Oil and gas in emerging markets: finding a new way forward

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The global oil glut and the resulting sustained low prices have profoundly affected many emerging market economies. For many emerging economies heavily dependent on oil revenue, the dramatic fall in prices has unleashed a chain reaction with far-reaching consequences for social spending, investment, economic development, government budgets and most especially for the National Oil Companies (NOCs) that account for around 60%[1] of global production.

The consequences of this new energy order engendered by sustained low oil prices have already been extraordinary. But what key changes and consequences are yet to come?

A price-slide tsunami

The downslide in oil price began two years ago, when US oil explorers and producers deployed new technologies and innovative approaches to tap tight oil resources. US crude oil production surged to an average 9.4 million barrels per day in 2015,[2] rivaling that of Saudi Arabia and Russia.

For most of the last two years, because of surging US oil production as well as increases in OPEC and other non-OPEC production, global oil supply has consistently exceeded global oil demand. In late 2014, after OPEC decided to protect market share rather than protect price by reducing production, oil prices began what would be a dramatic decline, falling by more than 70%, dipping below US$30 a barrel.

Prices have stabilized more recently in the low to mid-US$40s as supply not economic at lower prices, has left the market. Total non-OPEC production is expected to average about 700,000 barrels a day lower in 2016, and by April, it was estimated that US production had eased to slightly below 9 million barrels a day.[3]

On April 18, a meeting of both OPEC and non-OPEC producers to discuss capping production at January 2016 levels ended without agreement. Now, with US tight oil production more resilient, and demand growth less robust than anticipated, oil prices look likely to remain at lower levels, absent significant disruptions to global oil supply. We have entered a new oil production era.

A new "contract" with the state

Over the past two years, lower oil and natural gas prices have caused government revenues in many hydrocarbon exporting states to plummet, forcing them to curb spending while causing public deficits to grow.

But the price slump is transforming for NOCs, triggering cost-cutting and a profound rethink about roles and the fiscal relationships with statal stakeholders.

For NOCs, the "contract" with the state, includes multiple elements:

- Fund the state revenue
- Support state industrialization
- Promote economic diversification
- Employ and educate citizens and increase their skills
- Drive innovation, research and development, aiding their own and national development.

Volumes, margins and the new way forward

Falling oil prices have reduced the ability of NOCs to fulfil these obligations. Many Middle East producers, and some in Africa, have responded by maximizing **volumes**, seeking to partially compensate for lower prices by raising output. Others have focused on improving **margins**, while positioning themselves for more efficient operations — and thus government revenue contributions for when prices recover.

However, some governments are re-examining the relationship between their national oil company and the state while exploring different options. Some NOCs are considering partial privatization, with the sale of a minority NOC stake to private investors. Privatization introduces more market and fiscal discipline into NOC business/operating models. The transfer of state-owned NOC equity to an arms-length sovereign fund is also attracting interest because it also promotes more commercial behavior. A wider privatization and market liberalization program designed to normalize emerging market economies, making them more competitive may accompany such steps. These changes could produce a seismic shift with global implications.

[1] US Energy Information Administration, http://www.eia.gov/energy_in_brief/article/world_oil_market.cfm.
[2] U.S Energy Information Administration, http://www.eia.gov/dnav/pet/pet_crd_crpdn_adc_mbblpd_a.htm.
[3] US Energy Information Administration, http://www.eia.gov/petroleum/weekly/crude.cfm.

After capital opening, we would expect an NOC to embrace more market-oriented strategies, like those of a margin-oriented NOC or an IOC. Within these companies, cost reduction programs have been broad, often including reduced capital investment in exploration, and delays in new field development, steps which have hit oil field services companies hard, and they too are striving to cut costs.

Persistently lower oil prices and the cost-cutting measures that have resulted, have been a game changer for states or NOCs that rely on IOCs as partners in developing national resources. As NOCs look to IOCs for continued investment while IOCs focus on cutting costs, NOCs may have less leverage in negotiations with IOCs. In fact, there may be competition among NOCs and states to attract foreign capital, which could result in the loosening of production sharing terms and the relaxation of the other more onerous contract terms for oil and gas tenders. For example, the second bidding round of Mexico's oil sector opening to foreign investment was more successful after the government relaxed fiscal and contract terms. Other Latin American states that are keen to attract capital are taking similar steps.

"NOCs are beginning to shift from a budget culture to a margin culture."

From cost reduction to margin maximization

Over the next 2–5 years, as NOCs and states seek to maximize the margins from their hydrocarbon resources, we expect many NOCs to shift from a budget culture to a margin culture.

The process is well established. Companies first seek to understand where cost lies in the business, and how they can change the cost base. Next, they consider how best to deploy capital so that it has a measurable effect on profitability. Finally, capital is deployed to maximize margins. IOCs are typically operating in the last phase; many NOCs are still in the first phase. States with more diversified economies, less dependent upon oil revenues, are proving the quickest to embrace this transition.

The opportunity for NOCs internationally

NOCs that opt to maximize the return on total investment may also see the present low oil price environment as an opportunity to invest in foreign assets as a way to economically extend their technological capabilities or geographical footprint.

Inspiring numbers

From **US$100** a barrel in 2014 to **US$30** in 2015 – the oil price fall

Near term, oil prices are expected to move in a range between **US$30** and **US$50**

By late 2017–18 oil prices are expected to stabilize, likely around **US$50**

60% share of NOCs in global production

2–5 years – the window for NOC reform

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