figure 2. NOC Merger and Acquisition (M&A) Deals (2000 – 2005)



Source: J S Herold

Definitions:

Integrated Oil Company
A company which operates in all parts of the value chain from wellhead crude production to retail sales of refined petroleum products

LNG
Liquefied Natural Gas

GtL
Gas to Liquids

How Should IOCs Respond?

IOCs now face a market in which they have to both do business with and compete against a varied and sophisticated group of internationalizing NOCs. How can they respond? We see five capabilities as being critical – and crucially, most are equally important both to working with an NOC on its home turf, and to compete effectively internationally:

1. Know the resource holder
2. Tailor your strategy
3. Play integrated across the value chain
4. Broaden local content
5. Excel at technology and the basics

Know the Resource Holder

Having recognized that a new breed of competitor has emerged, to compete effectively, IOCs must now evolve their strategies. IOCs need to understand this new "currency."

A common characteristic of successful IOC country entries that Accenture has observed has been heavy in-country activity well ahead of any deal, focused on understanding the people, organizations, culture and processes at work in the host. Only through this degree of insight can IOCs develop a differentiated commercial offer aligned to the needs of the resource holder. While broad-brush characterizations

of NOCs may be tempting, the huge variation in NOCs' commercial and political roles, decision-making processes and aspirations mean that IOCs cannot short-cut this on-the-ground intelligence gathering and relationship building.

Figure 3. Relationships between Governments and their NOCs

Control	Operation Framework	Privatization	Pricing and Sales	Trade Restrictions	Fiscal Framework
<ul style="list-style-type: none"> • State Ownership 	<ul style="list-style-type: none"> • Joint Venture 	<ul style="list-style-type: none"> • No Privatization 	<ul style="list-style-type: none"> • Sales to government at market price 	<ul style="list-style-type: none"> • Import restrictions 	<ul style="list-style-type: none"> • Specific petroleum taxes
<ul style="list-style-type: none"> • Private Ownership (foreign restricted) 	<ul style="list-style-type: none"> • PSC 	<ul style="list-style-type: none"> • Privatization underway 	<ul style="list-style-type: none"> • Sales to government at fixed price 	<ul style="list-style-type: none"> • Export restrictions 	<ul style="list-style-type: none"> • Negotiable petroleum taxes
<ul style="list-style-type: none"> • Private Ownership (foreign unrestricted) 	<ul style="list-style-type: none"> • Concession 	<ul style="list-style-type: none"> • Privatization substantially complete 	<ul style="list-style-type: none"> • No restrictions on sales 	<ul style="list-style-type: none"> • Import and export restrictions 	<ul style="list-style-type: none"> • No specific petroleum taxes
<ul style="list-style-type: none"> • Combination-dominance of state 	<ul style="list-style-type: none"> • Service Agreement 	<ul style="list-style-type: none"> • Always in private sector 		<ul style="list-style-type: none"> • No restrictions 	
<ul style="list-style-type: none"> • Combination-dominance of private 	<ul style="list-style-type: none"> • Mixed 				

Figure 3 summarizes the variety of relationships that can exist between governments and their NOCs and the extent to which the government plays a role across the entire value chain. These can vary significantly across NOCs.

For example, an NOC might be state owned, with a mixed operation framework and no privatization. There may be no restrictions on sales or on trade. The fiscal framework may include specific petroleum taxes.

In addition, IOCs cannot assume that NOCs from the same region all have the same priorities or relationships with their governments. While they may share some common characteristics, other factors (such as control structures) may be quite different.

Tailor Your Strategy

Against this backdrop of company-specific knowledge, each IOC needs to develop highly tailored strategies to target and cultivate relationships with its key NOCs.

For example, in Nigeria, the development of downstream energy infrastructure and assets was a key element in licensing rounds last year. Due to the stand-alone economics, IOCs were reluctant to make this investment. CNPC, Sinopec and CNOOC were willing to invest in the downstream. Open bidding was used to establish a fair price. The Chinese, as strategic partners, were given the right of first refusal, and were awarded the assets.⁹

The strategy must be based not only on deep knowledge of the NOC involved, but also on a strong sense of self-awareness. The leading IOCs all offer competitive scale, expertise and track records, but there is a need to differentiate themselves from each other in many NOCs' eyes. Understanding these perceptions enables IOCs to create a strategy that both plays

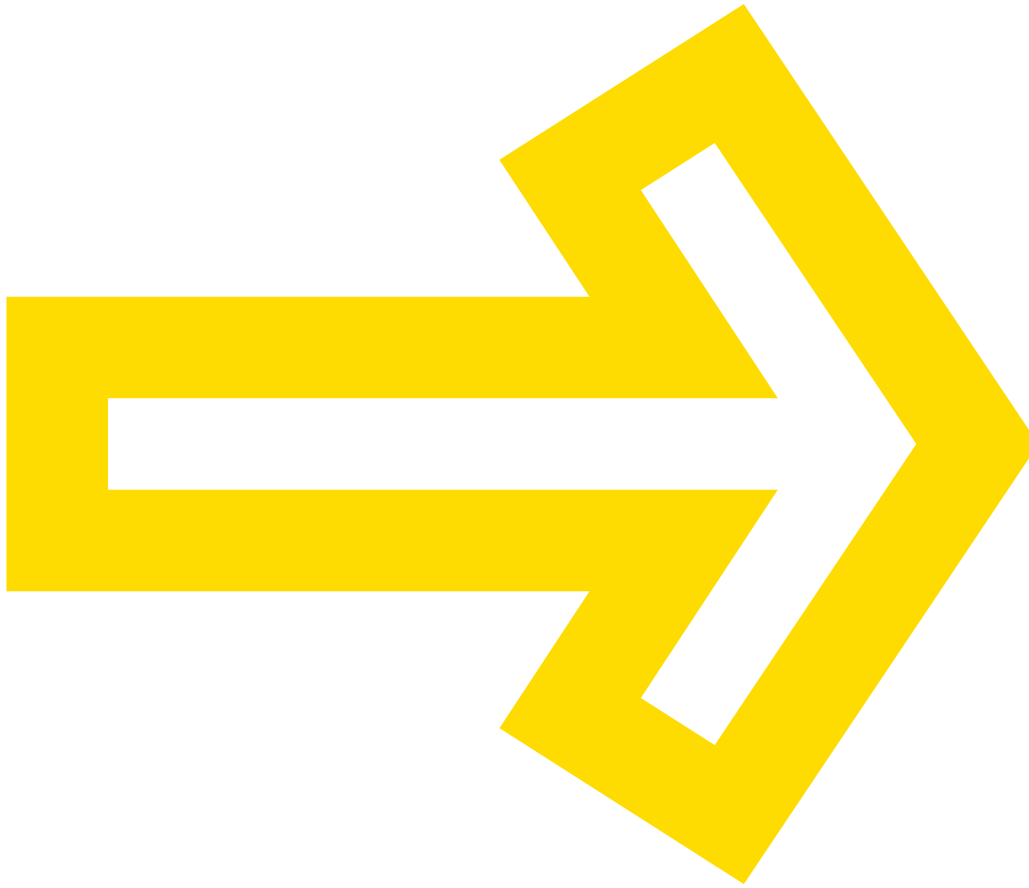
to their own strengths and differentiates themselves from other IOCs.

Finally – and perhaps most difficult – IOCs have to develop a view on how the value of relationships fits into their overall commercial framework. Competing in one market while being venture partners in another is traditionally how the oil industry works. This structure has evolved as oil exploration and production has required substantial investment and ever increasing risk as “easy oil” becomes a thing of the past. This partner/competitor dynamic is magnified as the IOCs both partner and compete more with the NOCs. For example, IOCs will be dealing with the NOCs in key target downstream markets like China and India, but competing against them in international upstream sectors like West Africa and the Caspian.

Play Integrated Across the Value Chain

For IOCs, scale, complexity and integration in deals offer the best opportunities to differentiate between both each other and against NOCs. As projects link across geographies, value chains and markets, the global scale and asset base of the IOCs provide a competitive advantage.

The major LNG developments of recent years best exemplify this phenomenon. A combination of huge scale, along with technical and market complexity has created strong conditions for IOC participation in Qatar. Libya is following a similar strategy as is indicated by the signing of the Marsa-el-Brega LNG project with Shell; this deal adds substance to Libya's expressed desire for downstream investment



to accompany upstream awards.¹⁰ With this in mind, IOC business developers need to act integrated at every opportunity, blending their exploration and production, gas and power, downstream, and chemicals businesses as necessary to build a more appealing commercial deal. They need to be willing to bring all of their assets and capability to the deal.

The geographic flexibility and sophistication of IOCs is also appealing to NOCs.

The topic of swaps came up often in the interviews. In the past, many IOCs were not too keen on swaps because, theoretically, there is no value created (zero-sum). However, to the NOCs, swaps had a clear strategic (option) value because the swaps enabled the NOC to do something else (e.g., gain experience in a technology, enter a market). For example, the

asset swap between Shell and Gazprom gave Shell assets in the heartland of Russia's oil and gas province and Gazprom a stake in Sakhalin LNG.¹¹

Broaden Local Content

Historically, IOCs have adopted a philanthropic approach to country contributions and tended to invest in a collection of worthwhile social initiatives related to matters such as health, education and the environment.

The IOCs that have moved beyond a philanthropic model to one that contains elements that meet the long-term strategic goals of NOCs and the nations that they serve (e.g., economic and infrastructure development, internationalization, environment, etc.) are those that have been more successful in winning business and securing a license to operate. For example,

in Trinidad, BP has committed to working for the long term development of the nation by investing in the local supply chain, education and community projects.¹²

This means looking beyond short-term philanthropic contributions and considering, for example, environmental protection (to avoid flaring or dumping) and long term skills development for local workforces, with the intent of handing over operations.

Thinking long-term means leveraging everyday local business, employment and supplier spend. For example, the IOC that genuinely integrates itself to maximize its use of a local workforce and supply chain can make a substantial impact on the economy, while at the same time benefiting from a simplified sourcing model and economic savings on import premiums.

In Accenture's experience, that type of winning offer extends well beyond adherence to "local content" requirements in project plans, and includes elements such as:

- Energy security
- Trade development
- Broad-based job creation and industrial development
- Developing NOC capability
- Environmental protection

To maximize the impact of this type of offer, IOCs must become adept at conveying the dimensions of value that they bring.

While the dominant source of value is likely to be derived directly from monetizing resources – inevitably the main focus for IOCs – the contribution made by adopting local supply chain and labor

resources, coupled with less tangible impact on national skills, standards and capability development can add considerably to create a compelling offer.

However, implementing the social and developmental aspects of national development has been enormously challenging for many technically and commercially-inclined IOCs. There may be a misperception that this is a zero-sum game. However, local supply and skills development should be a win-win, reducing the overall cost of operations.

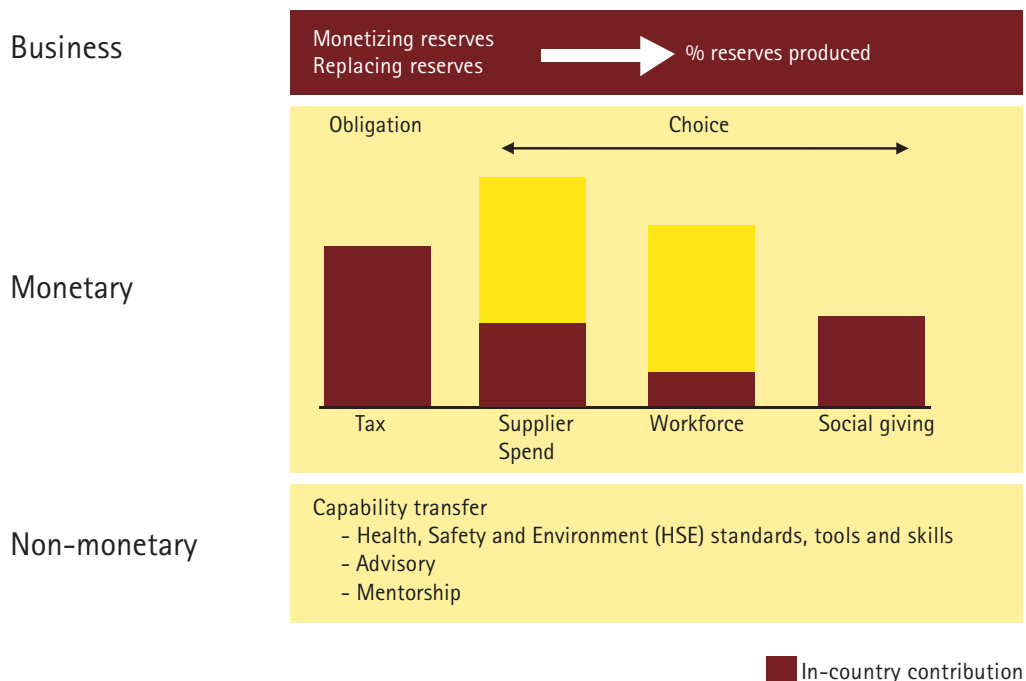
Excel at Technology and the Basics

Undoubtedly, deals in which technology and the management

of complexity are key form the natural battleground on which IOCs differentiate themselves from one another and to host governments. The capabilities required for an organization to deliver these projects are difficult to replicate or acquire in the near-term. If IOCs can craft enough of these opportunities, their role in both markets will be safeguarded, leading to a more competitive global marketplace.

Additionally, IOCs likely will remain the developers of choice for much of the activity emerging from the technical fringes of traditional business, such as GtL, the hydrogen economy and some areas of renewable energy.

Figure 4. Different dimensions of a country offer



However, many opportunities in the future – particularly on NOCs' home turf – will offer neither this technical nor commercial complexity on which IOCs naturally thrive.

In such "commodity" projects the basis of competition is around operational excellence – simply delivering the basics of the business more efficiently and effectively. A number of high-profile project overruns over the last year has tarnished IOCs' track records. Examples such as Aera Energy's extraordinary application of "lean manufacturing" principles to field development in California offer lessons to other IOCs.¹³

Capital project management is an area where IOCs often claim to offer leadership, but in Accenture's

experience, is one which still offers significant opportunity for progress. An innovative IOC that can operate this type of project with both ruthless cost efficiency, and unparalleled effectiveness in hydrocarbon recovery, could potentially create a new "premium market," where its technical and operational capabilities differentiate not by doing "what others can't do," but by doing what others can do in a demonstrably superior way.

IOCs that can credibly demonstrate this capability will be positioned well to address not only the new competition presented by NOCs, but also the emerging role of service companies as a pseudo-substitute for IOCs in a number of markets.

**"We mainly look to IOCs to share the risk of big projects with us. We also look for their technical experience around gas."
NOC Executive**

Definitions:

Host Government
Government with whom the National or International Oil Company is negotiating for access to oil and gas resources

Swap
An exchange of one or multiple assets whose standalone valuation (net present value, cashflow, etc.) remain the same.

Summary

This emerging competitive landscape will now see IOCs facing NOCs on two fronts:

1. In open international markets, where NOCs now represent both a potential venture partner or commercial competitor
2. In major resource holding nations, where the NOC typically fulfills its traditional role as custodian and assurance vehicle for the state

These NOCs have very different priorities that will shape the right approach. Accenture believes that to compete effectively and balance this dual relationship in either environment, IOCs will have to master a basket of at-times unfamiliar skills.

Where possible, IOCs should aim to create deals that offer the technical and commercial complexity in which their capabilities are difficult to replicate. The "currency" of competition is changing and deals are being made across a wide range of assets and capabilities, across a long term horizon.

In the less challenging technical and commercial environments that

still represent the bulk of major resource holders' portfolios, IOCs can more confidently compete by improving their ability to deliver differentiated levels of operational excellence in cost focused environments. However, for firms whose cost structures and process burdens can appear cumbersome to hosts, without radical change, those may be tough claims to make.

In dealing with NOCs and their host governments, IOCs need to establish a clear strategy founded on a deep knowledge of their potential partner, competitor or host. This strategy needs to position the IOC not only with the NOC, but also respect the objectives of ministerial, government-

tal and other key stakeholders. An important part of the strategy increasingly must focus on delivering a comprehensive and clearly articulated local content based on developing local supply and workforce that ultimately will lower operating costs and create a more commercially efficient long-term situation. This offer should genuinely create value to NOC nations far beyond that achieved by philanthropy and simple compliance with local contracting requirements.

IOCs that can master these skills will be well placed to deal with the fast changing role of their dynamic NOC counterparts on their journeys to high performance.

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