

Middle East Oil and Gas Sector Reform: Strategies and Policies for Improved Governance

Washington-area professionals gathered on April 15th for the sixteenth IRG Discussion Forum, Middle East Oil and Gas Sector Reform: Strategies and Policies for Improved Governance. Vahan Zanoian, President and CEO of PFC Energy, and Nawaf S. Al-Sabah, Manager of the Kuwait Petroleum Company USA, discussed the challenges facing National Oil Companies.

Energy-sector decision makers in the Middle East face diverse domestic, regional, and global realities and pressures. The roles of national and international oil companies and government policymakers, regulatory issues, and the operational linkages of oil and gas with the rest of the economy all need to be considered in their deliberations. Geopolitical factors, environmental concerns, industry consolidation, and competitiveness are also critical issues affecting Middle East energy policies.

The Traditional Role of NOCs

Historically, National Oil Companies (NOCs) in the Middle East have had limited direct or operational linkages with the rest of the economy, yet they have been the main source of financing for

the entire socio-political structures they serve. In countries already suffering from economic stagnation and chronic unemployment, this is a costly option.

Middle East governments are increasingly under pressure both internally and externally to translate oil and gas revenue into broader and more far-reaching domestic economic development. A narrowly focused energy economy and strong government cash reserves are no substitute for diverse economic development, as the latter spurs the creation of new industries, increases employment opportunities, and ultimately assists in the greater distribution of wealth throughout society.

NOCs have also been instruments of foreign policy, because the control they exert over world oil supplies has traditionally been the major source of the strategic significance of Middle Eastern nations. However, while the Gulf region remains the main supplier of crude oil to the global market, this alone no longer guarantees its strategic significance to the rest of the world.

The strategic interests of oil-exporting countries demand that they secure the present, by prolonging the importance of oil as a source of energy and their own importance as the predominant suppliers of that oil.

However, to secure the future, these countries will need to reduce their own dependence on oil revenues and diversify their investments in global markets. The first demand is being met by a see-saw strategy of

The traditional roles of the NOCs are not effective in the new global economy.

price defense and market share defense that allows NOCs to increase revenue growth and maintain profitability.

Securing the future is proving to be more problematic.

Energy and Economic Development

The vast economic development potential of energy remains unrealized in the Middle East, resulting in huge opportunity costs for the Gulf economies. Facing significant unemployment and growing populations, the

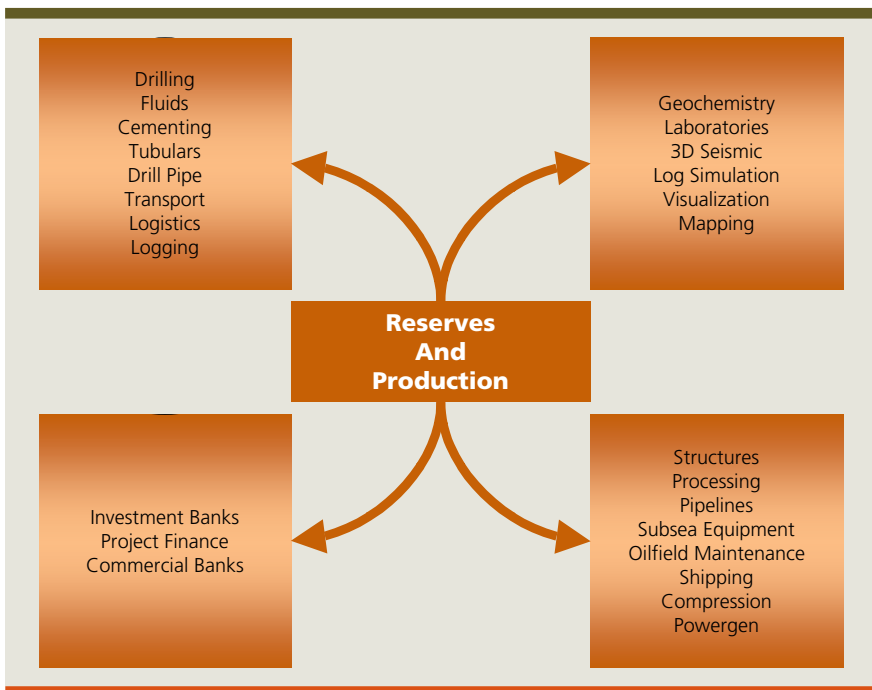
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Going Global: The Future of Kuwait Oil, interview by *The Georgetown Journal of International Affairs* with Nawaf Al-Sabah at www.pwcglobal.com
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Houston Cluster Description and Evaluation,
www.isc.hbs.edu/MetaStudyTemplateHoustonOilAndGas.pdf

region should begin to take advantage of this largely untapped potential. Securing the future will require macro-economic reform, energy-intensive economic development, and efficient energy clusters, such as those in Houston, Texas, and Stavanger, Norway.

These clusters create economic linkages between the energy sector and the rest of the economy that encourage and support a wide range of commercial activities. More than 100 companies associated with the Houston cluster have provided the area with 20,000 new jobs in industries and services supporting the sector (see figure 1).

**Figure 1:
The Efficient Energy Cluster**



The NOCs are the most viable vehicles for achieving similar linkages in the Middle East, where even a small fraction of this number of new jobs would be significant. Rather than using energy resources just for export earnings, they could be used to help:

- ♦ Develop local economies;
- ♦ Create economies of scale and synergies across different sectors of the economy;
- ♦ Diversify export earnings away from crude oil;
- ♦ Induce private sectors to invest in their own economies;
- ♦ Alleviate unemployment;
- ♦ Attract foreign investment and technology;
- ♦ Open new export markets and create new business relationships and alliances.

Securing the Future

The critical questions facing governments of the Middle East in determining the best means to secure the future, for both the oil industry and the larger society, include:

- ♦ Defining the role of NOCs in the development and management of hydrocarbon resources;
- ♦ Determining whether the traditional relationship between NOCs and their governments encourages and

promotes competitive performance;

Some NOCs are beginning to commercialize, focusing on the operational activities they are best equipped to perform.

- ◆ Realizing the full benefit of alliances with International Oil Companies (IOCs);
- ◆ Deciding whether NOCs could better serve the economic and strategic interests of the region by becoming competitive, performance-driven international energy companies.

Some NOCs are beginning to commercialize, focusing on the operational activities they are best equipped to perform. However, the requirements of a commercialized NOC are not always consistent with their traditional roles, and political realities can complicate the necessary process of changing those roles.

Transforming NOCs

The roles and responsibilities of all key players and stakeholders will need to be re-evaluated to identify the reforms necessary to manage hydrocarbon resources to foster the overall economic development of the region. Decentralizing oil and

gas sector activities and encouraging more outsourcing will be an important first step.

Clear government policies on sector objectives and processes and a transparent investment and regulatory framework could facilitate more private sector initiatives. Improved commercialization of NOC operations would

assist both in the establishment of competitive markets and the development of an open process for international oil and gas company participation in development initiatives. More regional cooperation and

integration between governments and within the private sector would encourage the expansion and diversification of these emerging markets.

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About the Speakers

Vahan Zanoian has more than 25 years of experience analyzing energy markets. His areas of expertise include production and pricing strategies of oil and gas producing countries and geopolitical forces affecting the global energy industry. Recently, he has focused on business development strategies in the Middle East and the challenges NOCs face in their relationships with host governments and IOCs. Before joining PFC Energy, Zanoian was a managing director at Wharton Econometric Forecasting Associates, where he founded the Middle East Economic Service and served as the company's expert on oil markets. Zanoian has graduate degrees in Economics from the University of Pennsylvania and the American University in Beirut.

Nawaf S. Al-Sabah is responsible for development of downstream business opportunities for KPC as well as policy analysis of energy and security issues. He first joined KPC's Corporate Legal Department, where he was Senior Legal Counsel and the principal in-house attorney on international strategic transactions. Al-Sabah also served as a corporate transactions attorney for Gibson, Dunn & Crutcher LLP, an international law firm based in Los Angeles. He has lectured to various energy and business groups, including the Harvard Business School, Wharton School, the Army War College, and the Texas State Bar. Al-Sabah holds degrees from Princeton University in Public and International Affairs and from Harvard Law School.

- ◆ Fostering a wider role for NOCs in overall economic development requires sufficient infrastructure, abundant human resources, and an entrepreneurial environment. Although the Gulf region has the necessary infrastructure, the other requirements are in shorter supply. Kuwaiti entrepreneurs, however, have demonstrated their ability to rise to the challenge by responding quickly and effectively to new economic incentives after the fall of the Iraqi regime, and the government of Kuwait is re-designing school curricula to ensure that students learn how to plan for lifetime careers, not simply finding a job.
- ◆ Changing the role of NOCs involves political as well as economic and technical transformation. In Kuwait, KPC is negotiating with Members of Parliament to enact an enabling law that will approve a basic framework for all subsequent negotiations between KPC and IOCs, thus simplifying and de-politicizing the ongoing negotiating process.

About the IRG Discussion Forum

The IRG Discussion Forum, a monthly event hosted by Henri-Claude Bailly (chairman of IRG's Board of Advisors), addresses issues affecting international development. Each session is informal, with guest speakers and attendees participating in a personal capacity. For comments, questions, or information on the Discussion Forum, contact discussionforum@irgltd.com or call IRG at 202-289-0100.

2004 Schedule

- May 20 Institutional Justice and Rule of Law
- June 30 Knowledge Management

Case Study: Kuwait

The Kuwait Petroleum Corporation (KPC) is the prime driver of Kuwait's economy. KPC accounts for 45 percent of GDP and 94 percent of total government revenues and employs 14,000 people and 17,000 contract workers (of which only 20 percent are Kuwaiti nationals). KPC aims to diversify the country's source of income beyond simply selling crude oil, create new job opportunities for Kuwaitis, and improve production efficiency through partnerships with International Oil Companies (IOCs).

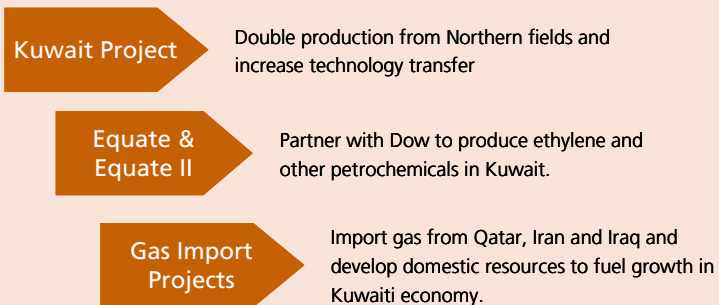
Under the operating service agreements that define these partnerships, KPC retains strategic control while IOCs have operational control, with government oversight. IOCs also commit to transferring technology and providing new employees with training comparable to that offered by IOCs in their home country. Over the course of their contracts, IOCs are expected to increase employment opportunities so Kuwaitis represent 90 percent of employees.

These IOC partnerships also encourage the involvement of Kuwaiti energy sector professionals and members of local academic and scientific communities in sustainable hydrocarbon research and development programs. Health, safety, and environmental procedures are held to the highest standards and best industry practices are maintained in all IOC operations in Kuwait.

By illustration, to decrease dependence on oil, KPC is partnering with Dow to produce ethylene and other petrochemicals in Kuwait as part of the Equate Project. Gas imports from Qatar, Iran, and Iraq for other projects are also helping fuel growth in the economy.

To meet its goal of increased production capacity while limiting future production cost increases, KPC is turning to IOCs for the necessary technology and expertise. Under the Kuwait Project, the objective is not merely to expand production, but also to provide training, technology transfer, use of best industry practice and international standards, and minimize risk. The solutions developed in the project site can then be applied to other oil fields. To date, three IOC consortia are seeking partnerships with KPC to help Kuwait use its resources responsibly and efficiently, while creating new jobs in a more diverse economy.

Selected Kuwait investment projects are designed to maximize local benefits to the economy.



International Resources Group (IRG) is an international professional services firm that helps governments, the private sector, communities, and households manage critical resources to build a cleaner, safer, and more prosperous world. Since 1978, IRG has completed over 650 contracts in 134 countries, delivering high-quality, cost-effective services that promote positive economic growth, institutional and social change, and intelligent use of resources—human, physical, environmental, and financial. IRG's international development staff include world-renowned specialists who have pioneered many of the analytical techniques employed in their fields. IRG's ability to provide management, economic, and technical advice is further enhanced by the diversity, cross-cultural experience, foreign language skills, and management capabilities of staff based in the Washington, DC, headquarters, corporate offices in India, Indonesia, and the Philippines, and 20 project-dedicated offices around the world.

