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Navigating geopolitics in oil and gas
Business solutions for a complex world

Executive summary

What is geopolitics and why should we care?

Geopolitics is a central concern for the oil and gas sector and can be viewed as a source of both risk and opportunity. The trend toward more nationalistic and assertive political behavior indicates global instability is on the rise. So it is no coincidence that one of the top risks facing oil and gas companies, as identified by EY in our most recent risk study, was geopolitics.

The term “geopolitics” encompasses a broad range of frequently interconnecting issues, including diplomacy and security, global economics, financial and supplier market uncertainty, commodity constraints and pricing, exchange rate fluctuations, and civil and workforce disruption. Because geopolitics is complex and volatile, with unpredictable players who have conflicting agendas and disparate motivations, it is tempting to see geopolitics as impossible to control or prepare for. While the fundamental nature of geopolitics is volatile, there is an opportunity to mitigate the impact of these forces on the industry. However, when companies are unable to foresee emerging trends or react to rapid, unforeseeable geopolitical change, the potential impacts on corporate and capital project performance can be significant.

Breaking down complexity

As part of our Capital Projects series, this paper seeks to demystify the complexity of geopolitics by highlighting the key constraints on behavior in the international system: geography, economics and technology. We also introduce a framework to isolate the individual interactions between key political actors: institutions, businesses and people.

The paper also looks at underlying global trends, which must be taken into account when assessing geopolitical risks, in order to examine the numerous connections between global phenomena. All oil and gas companies should have a deep understanding of how these geopolitical trends and events can destroy value.

Business solutions for geopolitical challenges

A greater appreciation for the underlying dynamics of geopolitics can inform the development of robust strategies and processes, and in turn help oil and gas executives make more informed business decisions. This paper assesses the potential for improvement in three areas of an oil and gas company, which are all deeply affected by geopolitical change:

• Robust investment and divestment planning through holistic geopolitical risk analysis
• Local content compliance strategy and implementation
• Anti-bribery and corruption controls

EY is committed to building a better working world, which is why our client-serving teams work alongside organizations every day to help them meet their most difficult challenges.
Shifting sands

The broader world is itself in a period of era-defining change, as the United States’ global power becomes diluted, China’s astonishing growth continues in spite of unanswered questions over a possible debt bubble and credit crunch, and long-simmering religious/sectarian conflicts metastasize into radical regional and international conflicts. The numerous and rapidly changing forces in the world have the potential to create vast change in the oil and gas industry and the global economy as a whole. In a destabilized world, competition for scarce natural resources will only increase, meaning geopolitics will become an ever-more-important factor in decision making for oil and gas executives.

For nation-states, energy security is paramount, and the oil and gas industry is at the heart of the global competition for natural resources and influence. This struggle creates shifting alliances and new partnerships as governments, businesses and individuals jockey for position and influence. Countries looking to secure their energy supply are using their national oil companies (NOCs) to explore overseas markets for new reserves, with the NOCs in effect becoming more like international oil companies (IOCs). This serves to disrupt traditional competition for contracts, given the significant financial power that sovereign states wield in order to guarantee a stable supply of oil and gas. IOCs need to continue innovating and adapting technically, commercially and in their political engagement with foreign governments to compete with state-backed NOCs. In addition, this shifting power balance from IOCs to NOCs means that joint ventures with a local NOC are becoming a prerequisite for any IOC wishing to invest in certain geographies.

Impact of geopolitics

Geopolitics has the capacity to exert sudden and disruptive pressure on the operations and security of energy assets across the world, meaning that no country or company is truly exempt from the effect of geopolitical change. Oil and gas companies frequently engage with national and local governments, local populations, subnational groups and supranational organizations, and consequently they are deeply affected by political change. Recent examples of these impacts include:

- In early 2012, relations deteriorated between then Repsol YPF and the Argentine Government, which decided to expropriate Repsol’s 51% stake in YPF. In the months following the expropriation, Repsol saw a loss of almost half of its market capitalization.
- In Nigeria, political instability and regional and religious sectarianism have contributed to the ongoing theft of up to 350,000 barrels of crude oil per day, which costs the oil and gas industry approximately US$1b per month in lost revenues, according to the country’s Finance Minister.4
- Strikes by oil workers enraged at perceived government corruption reduced Libyan oil production by 88% in 2013.5

Technological developments, especially the internet, have liberated more individual citizens to shape national and international events. Public protest has risen in the wake of the global economic downturn, and “citizen journalism,” enabled by social media and portable communications devices, is breaking down barriers to information and knowledge. As was shown frequently during the uprisings of the so-called “Arab Spring,” rising popular empowerment means that oil and gas companies must pay close attention to their local engagement strategy before investment and groundwork begin to minimize the potential financial and reputational risks associated with public protests.

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1 Spotlight on oil and gas megaprojects, EY, 2014.
3 Ibid.
How does the industry track risks?

Oil and gas companies and investors leverage various sources of information to make better strategic decisions. Country risk profiles, trend analyses and on-the-ground reports from private individuals, journalists, academics and occasionally state intelligence agencies all combine to provide the qualitative and quantitative inputs to the geopolitical risk analysis process. However, it is the meaning derived from these inputs that dictates how successfully companies will understand the environment and respond to future events.

Recently, the analysis process has been challenged in how effectively it predicts and reacts to global events. For example, the oil and gas industry was unprepared for the extent and speed of the Arab Spring, costing billions of dollars. In addition, certain black-swan events, such as terrorist attacks, are almost impossible to predict but can have a huge impact on global energy markets and individual oil and gas operations. For instance, the attacks on the United States on 11 September 2001 could not have been predicted, but attacks in southern Algeria, such as that on the In Amenas gas plant in 2013, were warned of months before the actual incident took place. The terrible outcome of that attack demonstrates in the clearest terms how important it is to prepare for external threats to oil and gas assets.

Specialist political risk insurance (PRI) is an additional form of protection for oil and gas companies, but its costs are spiraling higher in response to the increased uncertainty. In 2012, the industry took out PRI covering assets worth over US$100 billion. This constituted a 33% rise on 2011, despite an 18% drop in foreign direct investment (FDI), and a 200% increase on 2005 levels. Unless rigorous processes for analyzing and responding to geopolitical risks can be demonstrated to insurers, the costs are likely to continue rising.

What is missing?

To what extent is the industry understanding of geopolitics led by events, without a fundamental appreciation of the dynamics that shape it? Is the ability to react to events transferable? Can the lessons learned in one corner of the globe be applied across a full project portfolio? This paper posits that oil and gas companies can do more to analyze the individual dynamics of geopolitics across their portfolio and, in so doing, be better prepared for an uncertain future.

Because the industry faces increasingly complex geopolitical issues across different operating environments, oil and gas companies need to improve their organizational agility and resilience. Geopolitical events can very rarely be fully anticipated and controlled, but they can nonetheless be prepared for, and their impact can be mitigated to some extent. Applying nuanced geopolitical thinking on core business functions and strategic challenges enhances the ability of oil and gas companies to react quickly to changing circumstances and therefore maintain or increase shareholder value.

What follows offers a new perspective on the geopolitics of oil and gas drawn from EY’s global experience supporting industry leaders as they develop assets in some of the world’s most challenging geographies. EY’s framework for analyzing the business impacts of geopolitical phenomena helps companies to turn data and information into insights and tangible, actionable steps that protect and increase value.

Global maze: the dynamics of geopolitics

Complex interactions

Modern geopolitics is a complex and often unstructured web of interactions on a global scale, not simply the study of countries’ stated and unstated foreign policy intentions. Figure 1 below shows a snapshot of the vast web of interconnections between political actors — institutions, business and individual people — that define the global oil and gas industry. The size of the political actors shown reflects their relative influence on events. This demonstrates that assessing the global balance of power should not simply be an analysis of governments; it should also include the analysis of businesses and individual people.

Figure 1: Interactions between political actors

These interactions occur between political actors in both official and unofficial capacities. The world of oil and gas is characterized by competing interests. Often, geopolitically significant events in the energy industry derive from a conflict in the respective interests of the various players – NOCs, IOCs, banks, governments, contractors and sub-state actors, including terrorist militias.
Importance of interaction analysis

A single interaction, such as an employment dispute between a worker and an engineering, procurement and construction management (EPCM) firm, could cause a far-reaching outcome on its own. When viewing that single interaction in the context of other political interactions, such as a central government’s introduction of stringent labor legislation that favors the people of one region of a country over another, it is clear that more profound outcomes are possible.

In this simplified example, the result could eventually be localized ethnic tension and violence targeted initially at local officials. Given the global trend toward nationalistic political behavior, it is entirely plausible that the host government, in order to protect its own position, could blame the IOC that has contracted the EPCM firm. Situations like this can rapidly escalate if not managed sensitively by the oil and gas companies from the outset. They can manage a situation appropriately only if they are aware of the bigger political picture, hence the importance of analysis at the level of individual interactions.

Importance of context

It is important to understand the deep-rooted social, historical and psychological values of political actors. Given that civil unrest in Venezuela is different from civil unrest in Congo, Iran or France, it is essential to access reliable sources of local knowledge in order to analyze the particular dynamics of an emerging geopolitical situation. Parallels can be drawn between separate events and trends, but it can be dangerous to make assumptions about political actors in different geographies.

A “bottom-up” analysis of geopolitical phenomena as a set of individual interactions can help oil and gas companies rapidly understand unfolding world events — both seen and unseen by the general public — and may ultimately help them to capitalize on new opportunities and avoid or mitigate new threats.
Breaking down geopolitical complexity

Geopolitics can be defined as a power struggle between people, businesses and institutions (political actors) under the constraints of geography, economics and technology (geopolitical constraints), as shown in Figure 2 below. Although the inherent complexity and uncertainty of geopolitics can at times seem impenetrable, it is possible to analyze the various political actors and constraints in great detail while also maintaining a strategic view of larger global trends.

Breaking down the vast complexity of geopolitics into manageable interactions between political actors provides a method through which oil and gas companies can manage risks and opportunities in a more detailed and comprehensive way when investing in and managing large capital projects.

Geopolitical constraints set the context for what is possible for political actors to achieve at a particular point in time. However, these constraints are not immovable, as it is possible for political actors to alter the environment in which they operate. For example, geographic and technological constraints currently prevent businesses and institutions from economically tapping large oil and gas reserves in the Arctic. Advances in technology and the fact that the ice is melting begin to remove some of the constraints and provide an opportunity for oil and gas companies to prospect the region in more detail, if political interactions between governments allow for it.

Individual political actors interact with each other through employment, contracts and the legislative process. While people represent the interests of businesses and institutions, they are also individuals with their own perspectives, and it is either the confluence or clash of interests that produces political and business outcomes. The overlapping gray circles in Figure 2 represent this uncertain and varied interaction of interests.

Figure 2: The EY Geopolitics framework
Geopolitical constraints

Oil and gas companies operate in a world of sovereign states, intergovernmental organizations and regional separatist movements, not to mention private enterprises, the media, activists, citizen journalists, hackers and spies. These political actors are constrained in what they can achieve by structural elements of the world system. These constraints include:

- **Geography:** Geography limits what is possible in the natural world and helps to reinforce sovereign borders. For example, the Himalayas provide a natural barrier between India and China; the United States is isolated, and therefore protected, from Europe and Asia by the Atlantic and Pacific oceans; and the jungles of central Africa hinder large-scale movement of people and goods. The environment in which political actors operate will help to define their decisions.
  
  The level of air and ground pollution in a country will have an effect on legislation, which will affect companies’ decisions to invest. The various prevailing winds and tides affect the routes ships take to navigate the world’s oceans, which can affect the economic viability of a project. It naturally follows that influence, and sometimes tension, flows to countries close to these routes. For example, security threats against the Strait of Hormuz are frequently used as political leverage given how crucial it is to the transportation of oil and gas from the Persian Gulf.

- **Economics:** Economic constraints include the market forces that determine the price of oil, which has a direct impact on the tax revenues and royalties received by national governments and individuals, which in turn limits the options available to decision makers. The market will influence the decisions of pirates near the Strait of Malacca, who weigh the risks of hijacking a ship against the potential profits made from selling stolen oil on the black market or from the ransom paid for a kidnapped seaman.

  Interest rates, inflation levels and trade barriers all affect the appetite of organizations for doing business in any given country. Commodity prices, which can be manipulated by countries or supranational bodies, can also affect the economic viability of an oil or gas project. These prices can be manipulated by groups that are powerful enough to materially alter supply and demand levels of a given commodity. This competition for resources and the consequent effect on prices are important factors when analyzing investment cases for oil and gas megaprojects. The economic strength of a country will to some extent constrain how it goes about negotiating contracts with IOCs and foreign NOCs to tap its oil and gas reserves. A country with a relatively small gross domestic product (GDP) will likely have to settle for less favorable terms when compared to a large GDP neighbor with more resources available to fund projects.

- **Technology:** Technology also limits what is possible for political actors. Without fast boats, global positioning systems and high-speed communications technology, the capabilities of pirates and saboteurs would be severely constrained. And without reliable internet and electricity available in-country, it would be wasteful for oil and gas operators to invest in advanced systems for monitoring project performance remotely.

  Over the past several years the influence of social media has been rising dramatically. Social media has been used effectively by sophisticated pro-democracy protesters in the Arab Spring of 2011 and by the Islamic State of Iraq and al-Sham (a regional separatist group, also known as ISIS or ISIL) as part of their 2014 insurgency in Iraq and Syria. This paradoxical use of the same technology by political actors to achieve very different objectives has contributed to rapid change across the Middle East and North Africa, which has in turn led to both threats and opportunities for oil and gas companies.

  Much as geographic constraints differ depending on where you are in the world, technology is also unevenly distributed. For example, the US deploys advanced drilling and recovery techniques to tap unconventional sources of oil and gas. This gives political actors, such as oil and gas companies and state legislatures, a competitive advantage over rival companies and jurisdictions, and for NOCs it increases the benefits of joint ventures with Western IOCs who have superior technology.
What about politics?

Modern-day politics is about the interactions between people, business and institutions, and as such is represented within the white triangle in Figure 2. The dominant religion, political ideology or ethnicity of a country does not alter this dynamic. Politics is not itself a constraint on behavior; rather, it is a reflection of institutional, business and human behaviors within geographical, economic and technological constraints. Similarly, historical, cultural and psychological values are to a large extent reflective of a constraining geopolitical system, the individual conditions of which are particular to any given country, region or grouping of people.

Political actors

Institutions

Institutions are integral to any country. They can take the form of a central or local government, the judiciary, the military, schools, hospitals, or even large sports clubs. Strong institutions provide the foundation for a successful and prosperous country, whereas weak institutions can contribute to instability, inequality and crime without punishment. The behavior of institutions, and the people representing them, can lead to opportunities and risks for businesses.

The presence of clean running water and highly trained doctors in a country is a function of having strong institutions, and these luxuries are often taken for granted in the developed economies. Without the institutions to manage the infrastructure of a modern country, cronyism and inefficiency abound. This can make doing business in that country much more challenging but can occasionally enable foreign businesses to gain significant influence with institutional elites.

Discovering oil and gas can be both a blessing and a curse for a country and its people, and the institutional strength and stability of a country helps to determine which it will be. It should not be a surprise that many of the world’s largest oil- and gas-producing countries feature at the riskier end of the Fraser Institute’s geopolitical risk index.8

Institutions that are strong enough to regulate business and provide checks and balances for government bodies are better able to maintain national stability. For oil and gas companies, this can be both a risk and an opportunity. Although strong institutions are generally more stable and make doing business in a country less risky, they also mean that host governments are more empowered to regulate the oil and gas industry, which could mean higher taxes on production revenues and exports and more stringent operating and employment laws.

However, revenues from oil and gas, as well as other natural resources, could also contribute to institutional corruption and the development of a powerful elite that may siphon monies away from public projects that would otherwise improve the well-being of the country at large. The consequent decrease in trust between the local population and state institutions – whether that is the police, judiciary or elected officials – can lead to popular unrest. This can result in a multilayered, destabilizing effect termed the “resource curse.”

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8 “Global Petroleum Survey,” The Fraser Institute, November 2013.
Businesses
While private business and banking has long been an important consideration in developed and/or democratic countries, it is now seen as an essential driver of economic growth and prosperity in developing and/or autocratic states. As the private sector in the developing world grows, so too does the political influence of the investing businesses.

Businesses must interact with state institutions in order to negotiate production sharing agreements (PSAs), joint ventures (JVs) and concessions in order to operate in a given country. They can influence the decisions of lawmakers through leveraging the potential economic benefits of their business to the host country. Although government lobbying is sometimes frowned upon, it is a crucial aspect of any stakeholder engagement and communications strategy. Lobbying has its risks, though, as local legislation often prevents inappropriate contact between businesses and politicians and local officials. (The subject of combating bribery and corruption is discussed later in this report.)

Foreign businesses make profit from extracting sovereign oil and gas resources, which can lead to resentment among local people and legislators. Workers in the current Information Age are better informed and empowered to act either with their feet or with their fists. Business leaders and managers must communicate effectively with workers to mitigate the risk of strike action, which is often made likely by economic constraints. For example, oil workers in Scotland went on strike to protest the proposed closure of the Grangemouth refinery in 2013. Following negotiations facilitated by the Scottish Government, the labor unions and the refinery owner struck a deal for revised employment terms.

Governments are keen to encourage both FDI and domestic enterprise, given the potential multiplier effect of job creation, increased consumer spending and a resultant rise in relative national prosperity. Jobs put money in people’s pockets and makes popular unrest less likely. It is clearly in politicians’ interests to attempt to facilitate private business investment, given the increased corporate and income tax revenues generated for the state purse, and also due to their all-too-human desire to remain in power.

People
Businesses and institutions interact through negotiating tax breaks and drilling rights with oil ministries, for example, but it is the CEO that represents the corporation, or the judge who represents the justice system, or the minister representing the government department, who makes the final decision. This human element is where the unpredictability of geopolitics is most apparent.

Geopolitical constraints - the structures that define what is possible - provide the platform for individuals to make decisions and influence events. As an example, a political leader, such as the Russian president, might pursue a policy of pipeline brinkmanship in Belarus, Ukraine or Georgia in order to help achieve Russia’s foreign policy objective of maintaining and increasing influence around its periphery. This would be a rational decision, and thus any oil and gas company affected can model various resulting scenarios. Nevertheless, the timing and specifics of the president’s decisions would be very difficult to predict with any level of precision.

Although people may be constrained by the structure of the geopolitical world, they are also motivated by very personal factors. An individual’s decisions can be influenced by feelings of generosity, revenge, pride, prejudice and greed, to name but a few. These factors are rarely easy to discern at any given time and are therefore almost impossible to predict by even professional forecasters. Few could have predicted that a lone, disenfranchised man setting himself on fire in a Tunisian market would have sparked the Arab Spring. This catalyst, plus a range of economic, social and political factors, led to regional instability and reactionary national reform by political leaders who felt their power being eroded.

People may be drawn to separatist and protest movements along regional or ethnic lines, which can impact oil and gas companies in various ways. This is due partly to a sense of strong shared beliefs and partly due to the desire to belong to something. For example, in Nigeria, an anti-corruption and anti-western militant group, the Movement for the Emancipation of the Niger Delta (MEND), has targeted western oil and gas facilities in violent attacks and called for the expropriation of assets owned by western businesses. People are the common factor in all political interactions and as such are a large part of the inherent complexity and unpredictability of world events, which makes geopolitical risk analysis an art as much as a science.
Thinking geopolitically: industry insights

Assessing geopolitics can make for a complex and often confusing maze within which business, political and personal decisions are made. Isolating individual geopolitical interactions and trends enables a deeper analysis of the multiple, interrelated causes of insurrection, trade embargoes, international cyber-crime and other geopolitical phenomena.

But what practical steps can oil and gas companies take to confront the realities of a complex world and improve their corporate planning, decision making and operational capabilities? Several, in fact. Improvements can be made in several areas to help to identify, avoid, mitigate and manage geopolitical risks and capitalize on geopolitical opportunities throughout the whole value chain.

Making the right strategic decisions

Given that there are predictable and unpredictable elements of the geopolitical system, oil and gas companies must have sophisticated and flexible strategies and processes and be ready to change course rapidly in the face of uncertain future events. Traditionally, geopolitics is discussed most formally at the corporate or portfolio level. Oil and gas companies often use predefined risk frameworks to help plan investments and make decisions. These frameworks invariably include politics or geopolitics, confirming that it is already a consideration for oil and gas companies. Boards also need to have more exposure to external viewpoints, risk analysts must be more open to differing interpretations of events and trends, and attention must be paid to the optionality value associated with investing in projects in politically risky geographies.

Companies can approach geopolitical uncertainty in different ways, but in our experience, scenario planning is a highly effective method of modeling a large number of variables. Scenario planning is not about predicting the future, but instead it is about anticipating a range of conceivable futures. Other methods can be appropriate but have limitations. For example, contingency planning deals with one uncertainty at a time, while sensitivity analysis examines the impact of changing one variable while keeping all others constant. Scenario planning resists the tendency to oversimplify by focusing on the full range of external and internal uncertainties and the associated new states that can arise. Existing strategies are then tested appropriately, and new strategic responses can be developed.

Much as an oil refinery has a number of inputs, such as water and heat, that can be tweaked to optimize the outputs, so too does the scenario-planning process. The variable could be US interest rates, the rise to power of a left-wing political party in South America, or the occurrence of a terrorist attack against an ethnic minority in Southeast Asia. The impact of changing one or all of these variables can be modeled using predictive analytics to highlight the assets or business functions with the greatest exposure to geopolitical risk. With the addition of historical data and the input of experienced practitioners, the strategic decision-making process can be refined, and portfolios can be balanced with maximum possible confidence.

With oil and gas companies under continuous pressure to increase their proven reserves, CEOs are understandably determined to develop as many projects as they can as quickly as they can — especially as oil prices remain high and cheap financing is readily available. However, when companies move too quickly, their control processes can struggle to identify the potential impact of unbalanced geopolitical risk on a project portfolio. For example, geopolitical events have the power to radically affect the price of oil, which in turn affects the viability of projects.

A limited awareness of the different types of geopolitical interaction can cause internal stresses beyond the point of control. Further complications can be caused by the political and commercial arrangements associated with JVs, as well as the complex and often bureaucratic control mechanisms that NOCs impose on the venture. Geopolitical events and trends that affect personal and institutional behavior must be recognized and understood at an early stage. Once the oil and gas company has all the available information, and has completed detailed descriptive and predictive analytics, it is important to employ a flexible approach to strategic and portfolio planning. A reluctance to remain open to a wide range of possible futures could expose the company to significant undue geopolitical risk with potentially material financial and reputational impacts.
Scenario planning – case history

An international oil and gas company was developing a major LNG program and approached EY for assistance in project planning. The objective of the engagement is to maximize the value of the asset over a 20-year planning horizon.

The approach of the client-serving team focused on developing a broad range of future scenarios and using the scenarios to stress-test the client’s asset management plans.

The team’s role was to identify key uncertainties in the internal and external environment and then lead the development of scenarios and signposts. We were also called upon to constructively challenge the client’s assumptions. Finally, we worked with the client to apply the scenarios to the asset management plans to identify implications for the asset and the client.

The rich, compelling scenarios we created challenged the client to explore a range of possible developments outside of their traditional planning process. We also identified a range of implications for the client that were included in their asset management planning and other activities. This included new options, activities and actions.

Most critically, we created support for wider use of scenario planning within the client and increased alignment across the client organization as the work of this planning exercise served to connect disparate functions in a new and engaging way and thus aided in breaking down organizational silos.

EY has a proven scenario-planning framework that sets out the key steps to define the scope, establish the planning horizon, surface key uncertainties, co-create future scenarios and stress-test existing development plans based on these potential future states.

Uncertainty

- Understand the business model
- Explore the environment
- Analyze trends and uncertainties
- Confirm scenarios and stress test
- Build scenarios and signposts
- Early warning system
- Report findings
- Define the scope
Developing local content

Local content is about resource-rich countries increasing and developing their indigenous capabilities, and in so doing, developing a competitive supplier base, which stimulates domestic demand and employment opportunities, as well as export potential. Over the last decade there has been a global trend toward increasingly detailed and measurable local content legislation, presenting a significant strategic challenge for oil and gas companies across the world.

Local content stipulations developed from an increasing need for governments to get the best out of their natural resources. The “resource curse” theory – that countries abundant in natural resources can suffer from paradoxical underdevelopment – required a solution, and obliging oil and gas companies to contribute more measurably to national development is now seen as the best way forward. Local content carries with it the promise of increased employment for nationals, prevention of a “brain drain” through the retention of local talent, improved industrial and human resource capacity, and a public opinion boost for politicians seen to be promoting community interests ahead of big business.

Challenges

- Local industry and labor may be unable to compete on quality, skills, infrastructure and price
- Weak legislation and institutional corruption could undermine the business environment
- There could be a reluctance to accept certain job roles and high staff turnover
- Governments and business might adopt a “tokenistic” approach to local content development without committing to real knowledge, skills and capacity transfer

Opportunities

- Attract the best local talent to reduce reliance on costly expatriate labor
- Rationalize local supply chains founded on strong commercial relationships
- Improve operational performance as ease and speed of doing business is increased with more “local-to-local” relationships
- Build better relationships with governments and local communities to reduce the risk of project disruption

As countries continue to develop economically, their relative influence on the world stage will increase as international power is more evenly distributed. Successfully implemented local content programs will go a long way to enable and maintain positive relations with host governments and open up future opportunities for capital project investment in the respective country.
Local content – case history

*Delivering local content from public and private sector perspectives*

EY firms have experience working with clients on both sides of the local content challenge: developing and responding to legislation.

**Private**

A major oil and gas company needed to relocate most of its business in-country and rapidly expand its activities in a short time frame while maintaining cost effectiveness through localization of its supply chain and workforce.

Our client-serving teams first conducted a capability assessment of the local supplier base for over 30 sectors (from business services to drilling). Once both the local capacity and competence were clear, we developed a strategy to increase supplier localization, outlining priority sectors and areas of investment needed. We also introduced local content metrics to track goods and services to be able to report compliance.

As a result, the client saw a significant increase in the use of local suppliers and benefited from numerous initiatives to improve supplier capability, including the establishment of centers of excellence across a range of sectors.

**Public**

EY was approached by an oil-producing nation to assist with a development strategy through 2020.

Our client-serving teams supported both the Presidential office and Energy Ministry in creating a development strategy focused on leveraging the energy sector, which contributed a significant amount to the nation’s GDP.

Our approach included defining supply chain and workforce localization policies and identifying priority sub-sectors and opportunity areas for local content development. We also designed the reporting system to monitor local content progress for goods and services across the country.

The client passed regulations and policies shaped by our teams into local content law. Since implementation, supply chain and workforce localization has increased by 10%. A key milestone was the manufacture of gas platforms moving from the US to an in-country business.
Combating bribery and corruption

Many oil and gas companies have faced attempted bribery or corruption in one form or another. Designing and maintaining robust processes and controls to protect an organization from these occurrences requires an acute awareness of the geopolitical and psychological drivers and enablers of corrupt behaviors. Oil and gas companies operate in a high-pressure environment, often in emerging markets, where the potential payoffs from successful ventures are considerable. Conversely, delays or downtime in the value chain can significantly erode the bottom line. This pressure can create an imbalance between compliance and operations and induce activities that may not be aligned with corporate policies. Three areas of particular risk are discussed below.

In countries where the government wholly or partially owns the oil and gas industry, it is often necessary to engage government officials, which is frequently done through well-connected in-country intermediaries. This exposes oil and gas companies to an increased risk of bribery and corruption. The institutions of developing economies can tend to be excessively bureaucratic. These layers of bureaucracy open up opportunities for underpaid government workers, who each have a designated area of responsibility, to request payoffs from both foreign and local companies in return for quicker completion of tasks. The high number of interactions with government across all levels of the oil and gas industry increases the risk of corrupt practices influencing policy and officials using their positions of power to solicit bribes. Oil and gas companies frequently hire third parties, such as EPCM firms, to manage parts of their in-country operations. Similarly, companies contract with NOCs and form JVs to develop their oil and gas fields. The other JV partners may appoint government officials to sit on the board of directors to protect the interests of the state. These arrangements can increase the risk of perceived or real conflicts of interest and damage the reputation of the company. Additionally, these contractual arrangements can leave IOCs liable for any bribes or kickbacks paid by their JV partners. Exercising control can be a significant challenge when entering into these JVs and contracting with third parties overseas.

Enforcement under the US Foreign Corrupt Practices Act, the UK Bribery Act and most other international anti-corruption legislation relates to parent companies being held responsible for the behavior of their agents and intermediaries when performing services on behalf of the parent or local subsidiary. When operating overseas, the local employees of oil and gas companies may have a strong network of relationships that can create conflicts of interest and increase the risk of bribery and corruption, such as those with public officials, suppliers and community leaders. Differing cultures and business standards may lead to conflicts remaining undisclosed and business funds being improperly channeled.

Expatriate staff typically operate with a large degree of responsibility and autonomy, providing them with an opportunity for improper practices. On-site policies and procedures are often embedded weakly or not rigorously enforced, enabling expatriate staff to dictate their application. This can lead to processes that circumvent controls, either intentionally for personal gain, or through a genuine desire for the operation to succeed. Staff can become distanced from the core corporate values and rationalize control violations overseas as a necessary way of conducting business in the region.

In recent years, some of the largest oil and gas companies have made a number of multimillion-dollar settlements. While institutional structure or cultural values can tend to drive corrupt practices, many IOCs pursue highly lucrative contracts in these geographies with the knowledge that pressure will be put on them to follow questionable business practices in order to win business. This is not to say that individuals or companies operating in this sector are more corrupt or susceptible to bribery. However, the global nature and scale of the oil and gas industry — and the complexity of the working and contractual relationships with governments, venture partners, customs officials, freight forwarders and other contractors — are characteristics of the industry that increase the risk of bribery and corruption.
Anti-corruption – case history

A major oil and gas company needed to enhance their anti-bribery and corruption compliance program as operations shifted to higher-risk locations. They reached out to EY for assistance to redesign and develop policies, improve training, and conduct audits.

Our approach

To begin, EY client-serving teams performed a current-state assessment and analyzed how existing procedures and organizational culture addressed anti-bribery and anti-corruption. We connected with employees across the organization, including senior management, operational employees and regional regulators. These findings were benchmarked against leading industry practices. A customized regional risk assessment was provided, which included a compliance audit by country. These risk assessments provided the client with a more clear understanding of the specific risks across the organization and included regional recommendations for improvement. By implementing the program, the client was also able to demonstrate to regulators a willingness to comply with local legislation.
Conclusion

Geopolitics can be a complex and sometimes overwhelming phenomenon in the context of a rapidly changing world. Many oil and gas companies struggle to analyze geopolitical events and trends adequately and therefore miss opportunities to protect the value tied up in operational assets and the value attached to future projects.

Portfolios are not managed to be responsive to fast-moving geopolitical risks; capital projects are canceled because the local regulatory environment is not understood or engaged with; and bribery and corruption are endemic in a large number of resource-rich countries. It is possible, however, to isolate the individual dynamics and specific interactions between political actors – institutions, businesses and people – acting within the geopolitical constraints of geography, economics and technology.

Isolating the constituent parts of geopolitical dynamics and interactions with the aid of the EY Geopolitics framework helps oil and gas companies analyze existing trends in a nuanced way, enabling smarter decision making and more processes that are tailored to the local environment. This improvement can be sustained through maintaining detailed historical information databases, leading to enhanced organizational intelligence.

Oil and gas companies must act quickly to confront the challenges that a more unstable world presents. The energy landscape is likely to change markedly up to 2020 and beyond, and it is imperative that companies analyze the qualitative and quantitative data they receive from various sources in an informed and intelligent way. No two interactions are the same, and oil and gas companies must resist the temptation to generalize and assume that behavior in one geography will be mirrored elsewhere.

Geopolitics is a reality that all companies must face, but the oil and gas industry is especially susceptible to geopolitical risks due to the exposure to the majority of politically and economically unstable regions of the world. Avoiding geopolitical risk is rarely an option for oil and gas companies, but they can protect the value they create through making the right decisions at strategic, operational and tactical levels based on reliable analysis. This is the new business reality in oil and gas.
How EY can help

Strategic decision making
EY’s global network of firms provides effective geopolitical analysis tailored to oil and gas companies’ needs through:
• Identifying the geopolitical risks relevant to their company’s operations
• Understanding how those risks could impact on them
• Integrating the analysis into their strategic decision making and investment

Navigating local content
There are a number of moving parts relative to local content for the oil and gas industry. Our teams can help navigate them so companies can manage risk, mitigate the potential for penalties and avoid pitfalls. We can assist companies in monitoring and evaluating the impact of tax, regulatory, labor and legal updates within various countries.

Resources will have to be developed or brought in via joint ventures to keep up with technological demands and advancements as operations become increasingly complex. Local content in most countries was partially created to help generate employment. Our professionals can assist with support for new ventures and joint ventures. In addition, oil and gas companies need to tailor their human resources and mobility policies and procedures. We can navigate many local content requirements including:
• New country entry support
• Valuation and business modeling
• Operating model structuring/restructuring
• Supply chain operation and logistics
• Occupational health and safety and environmental management
• Sustainability report advisory and assurance services

Combating bribery and corruption
As business in high-risk jurisdictions continues to grow in the oil and gas sector, companies will be subject to intense scrutiny from enforcement agencies. This requires significant management focus to comply with anti-bribery and anti-corruption regulations. Oil and gas companies need to address their corruption risks proactively by implementing an effective anti-corruption compliance program. EY has developed eight key steps to follow to implement an anti-corruption program, as listed below:
1. Conduct a risk assessment program
2. Develop a corporate anti-corruption policy
3. Implement anti-corruption policies and controls
4. Implement anti-corruption financial controls
5. Conduct anti-corruption compliance training
6. Monitor the program
7. Embed anti-corruption procedures in M&A
8. Reassess risk and modify the program

Although no measure can absolutely guarantee that a company will eliminate all risk of corruption, it can substantively mitigate these risks by quickly identifying and treating them. By adopting such a program, companies may also be in a better position to demonstrate the measures that were taken to manage such risks, as well as identify potential breaches which can be scrutinized by regulatory authorities.
About EY

EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

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How EY’s Global Oil & Gas Center can help your business

The oil and gas sector is constantly changing. Increasingly uncertain energy policies, geopolitical complexities, cost management and climate change all present significant challenges. EY’s Global Oil & Gas Center supports a global network of more than 10,000 oil and gas professionals with extensive experience in providing assurance, tax, transaction and advisory services across the upstream, midstream, downstream and oilfield service sub-sectors. The Center works to anticipate market trends, execute the mobility of our global resources and articulate points of view on relevant key sector issues. With our deep sector focus, we can help your organization drive down costs and compete more effectively.

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EYG No. DW0445
CSG No. 1409-1322930
ED None

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