Governance in the Oil and Gas Industry: Past Approaches, New Challenges
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Abstract

The oil and gas industry plays a crucial role in driving the global economy. Processes and systems involved in producing and distributing oil and gas are very complex, capital-intensive and require state-of-the-art technology. Predicting the future of the industry can be a rather dicey undertaking given the myriad of variables that affect the industry environment.

Regardless of their position in the value chain, there is one common and essential element for all players in the sector. This element refers to the establishment and implementation of a governance framework that can help overcome certain obstacles and yield many benefits in order to achieve sustainable development as one of the preconditions for the development of today’s society.

In the light of the recent economic and financial crisis, governments across the globe are adopting measures designed to improve systems of corporate governance, especially the elements of risk management and compliance. Without proper governance, companies can face great challenges both internal and external to the organization. For example, attracting investment may be very difficult if investors are not convinced that there are adequate controls, checks and balances that a governance framework can provide in place. Additionally, the lack of governance can lead to inefficiencies, such as operational issues, in the system, and one must also bear in mind the various effects on sustainability, social responsibility and the society as a whole. However, with a carefully crafted and successfully implemented governance framework, many of these problems can be reversed.

The aim of this paper is to provide the reader with information on how companies in the oil and gas industry approach corporate governance and to present and critically assess some of the main challenges that lie ahead.

Keywords: Corporate governance, oil and gas industry, sustainable development

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1. Introduction

The growing dependence on fossil fuels on a global level must be addressed with great caution and urgency. The coordination of efforts among international leaders and leading countries has already proven to be a challenging endeavour. In order to initiate meaningful international policy measures to combat fossil fuel dependence and climate change, it is necessary to take decisive steps domestically to pave the way for world progress.

While economies of the United States and most other industrialized, Western countries will strengthen this year, all of the world’s oil and gas consumption growth of 1.1 million b/d is believed to occur in emerging markets. This represents a well-established trend. Economic growth is fastest in the industrializing world, and factors such as energy-efficiency gains and underlying macroeconomic concerns moderate projections for oil demand in developed economies (Xu, Bell, 2014).

Meanwhile, the dramatic oil supply increase outside the Organization of Petroleum Exporting Countries, boosted by the US shale revolution, is challenging the market share of traditional oil exporting countries. OPEC’s output strategies thus face unprecedented challenges. Due to the present constellation of power in the global oil and gas industry and respecting the paradigm of corporate social responsibility and sustainable development, one should also take a look at the oil and gas industry in the emerging economies (Searle, 2010).

Many developing and emerging economies try to take advantage of the natural resources available in their countries in order to boost development (Deloitte, 2014). National Oil Companies (NOCs) that deal with the extraction, development, and sales of oil and gas resources are a vivid example. The role of these NOCs is very important in many regions around the world. Regardless of the type of companies set-up, (entirely public, partnerships with private companies, or other operating models), there is one element that is common and essential to them all to ensure maximal returns are realized. This element is that of establishing and implementing a governance framework that can help overcome certain obstacles and yield many benefits (Deloitte, 2014).

Without proper governance, oil and gas can face significant challenges in many areas, both external and internal to the organization. From an external point of view, sourcing funding and attracting investment would be very difficult if those sources of funding and investment are not persuaded and sure that there are adequate controls, checks and balances that a governance framework can provide in place. Additionally, financial statements can be impaired by the lack of trust and confidence in the numbers that are being published without proper oversight. Internally, the lack of governance can lead to inefficiencies in the system in all aspects such as capital deployment, organizational performance and operational issues. There are also adverse effects on sustainability and social responsibility given the nature of NOCs’ responsibilities and their impact on society. However, with a carefully designed and successfully implemented corporate governance framework, all of these problems can be dealt with.
Best-practice have been defined and created in successful oil and gas producing countries, but while such practices may work well for successful, well-resourced producers, the same policies may be completely inappropriate for emerging producers in developing countries, which often face great development challenges, such as weak institutional capacity and low knowledge of the oil and gas sector, in addition to growing socio-economic issues. In other words, emerging producers should pursue policies that acknowledge the realities of their national contexts, that can bring about rapid results in a context of urgent need, and that allow for incremental improvements to their governance processes. These will be presented in the following sections.

2. The Essence of the Corporate Governance Framework

Corporate governance can, most simply, be defined as a system by which firms are directed and controlled. This system embodies a whole set of relations between the management, board, and stakeholders of a firm. Moreover, it defines the framework for setting goals and determining the means to achieve those goals, as well as for monitoring the performance and efficiency of the firm (Tipurić, 2008).

Corporate governance refers to the processes and structures by which the business and affairs of an institution are directed and managed. In order to improve long-term shareholder value by enhancing corporate performance and accountability, while taking into account the interest of other stakeholders. Corporate governance also refers to building credibility, ensuring transparency and accountability as well as maintaining an effective channel of information disclosure that would foster good corporate performance.

The essence of corporate governance is to ensure good business performance, accountability towards stakeholders (e.g. customers, staff, shareholders, suppliers, regulators and local communities) and risk mitigation.

3. Corporate Governance System in the Oil and Gas Industry: The Rise of National Oil Companies and the Issues in Emerging Countries

The oil and gas industry can be divided into three segments: the “upstream”, “midstream”, and “downstream” segment. The “upstream” segment consists of the exploration and production of oil and natural gas and is dominated by the state-owned national oil companies which comprised more than 52% of production in 2007 but more importantly, possessed 88% of worldwide reserves that year. (Searle, 2010; IEA, 2009 in Searle, 2010). The “midstream”, which refers to the transportation and storage of products, and the “downstream” segment involving the refining and marketing of crude oil, both of which are dominated by the publicly owned companies (Standard & Poor’s, 2010 in Searle, 2010).

The oil market can only be seen as international in scope. While the focus of this paper is to be the NOC’s in the emerging companies, it is important to recognize the broader context of the market. To gain a more precise understanding of the various actors in the oil market, it is helpful to make an initial distinction between NOC’s and the publicly owned IOC’s. While the IOC’s operating according to the principle of maximizing shareholder value, the NOC’s, as an
extension of a national government, often possess vast reserves and resources, but operate according to objectives defined by their government. According to Petroleum Intelligence Weekly, the examples of two largest NOC’s in 2009 were Saudi Aramco and NIOC. Their objectives can vary from employing citizens, generating long-term revenue, or complementing domestic and/or foreign policy measures. Another form of state-ownership exists, which blends commercial interests with a national agenda. For example, Petrobras (Brazil) and Statoil (Norway) balance their national concerns with their own commercial interests. (IEA, 2009)

With respect to the oil and gas industry development in emerging countries, the number of mega-projects with enormous budgets in these markets has increased dramatically, but with them comes incredibly challenging environments, an unavoidable obstacle of frontier oil and gas exploration. Some problems those markets face refer to lacking infrastructure; transport i.e. roads, ports, rail, airports as well as utilities aren’t as sophisticated as their more-established counterparts. Moreover, due to these areas being relatively immature when it comes to oil and gas development, the supply chain is also rather limited and therefore the projects need to lean on the global marketplace and supply and service organizations to be able to provide resource and materials and to help develop the market maturity.

Infrastructure hurdles require a long-term perspective; therefore, average supply chain processes can add hundreds of millions if not billions more to the total project cost. It is important that clients embarking on these growth areas choose the right supply chain strategy to ensure costs do not spiral out of control (McNeil, 2014).

A governance framework embodies various dimensions of an organization starting with defining the core purpose for the company and going down to details such as defining standards for policies and procedures. Additionally, it should also define the support mechanisms that should be arrayed around it to help in achieving proper governance and control. These include areas such as a suggested organizational structure, reporting lines and definitions of roles and responsibilities, a defined approach to risk management, and the ability to monitor and enforce compliance, etc.

The rise to prominence of national oil companies has shifted the balance of control over most of the world’s oil and gas reserves. During the 1970s, the NOCs controlled less than 10% of the world’s oil and gas reserves; today, they control more than 90%. This dramatic shift has increased the ability of NOCs to source financial, human and technical resources directly and to build internal capabilities. (Leis, McCreery, Gay, 2013) However, despite the rise of the NOC’s, such companies in developing and emerging oil and gas countries face significant governance issues which will be the topic of this chapter.

An effective governance framework should provide clear answers to the following questions:

- What is the mandate of the organization?
- What are the roles and responsibilities of entities/departments?
- What capabilities, processes and systems will be required?
- How should the risk management processes be organized?
What information and reporting requirements support the proposed model?
What are the appropriate mechanisms and interfaces required to support the proposed governance? (Deloitte, 2014).

Marcel and Chatham House (2013) define the following objectives for corporate governance in the emerging oil and gas industries:

- attract the most qualified investors for the long run
- maximize economic returns to the state through licensing
- earn and retain public trust and manage public expectations
- increase local content and benefits to the broader economy
- gradually build up capacity and enable actors to perform their role
- ensure national oil company participation in the development of the resources
- increase accountability

For each objective, emerging producers may face various problems in accordance with national contexts they belong to.

With regard to the concept of long-term investments, emerging producers face the issue of attracting established firms to a frontier area. The governments of such countries should encourage speculative companies to sample and provide geological data, since data reduce investor uncertainty.

Strong prequalification criteria are also needed to create distance from any suitors who may be under-qualified for exploration and production. The oil and gas legislative should specify that government approval is necessary for any transfer of control. Disclosure of bidding information to the public will discourage bidders that are keen to corruption. At the same time, growing producers that are operating in a context of low exploration interest often struggle to implement best practices when issuing licences. Auctions work well where there is high investor interest. To achieve good results with direct negotiations, producers must apply transparent selection criteria. New circumstances prompt many producers to change the terms of their contracts with foreign companies. Governments should avoid changing the terms of existing agreements; instead, they should amend future licensing terms. This will help the country to better maintain investor interest in the long term (Marcel and Chatham House, 2013).

Emerging producers should define fiscal terms that give the state early revenues for urgent development needs, while ensuring long-term economic benefits. Emerging producers must overcome the knowledge asymmetries that they meet with during negotiations with foreign oil companies. Contract transparency too can help to reduce asymmetry. Emerging producers must develop appropriate tax structures and must also define the fiscal terms that govern upstream oil and gas activity. Tax obligations should be defined in the tax code rather than in contractual agreements.

One of the challenges emerging producers face refers to winning the trust of the public, especially in post conflict situations and in countries where corruption has been a continuous phenomenon. In that manner, continuous and timely communication with stakeholders is
crucial and governments as well as oil and gas companies should disclose as much information as possible to build public confidence in the system. Moderating expectations is also an important issue. Before any oil or gas discoveries are made, governments and companies should begin considering how to manage the public’s expectations of the benefits that might emerge from the industry.

With regard to broader benefits, national development should be encouraged. For this purpose, governments should have clear objectives and identify which branches are responsible for upholding the various aspects of the defined development goals. At the same time, governments should enact capacity-building plans to ensure that domestic producers are able to supply the skills, goods, and services that the oil and gas companies require. Also, actors in the oil and gas industry should focus their capacity-building efforts on services for which the sector has an immediate need (Marcel and Chatham House, 2013).

Moreover, governments should wait to make significant investments in developing an national oil company operational capabilities until discoveries have been made that establish a reserves lifespan of minimum 15 years. In cases where the resource base is uncertain and human and administrative capacity is limited, the government should concentrate capacity building efforts in either the ministry of energy or the national oil company and task one of these two entities with regulatory responsibilities.

Various drivers can start the need to improve accountability processes in the oil and gas industry and one of the most significant triggers is the beginning of the production phase, which brings significant revenues. Emerging producers do not necessarily need to set a ‘final’ institutional structure from day one. Emerging producers should follow a phased approach and make incremental changes, structuring their reforms as a continual evolution, whereas and governments should immediately introduce key mechanisms for public accountability, including audits of agencies and state-owned companies and regular disclosure of information to the public. Governments should increase the public disclosure of data to improve public trust and manage public expectations.

Once the governance framework is created, there are six critical success factors for effective implementation. These six elements also depend heavily on the involvement and actions of stakeholders who should aim to understand and support the values of the organization. These are mostly focused around creating a compelling case through an in-depth understanding of stakeholder motives. Secondly, by interacting with the stakeholders, oil and gas companies will be aware of where pushback will come from and on which issues, leading to better mitigation strategies. In that light, a strong, united leadership will create a unified front for all stakeholders to get behind, to accomplish the task at hand. Next, providing enough time for all the changes to embed across the organization will ease the transition from the previous state to one with more controls and governance. All along, ensuring that there is proper two-way communication between the stakeholders’ groups will provide both with a means to deliver the messages across the organization, as well as relay feedback and concerns from the stakeholders back up to the leadership team. Lastly, having a well-articulated and detailed
plan, along with review points and targets, will help with establishing the transition to an organization with proper governance at all levels of the organization (Deloitte, 2014).

4. Towards a Conclusion

The oil and gas industry is extremely volatile and unpredictable. The cyclical trends that persist present market and competitive uncertainties for firms. A sound governance framework spans multiple areas across an organization and there are several crucial segments to include in the planning to ensure that the developed governance framework is both implementable but also takes root within the organization to ensure its benefits are realized.

References:


