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The Role of National Oil Companies in International Energy Markets

by

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The Baker Institute Energy Forum
Workshop on « The Role of NOCs »

Houston/Texas
May 5, 2005

N05-24

Presentation Outline

- **Introduction**
- **Genesis and mandate of a typical NOC**
- **Impediments to NOC transformation**
- **The NOC/IOC relationship**
- **The Algerian case**
- **Conclusions**

The classic NOC dilemma: Reconciling political and business interests

- **NOCs were created with a dual mandate**
  - Take over and operate IOCs nationalized assets
  - Implement the government energy policies
- **The overall mission was to increase State revenues and act as the engine of the country's economic development**
- **By and large, OPEC NOCs were partly successful in their original dual mission**
  - Aggregate share of world output increased from 10 to 40%
  - Ten-fold jump in combined oil revenues
- **But little progress was made in economic development and diversification in spite of artificially low petroleum product prices**

The public service mandate progressively overwhelmed the commercial function

- **Under the pressure of the State, NOCs paid less attention to the corporate interest**
- **Most NOCs ended up with a broader mandate which included political and social responsibilities**
  - Role of welfare provider within the State
  - Increased contribution to meet social targets (job creation)
  - Non-commercial and non-revenue creating functions
  - Non-energy related services (hospitals, schools, roads, etc.)
  - Involvement in political activities
- **NOCs became super government bureaucratic agencies, managing the State hydrocarbon monopoly and often performing a regulatory role**

The need to reform NOCs is widely acknowledged but progress is slow

- **The objective is to improve performance, be competitive and create value for shareholders**
  - Cut cost and streamline
  - Focus on core business
  - Achieve financial sufficiency
  - Generate profits and pay dividends

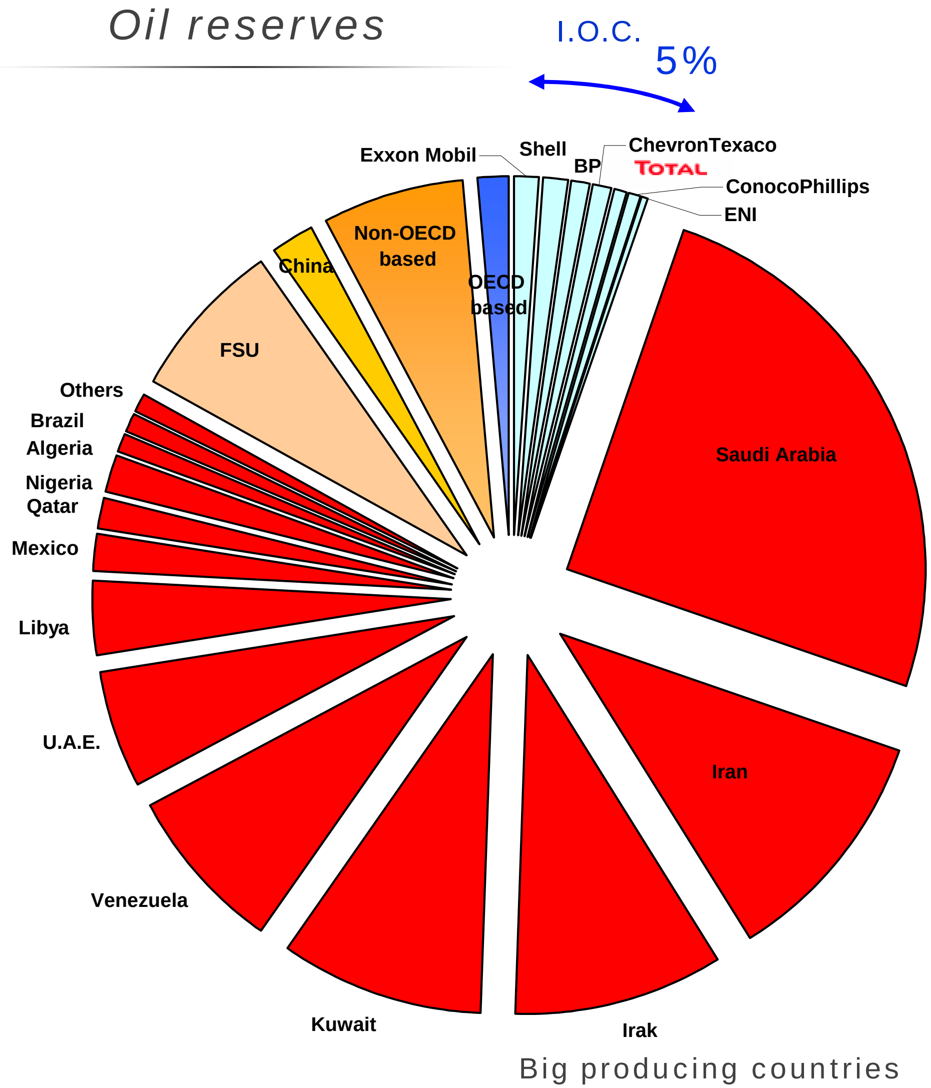
- **This requires, at the very least, a clear separation of the task of defending the national interest from the task of defending the corporate interest**
  - The State should recover and exercise its property/regulatory rights
  - The NOC should focus on its corporate interest

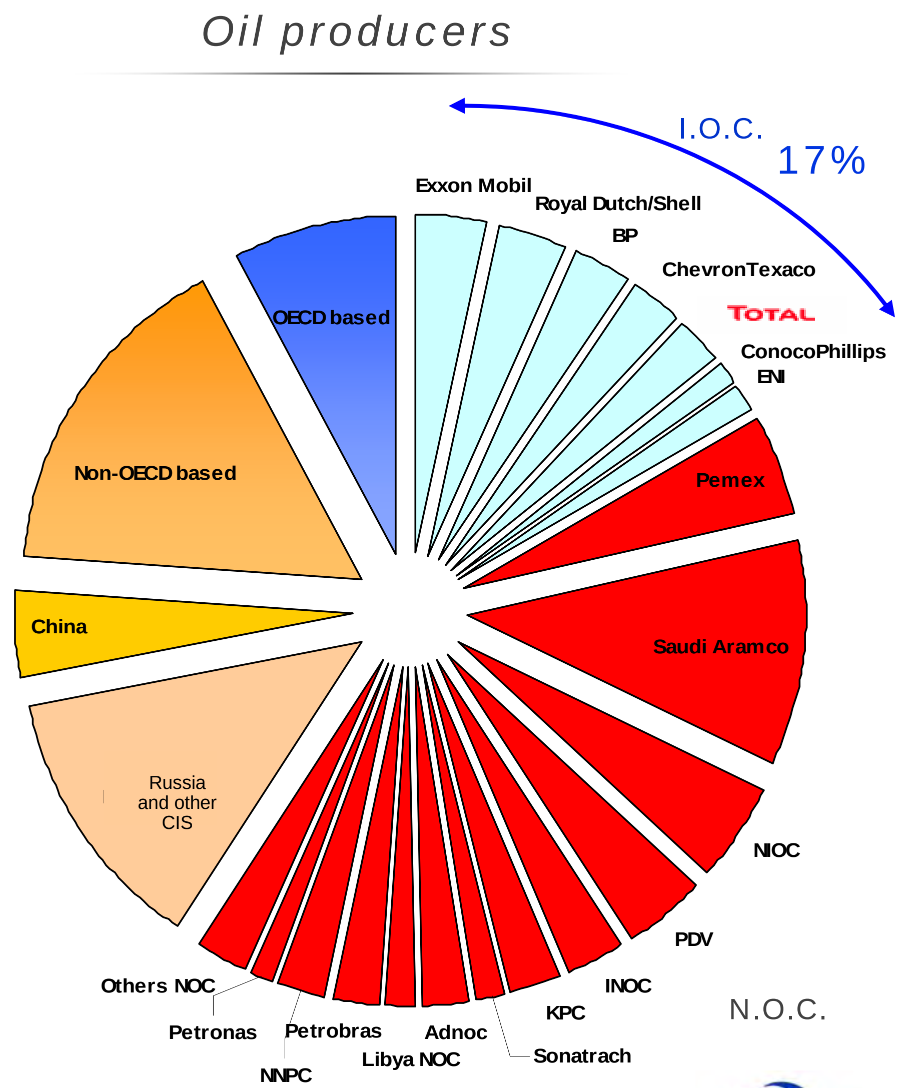
- **But this separation may not be possible as long as the State remains the exclusive shareholder**

The crucial question is whether the State is prepared to deliver its side of the deal

- **Can the NOC be freed from the shackles of political pressure, outside restraints and unwanted interference?**
- **Will the government deal with its NOC as a normal shareholder would? Will NOC's managers be appointed on merit rather than on political affinities?**
- **Will the State allow NOC to function as a commercial entity? Will it have a responsible dividend policy enabling NOC to meet its financial needs for expansion, maintenance and other investment requirements?**
- **If the anser is yes, there is no doubt that NOCs can adapt to the new environment. It is not sure, however, that the political leadership is ready for a change.**
- **Short of privatization, only good governance will free the NOC from excessive State intervention.**

Distribution of world oil reserves and production





Sources : 2002 BP Statistical Review, PIW

Oil production 2002 = 73.9 Mbpd

According to the IEA , the demand for OPEC oil is projected to increase to 50 mmbd in 2020 and 65 mmbd in 2030

(mmbd)	2002	2010	2020	2030	Average 2002-2030 Growth p.a.
World Oil Demand:					
OECD	45.4	49.7	54.4	57.1	0.8
Non-OECD	28.6	37.5	48.8	60.4	2.7
Other	3.0	3.2	3.5	3.8	0.9
Total	77.0	90.4	106.7	121.3	1.6
World Oil Supply:					
Non-OPEC	45.3	51.3	47.9	43.4	(0.2)
OPEC	28.2	33.3	49.8	64.8	3.0
Other	3.5	5.8	9.0	13.1	4.8
Total	77.0	90.4	106.7	121.3	1.6

Source: IEA - World Energy Outlook 2004

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For the period up to 2030, the IEA estimates(1) cumulative investment requirements at $ 6 trillion for the oil and gas sector

(in $ billions)	Oil	Gas	Total	Average Annual Requirements(2)
Global Requirements	2 839	3 145	5 984	199.5
Exploration/Production	2 222	1 731	3 953	131.7
OECD	684	826	1 510	50.3
Non-OECD	1 538	905	2 443	81.4
of which:				
FSU	421	272	693	23.1
Middle East	408	140	548	18.3
Africa	311	153	464	15.5
Latin America	241	141	382	12.7
Asia	156	199	355	11.8

(1) Source: IEA - World Energy Investment Outlook - 2003
(2) For the 2001-2003 period

NOCs and IOCs perceive a mutuality of interest in joining their efforts to meet long-term demand growth

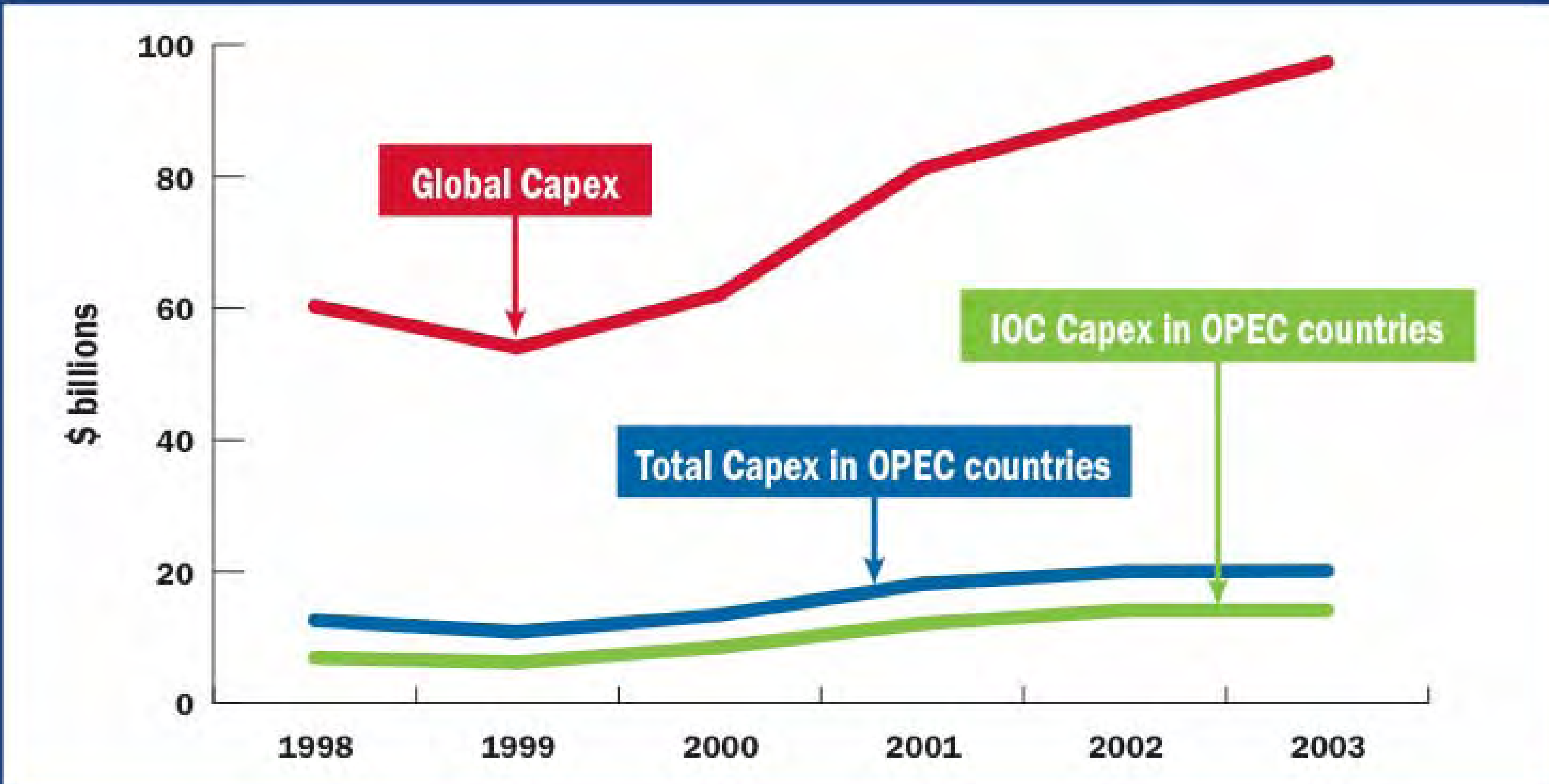
Revenues and techno-logical needs compel OPEC countries to consider new policies vs. private foreign capital

- **NOCs can offer what IOCs need**
  - Access to a proven resource base
  - Opportunities in low cost / low risk ventures
  - Surest way to achieve reserve replacement objectives
  - Large projects to support production growth
  - Potentially attractive returns
- **IOCs can offer what NOCs need**
  - Additional risk capital
  - Leading edge technology
  - Capacity to manage large and complex projects
  - Ability to cut cost and operate efficiently
  - Access to diversified markets

Share-holder pressure compel foreign oil companies to improve performance with low cost/ low risk OPEC ventures

But, in spite of this apparent alignment of interests, limited progress has been achieved so far

International oil company capital expenditures in OPEC countries are only one-fifth of oil industry upstream investment worldwide



Source: Wood McKenzie data upstream and some midstream investment

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The impediments that stand in the way of increased IOCs' involvement in the OPEC upstream are complex

- **National sovereignty considerations/resource nationalism**
- **Unilateral sanctions**
- **Perceived political risk**
- **Perception of an imbalanced relationship between NOCs and IOCs**
- **Terms and economic conditions of access**
  - Do IOCs seek unreasonable rates of return?
  - Why do IOCs use ultra-conservative price scenarios?
  - Are IOCs loosing out to new/more aggressive competitors?
- **Can IOCs operate successfully without stronger political support from their home governments?**

Critical needs vs. political/cultural barriers: The future of NOC/IOC cooperation

- **The trend towards increased IOCs' involvement in the OPEC upstream is inevitable**
  - Global forces are driving the move towards an open market
  - Individual country needs are reinforcing the global trend

- **But the pace will continue to vary from country to country**
  - Fundamental desire to retain control will constrain changes
  - In some countries, the driving force is immediate revenue needs

- **High prices can reinforce resource nationalism and « go it alone » attitudes**

- **Venezuela has demonstrated (together with Russia and Kazakhstan) that it is not a one-way street and Kuwait's hesitations remind us that political and cultural barriers can slow down the process**

- **At the other side of the spectrum, Algeria has recently adopted a very liberal regime**

The new Algerian hydrocarbon law restores the Ministry's prerogatives in exercising the State's rights

- The State retains ownership of the source base
- The Ministry is entrusted with the responsibility of ensuring optimum development of national resources
- The Ministry contributes to the definition of the Government's hydrocarbon policy and looks after the implementation of the new legislation
- The State's property and regulatory rights are exercised by two "independent" agencies under the supervision and control of the Ministry
- The Ministry has the final word on all fundamentals decisions
  - E&P contracts and pipeline concession awards
  - Reference prices for taxation purposes
  - Production levels in line with OPEC quota decisions
  - Exceptions to the bidding process

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The rationale of the new law is to extend to the hydrocarbon sector the Government's ongoing reforms towards a free market economy

- Eliminate the constraints faced by private capital investment in the sector
- Reduce direct state management of resource development
- Enhanced role for foreign investment by opening the entire industry
- End of Sonatrach's monopoly upstream
- Privatization of refining and distribution activities
- Local market price subsidy to be borne by the State
- Sonatrach will compete with private companies on essentially the same terms

Levelizing the playing field between the NOC and private companies

- **The new licensing terms are relatively generous**
- **The PSA contract is replaced by a new fiscal system based on**
  - A variable royalty rate
  - A progressive petroleum revenue tax
  - A corporate tax on profit at the prevailing rate
- **The new regime guarantees**
  - Access to transmission infrastructure at regulated tariffs
  - Free export of foreign equity gas under certain conditions
- **E&P contracts and pipeline concession are awarded through a transparent bidding process**
- **Sonatrach has the option to take a 20 to 30% interest in new discoveries**

The new regime entails radical and far-reaching consequences on Sonatrach

- End of its monopoly status in the national hydrocarbon industry and the attached economic and financial privileges (particularly in the very lucrative transportation sector)
- Transfer all of its mining rights to the Ministry which will reassign to the national company, through Alnaft, the rights Sonatrach wants to retain under the new legislation
- Operate its transmission infrastructure under the proposed concession regime with TPA and regulated tariffs
- Align, in due time, the economic and financial terms of its existing contracts to the new fiscal system
- Enter into a parallel contract with Alnaft to conform to the law Sonatrach's rights and obligations under existing PSA's or Joint ventures without infringing foreign partners' rights

The new regime entails radical and far-reaching consequences on Sonatrach (Cont.)

- **Sonatrach will however remain a preponderant actor in the Algerian hydrocarbon scene**
  - Extensive mining rights
  - Access to a very large share of the resource base
  - Option to participate in any new discovery on attractive terms
  - Ownership of a vast transmission and distribution network and of several refineries and LNG facilities
- **To face the growing competition, Sonatrach is expected**
  - To cut cost, streamline and improve performance
  - To reduce its social role of welfare provider for the State
  - To focus on core business and value creation
- **It must raise its own financial needs (circa US $ 5 billion/year)**
  - Without the State's guarantee
  - With no contribution from the national budget

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The new regime entails radical and far-reaching consequences on Sonatrach (Cont.)

- **Sonatrach's financial constraints will be somewhat mitigated by:**
  - A lower tax burden for the major part of its production
  - The transfer to the State Treasury of any subsidy on domestic hydrocarbon prices
  - Cost saving resulting from reduced social/welfare mission
  - Divesting from non-revenue creating activities
  - Increased partnership with private oil companies
- **Whether Sonatrach will rise to the challenge of competition and commercial orientation will depend, to a large extent, on the attitude of the State during the transition period**
  - Will Sonatrach be protected from political pressures and unwanted interference?
  - Will the State ensure the financial equilibrium of the national company?
  - Will the State have a responsible dividend policy?
- **If the State cannot deliver its side of the deal (i.e. good governance), then Sonatrach may be forced to sell some of its assets and substantially reduce staff at a time when the country suffers from a very high unemployment rate**

Conclusions

- **The oil market is in the midst of a major and possibly lasting structural change**

- **This change has highlighted the crucial role and responsibility of the producer NOCs in world markets**

- **NOCs are at a turning point**

  - Either they remain bedrocks of sovereignty, privileged national champions, resource monopolists and tax collectors, subject to political influence

  - Or they streamline, get rid of their privileged position, concentrate on their core business, both at home and abroad, and diversify their activities to become global companies

- **NOCs' transformation will clearly depend on their governments' abilities to embrace economic and political reforms**

- **IOCs can help NOCs' transformation process through new business models**

« It is not the strongest of the species that survive, nor the most intelligent, but the one most responsive to change » **(Darwin)**