NATIONAL OIL COMPANIES NEED TO UP THEIR GAME

To compete with the majors, NOCs must improve their enterprise risk management

Alexander Franke and Volker Weber

National Oil Companies (NOCs) and their governments – just three years ago riding a wave of $100 oil – today face unusually trying times. Thanks to a plunge in oil prices, at one point to below $30 a barrel, NOCs are earning about $170 billion less than they did a decade ago, even as their sponsor governments are being asked to spend more on defense, social programs, and infrastructure.

$170 billion

How much less NOCs are earning than a decade ago

The result: Many parent governments are confronting daunting budget deficits for the first time. In 2016, Qatar reported its first budget deficit in 15 years, while Saudi Arabia reported its largest shortfall ever the year before. Cumulative government net lending and borrowing by members of the Organization of the Petroleum Exporting Countries (OPEC) went from a net positive $188.12 billion in 2012, to negative $312.79 billion by the end of 2016, based on data and 2016 estimates from the International Monetary Fund's World Economic Outlook. (The calculation excludes Indonesia, which was suspended from OPEC in November 2016.) Between 2014 – the year oil prices took a nosedive – and 2016 alone, OPEC borrowing grew by more than eight times.

LOOKING FOR A BOOST IN NEW PLACES

The pressure is rising, not just on governments, but also on the NOCs, especially those that supply oil-dependent nations with the overwhelming majority of their revenue. To overcome the volatile economics of the oil market and buy access to new, expanding markets, the NOCs have been actively investing for more than a decade in operations outside their home countries.

The most recent example of this strategy is Saudi Aramco's $7 billion deal for a 50 percent stake in a massive oil refinery project being developed by Petronas, Malaysia's NOC, in the southern state of Johor, near Singapore.

The investment, which officials say will make Aramco the biggest foreign investor in Malaysia, is expected to help the Saudi NOC increase business in the burgeoning Southeast Asian market.

But despite the sizable outlays often involved, the tactic has not produced the kind of results that the NOCs had hoped to achieve. (See Exhibit 1.) While NOC profit margins have plunged by roughly 8 percentage points since oil prices recently hit $50, the decline actually started in 2006, not long after they began to expand their operations globally. The reason? While international expansion promises benefits, it also has increased the NOCs' exposure to risks ranging from delivery delays, cost overruns, and partner disputes on international projects, to a globally diverse menu of regulatory requirements. With more of their operations stretched across continents, there is a danger that the timelines and budgets for even domestic projects may be affected. Expanding their international footprint also put them at greater risk of "black swan" events, such as sophisticated cyberattacks, that could trigger global operational meltdowns – risks that few, if any, NOCs had even recognized in the past, let alone prepared for.

PUTTING A PRICE TAG ON RISK

If NOCs are to compete globally with international oil majors and match their performance, they will need to bolster their financial resilience and dramatically improve the quantity, quality, and timeliness of their data. A first step would be the development of enterprise risk management (ERM) infrastructures that go beyond recognizing and assessing risks, to putting price tags on the potential threat that each risk presents.

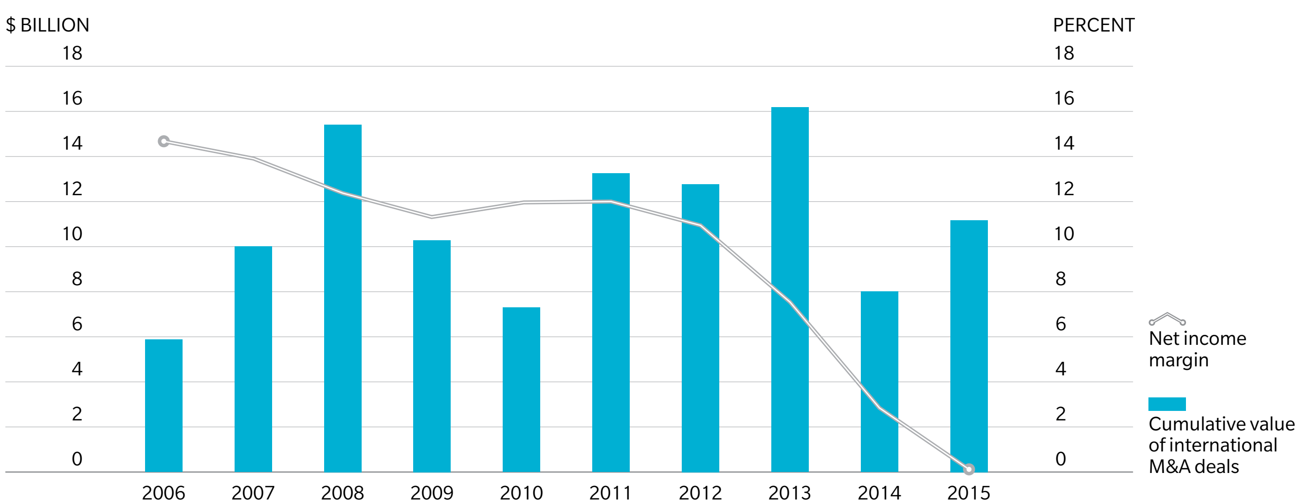
For many years, NOCs were moneymaking machines for their governments, with little incentive to diversify or build advanced data collection capabilities. But with their new role as international players comes a requirement for greater transparency into their systems and information. NOCs need to put ERM to use not just for mitigating risk, but also as a way to drive business.

First, NOCs should develop the kind of enterprise-wide, risk-management systems that embed risk assessment and mitigation into all of their key decision-making processes, such as strategic planning, investments, and business planning and budgeting. This ensures NOC managers timely access to risk-related intelligence and insights that can then be used to navigate through uncertainty and inform decisions on proposed expansions and new projects, as well as active operations.

NECESSITIES OF A RISK CULTURE

That said, senior managers must understand and know how to apply data and insights as they emerge. This will require that NOCs professionalize and formalize ERM by adopting standardized and consistent definitions of risk management concepts and processes, as well

EXHIBIT 1: WAITING FOR A RETURN ON INVESTMENT
National oil companies' diversification overseas has failed to live up to expectations



Sources: EBITDA margin: Sinopec, Petrobras, PDVSA, PetroChina, Pemex, Petronas, Pertamina, Statoil, Gazprom, Rosneft, Socar, Ecopetrol SA, QP (standalone), KPC M&A deals: Petrobras, PDVSA, PetroChina, Pemex, Petronas, Pertamina, Statoil, Gazprom, Socar, Ecopetrol SA, Sonatrach, Saudi Aramco, ADNOC, QP, KPC

Note: Cumulative value of M&A deals from 2006 onwards as delineating the roles and responsibilities of those who manage risk. It all boils down to one thing: establishing a risk culture.

Additionally, NOCs will need to invest in the kind of state-of-the-art automated solutions – typically in use at the major oil companies – that streamline and upgrade internal data flows. Such a framework empowers the entire workforce to protect the enterprise from downside scenarios, increasing a company's organizational resilience and establishing a consistency in how ERM is applied.

As international players operating in a much more public space than many of them are accustomed to, NOCs are taking on new reputational and regulatory risks as they contend with greater scrutiny from foreign entities. Outside their home countries, they lack the clout and control they enjoy on their own turf, thus elevating their risk exposure. One key element of ERM for NOCs will be the need to recognize the vastly different regulatory environments that exist across their enterprises, and develop risk management processes that address the variety of standards and politics.

Ultimately, NOCs will have to analyze their own risk appetites and develop a global agreement among major stakeholders on the amount and type of risk that is acceptable. Without that baseline assessment, NOCs will find it difficult to create the kind of cross-functional cooperation and perspective that will allow them to not only improve their financial performance, but also take advantage of offshore opportunities that allow them to grow over the long run.

Alexander Franke
is a Zurich-based partner in Oliver Wyman's Energy practice

Volker Weber
is a Dubai-based partner is Oliver Wyman's Energy practice

This article first appeared in *Arabian Oil and Gas*