

When should national oil companies have subsidiaries?

Rationales for establishing subsidiaries in national oil companies and how these NOCs can manage their existing subsidiaries more effectively – should they merge subsidiaries into business units or privatize them?



National oil companies (NOCs) are becoming ever more influential in today's oil and gas environment, dominating production output and expanding their footprints beyond their local boundaries. With this growth and increase in influence, many NOCs have expanded their organizations over the years, creating subsidiaries and other holding companies, all of which were meant to ease management of resources, technology, and people. Due to their inherent challenges in managing large organizations, as well as external challenges such as the recent changes in market dynamics (new-player entrants, non-conventional plays, etc.) and long-term low oil price, NOCs are reconsidering their organization structures and aiming to become more agile.

NOCs can be organized in business units, or have separate legal entities (subsidiaries) to manage the operations. For instance, Saudi ARAMCO organizes itself mainly through business units and has very few subsidiaries, while other companies, such as Kuwait Petroleum Corporation (KPC), Abu Dhabi National Oil Company (ADNOC), Qatar Petroleum (QP), and PETRONAS have between eight and 37 subsidiaries. Each company has a different number of subsidiaries, with varying allocations of activities. However, establishing subsidiaries should not be ad hoc, but based on well-defined criteria. In this viewpoint, Arthur D. Little highlights how NOCs can decide whether they should create new subsidiaries and what to do with existing subsidiaries. There are multiple options for existing subsidiaries, ranging from merging them into business units, to privatizing them, to maintaining the status quo.

Criteria for establishing a subsidiary in oil and gas

In our recent study on organizational restructuring, we analyzed a number of NOCs across all regions. The underlying conclusion was that NOCs had created subsidiaries and sub-subsidiaries based on their business requirements and/or political reasons – not on standardized parameters, as companies had done in many other sectors. NOCs were looking for benefits from the establishment of subsidiaries, such as independence, agility, less bureaucracy and more business focus. However, these benefits can also be achieved through existing business units with better processes, systems, and appropriate delegation of authority to the different functions.

Four parameters warrant the existence of subsidiaries within the oil and gas sector. However, not all these parameters must be met in order to establish a subsidiary – one parameter is enough.

Local legal constraints: Some countries have legal constraints in executing activities within a business unit, and thus these activities must be managed within separate entities to be compliant with the law. For instance, in one of the Middle Eastern countries, economic zones are required to have a separate legal entity in order to receive tax and custom benefits.

Legal and financial protection of a holding company: NOCs manage highly risky operations entailing large and capital-intensive projects. These NOCs require separate entities to shield their holding companies from the legal and financial implications of these investments. For instance, in one Middle Eastern country, the pension, saving and welfare funds are managed by a separate subsidiary of the NOC to protect the NOC from any liabilities associated with the investments the funds conduct. The pension fund has numerous investments, including engineering companies dealing with several subcontractors. In the event that one of the engineering

companies fails to pay its subcontractors and they file lawsuits against the engineering company, the pension fund will be held accountable, while the parent company (the NOC) will be shielded against any legal and financial implications.

Foreign activities: In recent times, NOCs have been expanding their footprints and investing in foreign operations in order to diversify their portfolios, secure additional reserves, and facilitate their access to export markets. When operating abroad, NOCs are bound by legal requirements from their host countries to establish local legal entities to execute the activities. In some instances, this can lead to the set-up of multiple local operating company subsidiaries, particularly with long histories of acquisitions. These subsidiaries often lack the required delegation of authority, the proper governance model, and cost management capabilities, which can lead to conflicts with international joint venture partners.

Specialization: A specialized activity could require a separate entity and a separate brand name/identity independent of the holding company. This subsidiary could also require a separate salary scale to match specialized skill sets it needs. For instance, some NOCs have separate subsidiaries to manage healthcare service provision to the employees of the holding company and all its subsidiaries. This activity is not core to the oil and gas sector, and requires an independent entity with specialized staff in healthcare.

Benefits and challenges of having subsidiaries

Establishing a subsidiary has multiple benefits for a NOC:

- Independence from the holding company and agility in the decision-making process. This benefit can be achieved if the holding company provides the appropriate delegation of authority to the subsidiary. Otherwise, inefficient and slower decision-making will result because of the increase in number of decision-making layers (such as General Assemblies and Boards of Directors).
- Increased awareness of the service provided by the subsidiary due to a dedicated brand image and name. In the case of the NOC, providing services to other companies (such as drilling services), a dedicated subsidiary will provide a better marketing vehicle to attract and engage customers.
- If the NOC is planning to privatize some of its activities, having a legal entity (subsidiary) in place for these activities will make the privatization process easier. The private sector will be able to buy the legal entity without disrupting the rest of the holding company's businesses. Thus, establishing the subsidiary could pave the way for privatization initiatives.

However, establishing a subsidiary could lead to certain challenges that the NOC needs to anticipate and address:

- Potential **lack of visibility** of the subsidiary's activities. Some subsidiaries fall into the trap of being very independent

from their holding companies and fail to maintain seamless reporting mechanisms with the holding entities. The holding company should have visibility of the subsidiary's activities and performance in order to support the subsidiary, while also leveraging and disseminating lessons learned across the organization.

- Potential **increased costs** from set-up and operating expenses incurred from creating a new legal entity.
- Potential **duplication of positions and activities**, especially support functions. NOCs should clearly delineate the roles and responsibilities between holding company and subsidiary to avoid any redundancy. NOCs could consider maintaining some functions centralized at the holding level or creating shared-services organizations to serve their holdings and subsidiaries based on service level agreements (SLAs).

What to do with your existing subsidiaries?

NOCs with existing subsidiaries should evaluate each subsidiary's objective and requirement as a separate entity. This can be conducted by applying the criteria explained above. If the subsidiary meets at least one of the criteria, it should remain a separate legal entity. Otherwise, the NOC should merge the subsidiary's activities into the holding company's business unit(s). Such benefits include:

Authority and control improvement:

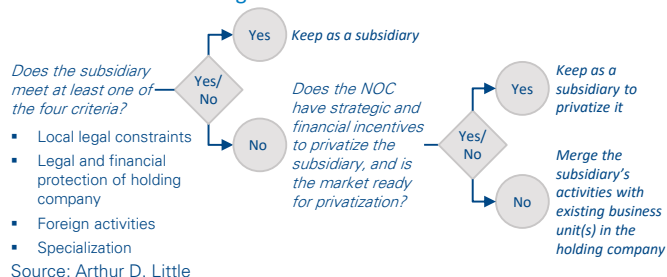
- Removal of interim decision layers between holding companies and subsidiaries, such as boards of directors and, in some other instances, general assemblies, which leads to faster decision-making and reduction in the number of direct reports to their MDs and deputy MDs.
- Easier to manage critical resources, streamline processes, track changes, and provide accountability and responsibility to different parts of the value chain.

Streamlined organization:

- Potential cost savings from consolidation of activities within business units.
- Reduction in shared functions such as finance, IT and HR.

In the event that the NOC has strategic and financial incentives to privatize a subsidiary, it is recommended to keep the subsidiary as a separate legal entity and not merge it with business unit(s), even if the subsidiary does not meet at least one of the four criteria for establishing a subsidiary. Maintaining a separate legal entity will facilitate the privatization implementation and avoid disrupting the rest of the holding company's businesses. Moreover, the NOC will have a clear demarcation between what to sell and what to keep in-house, facilitating any HR and financial decisions to be taken during the implementation, as the privatization boundaries are well defined.

Decision tree for existing subsidiaries



Privatization

Today, around 85 percent of all global oil and gas reserves are owned by state-owned companies. This compares to 30 percent in the 1980s. The nationalization wave of the 1970s created NOCs with total control of oil and gas assets, which resulted in monopolies; however, the misconception that fast progress is possible without private sector intervention has remained.

Most NOCs are unable to compete with international oil companies (IOCs) in the following areas: profitability, commercial efficiency (i.e., poor cost structures), technology development, and value creation for their stakeholders. The reason is complex in nature, creating conflict in the NOC's strategy of commercial effectiveness and national social agenda (social development, job creation, unfair income redistribution).

NOCs are taking concrete steps to increase efficiency through market competition and sector development through investment, removing special protection and implementing progressive pricing policies and fair governance. All this has led to increased privatization and liberalization in both export- and import-driven oil and gas countries.

Criteria for assessing market readiness for privatizing the activities of a NOC subsidiary

NOCs should assess market readiness before privatizing the activities of their subsidiaries to ensure smooth transition of the activities to the private sector.

In a heavily state-regulated and subsidized oil and gas market, we do not recommend privatization of subsidiaries if it leads to disruption and destabilization along the value chain. The reason is that the private market is not as developed as it would be in a free market. ADL assesses market readiness for privatization by applying four key criteria.

Criterion 1: Availability of a similar business model

This criterion is about the market's existing familiarity of managing businesses and operations in the oil and gas value chain. Privatization of an entity will have a higher success rate if a similar business model is available in the market, highlighting market readiness, competition, and acceptance. Furthermore, if the entity is sold to a private company with no relevant experience in the field, the privatization will not be successful. For instance, not long ago, a large Chinese oil and gas company had privatized through listing 40 percent of its

large retail business to private companies with no competencies in the field, and the privatization did not contribute to improved performance of the company.

Moreover, the business scope and competitive landscape play a role in the availability of the business model in the market. For instance, the highly competitive retail sector is more privatized than the less competitive exploration and production sector.

Criterion 2: The private sector's ability to develop/buy technology

The private company's ability to develop its own technology or source technologies from the international market to remain competitive from a global perspective is important for privatization assessment. For example, oil refineries require advanced cracking methodologies such as "steam cracking" to produce olefins from crude oil directly, which leads to production cost savings. Proven ability to adapt to a changing environment provides a proxy of the private sector's readiness to manage such changes.

Criterion 3: Private sector's ability to secure capital

As oil and gas is a capital-intensive industry, private companies should be strong enough to raise capital through the debt/equity market or banks and reinvest the industry's own capital to showcase its market strength and sustainability.

Criterion 4: Level of market freedom/price-setting and tariff

Market deregulation allows companies to sell their products and develop strategies to compete effectively. This criterion assesses how deregulated the market would be for that particular service offering, and whether significant fiscal or regulatory policies would need to be modified.

Key factors to consider before privatizing a subsidiary, based on lessons learned from previous privatization initiatives

Privatization is not a simple, uniform, or "one size fits all" process. Each privatization has different objectives and a wide variety of challenges, but some key success factors are common:

- **Commitment and ownership** – Economic theory is agnostic to ownership change, giving market structure and competition level much greater importance. Market structure changes rarely occur in the absence of ownership changes, especially in state-owned enterprises (SOEs) and their subsidiaries, given their reluctance to change.
- **Transparency** – Lack of transparency leads to allegations of corruption, creates backlash from investors and the public, and threatens to halt privatization and liberalize reform in general.
- **Social impact mitigation** – Privatization of NOC subsidiaries may require sizable labor-force reductions. The process will always be contentious, but problems can be reduced if government, and sometimes the private buyers, commence dialog with labor early in the process and jointly work out an acceptable approach.

Market-readiness methodology

Market-readiness elements	Definition	Market unready	Market ready
Part I			
Is the business disruptive or strategic to the value chain?	Is there a strategic link with the rest of the value chain, and will there be a risk of bringing sudden value chain instability and unpredictable threat (including natural monopolies) in the case of privatizing the business?	<div style="border: 1px solid black; padding: 5px;"> Deterministic question Yes No Next step </div>	
Part II			
Availability of similar business models in private sector	Private sector's technical and operational abilities to run the operations and business activities, and availability of service providers for the specific business	<div style="border: 1px solid black; padding: 5px;"> Scoring Scale <input type="radio"/> No similar private businesses <input checked="" type="radio"/> Existing private businesses </div>	
Capability of private sector to develop/acquire required technology	Complexity and accessibility of technological improvement necessary to optimize the operations in the value chain	<div style="border: 1px solid black; padding: 5px;"> Complex technology requirement Developed technology </div>	
Ability of private sector to secure capital requirements	The need and ease of providing capital investment for the private sector to make the value chain operational or profitable	<div style="border: 1px solid black; padding: 5px;"> High capital requirement/hard to finance Low capital requirement/easy to finance </div>	
Level of market freedom, price setting and tariffs	Market deregulation and ability of companies to sell their products and services free from tariffs and restrictions	<div style="border: 1px solid black; padding: 5px;"> Regulated market structure Liberal market structure </div>	

Source: World Bank; OECD; Transition from public to private sector, L.M. Murphy; Arthur D. Little

Conclusion

NOCs are consistently considering improvement measures to their organizational structures in order to become more agile. One of the key elements of their organizations that they need to evaluate is current subsidiaries and the need for new ones. If the NOC's activity requires a separate legal entity based on local laws, requires protection of the holding company from legal and/or financial risks, requires specialization with a dedicated brand image, or is actively involved in foreign activities, then the activity needs a separate legal entity

If an existing subsidiary does not meet at least one of four criteria to create a subsidiary and the NOC does not plan to privatize it, then the subsidiary's activities can be merged with the existing business unit(s) of the holding company. However, if the NOC plans to privatize the subsidiary and the market is ready for the privatization, then the subsidiary should remain a separate legal entity to facilitate the implementation process and avoid disrupting other parts of the holding's operations. Privatizing the subsidiary should be well planned and the overall process clearly communicated to employees to ensure smooth transfer of ownership from public to private sector

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We have extensive project experience in linking strategy, innovation, and transformation in the oil and gas sector. Projects including the reorganization of the entire oil and gas sector, as well as reorganization of NOCs and their subsidiaries, in Latin America, Africa, the Middle East, and Asia.

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