

NOCs in the new reality

Maintaining profitability during the shift to renewable energy



There is no doubt that the entire oil and gas industry will need to be part of the energy transition. However, for national oil companies (NOCs), embracing renewable energies comes with both challenges and opportunities—particularly since they’ve been hit with a multitude of shocks during this pandemic year. Specifically, plummeting oil prices have resulted in dramatic revenue loss; there is significant spending pressure as governments demand increased dividend and tax revenues, and confidence in the future of the oil and gas industry has been impacted by alarm about the climate crisis.

In this environment, it is clear that NOCs have to find a balance:

- On the one hand, there may be resistance to the energy transition given that the vast majority of NOCs’ revenues (a median of 86 percent) come from oil and gas.ⁱ And the overall transition away from fossil fuels will lead to a permanent decline in oil and gas prices, which would negate the significant investments NOCs have made in technology and oil exploration assets.
- On the other hand, NOCs are a natural fit to lead the energy transition, given their experience managing complex projects across national borders and existing integration in fuel and power supply systems. Further, the issue is being forced to some extent by the OPEC+ agreement that mandates cuts in national production.ⁱⁱ (See sidebar.)

In this paper, we seek to expand on the insights provided to oil and gas companies in our recent thought leadership piece, *Revival of the Fittest*. Here we home in on how NOCs in particular can turn changes stemming from COVID-19 and economic crisis into competitive advantage.

OPEC+

The OPEC+ agreement began as an historically unique arrangement between OPEC and Russia. Specifically, Russia had to cut nearly 10 percent of the country’s global oil and gas output or 9.8 million barrels a day, starting in May 2020.ⁱⁱⁱ These cuts were gradually decreased to 7.7 million barrels a day in August 2020 and to 5.8 million barrels a day in January 2021. Due to OPEC’s view that global GDP was shrinking, it was decided at a December 2020 meeting to extend the agreement to other countries, which was given further impetus by Saudi Arabia’s advocacy for the initiative.

The OPEC+ agreement reflects challenges that are unique to NOCs, as opposed to IOCs. As NOCs turn off significant production capacity in their oil fields, including conservation of their wells, they carry the burden of stabilizing the global oil market at the expense of their own production volumes and market share.

ⁱ David Manley, David Mihalyi, and Patrick R.P. Heller, Hidden Giants, Finance & Development, December 2019.

ⁱⁱ IMF, Fiscal Policy Responses to the Sharp Decline in Oil Prices, Fiscal Affairs, 2021.

ⁱⁱⁱ IMF, Fiscal Policy Responses to the Sharp Decline in Oil Prices, Fiscal Affairs, 2021.

Adapting to the new reality for oil and gas

While it is clear that NOCs will face challenges as they seek to find their place in the energy transition, they can minimize their risk and maximize their success by embracing several imperatives that are impacting the industry.

Integrating ESG into the operating model

Some countries are recognizing NOCs' contribution to budgetary and social stabilization by offering them some flexibility in aligning with the climate change agenda—albeit only temporarily. However, other countries, particularly in the Asia-Pacific region, are pushing for NOCs to achieve parity with IOCs. For example, in Malaysia, the government has announced that it will increase its renewables presence, as exemplified by the country's recent investment in a solar photovoltaic system for residences and small- to medium-sized businesses across the country. China's largest NOCs—Petrochina, Sinopec, and CNOOC—are taking steps toward diversifying into wind and hydrogen power. And in Vietnam, PetroVietnam has set an ambitious target of 100 MW of renewable capacity by 2025 and 900 MW by 2035, which would make the country the most promising market for offshore wind in the region.

Saudi Aramco

A notable example of progress along the climate change journey is Saudi Aramco. The company has a long history of investing in reducing the greenhouse gas intensity of crude oil and its derivatives. Since 1980, the company has been installing flare-gas recovery systems at its onshore Safaniya facilities as part of its Flaring Minimization Program. Research and development efforts are largely focused on four strategic areas: (1) sustaining low-carbon-intensity crude oil, (2) growing nonfuel applications for crude oil, (3) advancing sustainable transport, and (4) driving high-impact solutions. Saudi Aramco's leaders have expressed the belief that climate change can only happen if countries reduce their emissions and implement abatement measures, such as natural sinks that absorb CO₂. Further, CO₂ is viewed not just as an emission to be controlled, but also as a source of additional value; capturing CO₂ and other gases and redirecting them into manufacturing industrial products and feedstocks can stimulate economic growth and job creation. As these moves will be beneficial not only to consumers but also to energy producers themselves, Saudi Aramco could serve as a model for NOCs throughout the world of how to align with the climate agenda.

Ensuring financial resilience

Although the pandemic has highlighted how lower production costs are allowing some NOCs to endure depressed oil prices for longer than their international peers, this is certainly not the case across the board. Most NOCs are facing reduced revenues and profits resulting from mandated decreases in their production capacity as well as escalating pressure to provide dividend and tax revenues for their governments. Further, they are subject to restrictions on workforce reductions due to government requirements to maintain social stability. Given these burdens, NOCs are challenged by the effort to maintain their own financial stability. Therefore, most will have to turn to other measures to ensure their viability. For example, a large Russian NOC has reduced staff working hours instead of instituting layoffs. And Petrobras is seeking to optimize its cost structure by addressing general and administrative overhead costs and reducing debt to levels achieved by its international peers.

Exploring strategic acquisitions and partnerships

NOCs with stable balance sheets and government support are able to pursue diversification outside of traditional operational areas.

Those with a limited appetite for exiting oil and gas portfolios are looking to IOCs for available assets. The largest oil and gas companies, including ExxonMobil, Royal Dutch Shell, Chevron, and BP, are expected to sell a combined \$100 billion in oil and gas assets around the world so that they can focus on their top-performing products and regions, e.g., U.S. shale. Acquiring IOCs' assets offers NOCs the opportunity to expand their presence beyond the borders of their own countries, although this is subject to government approval and acceptable funding structures.

Other NOCs are partnering with large trading companies to form joint ventures. These deals give NOCs access to capital to assist them in their expansion efforts into new markets. In turn, trading companies are able to profit from NOCs' significant supply capacity. For example, despite challenging market conditions, a deal was recently announced between Trafigura and Rosneft, a Russian energy giant. Under the terms of the deal, Rosneft will sell to Trafigura 10 percent of the capital in the Vostok Oil project—an ambitious initiative to develop hydrocarbons in the Russian Arctic. Vostok has entered into the Ermak Neftegaz venture with BP to construct pipelines, roads, and other infrastructure to allow produced oil to be shipped to Asia via the Northern Sea Route. Finally, Russian gas giant Gazprom is expanding its investment program through initiatives that include the restart of its North Stream II pipeline to Europe, giving them access to a very lucrative market.

Conclusion

In the new reality, NOCs face some unique challenges as they seek to balance climate change pressures with their own financial viability. To the extent that they can include ESG in their operating models, take cost out of the system, and pursue strategic acquisitions and partnerships, they will be in a stronger position to expand their market presence around the world.

How KPMG can help

KPMG has helped oil and gas companies capitalize on opportunities and build resilience for decades. Now, we're ready to help meet your complex and evolving needs as the industry begins to recover from recent demand destruction, geopolitical events, and the long-lasting impact of COVID-19.

KPMG global professionals are skilled and experienced in the following areas across the oil and gas, chemicals, power and utilities, and natural resources sectors:

- Digital transformation and technology enablement
- Strategy and process redesign
- Sustainability, including reporting and assurance
- Zero-based budgeting and cost takeout
- Working capital management
- Risk management, including climate and third-party risk.

We look forward to speaking with you about developing and executing on strategies that will allow your business to thrive in the new reality.

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Anton is the global head of Oil & Gas and sector leader for the KPMG in Russia practice with global responsibility for the region plus nations in the CIS. He has more than 20 years of experience in auditing and advising companies in the Russian energy and related industries. Anton has broad experience with issues related to listed groups reporting under various standards (IFRS, U.S. GAAP, Russian GAAP) and transaction-related work as well as setting up and conducting major audits and advisory projects for large groups.

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Regina leads the KPMG Energy & Natural Resources practice globally. She is a recognized thought leader on the disruptive trends affecting the various segments of the energy value chain, from the wellhead through retail, and from power plant to burner tip. For more than 25 years, Regina has helped major energy companies around the world realize large-scale business and technology transformations.

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