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Dr. Eduardo Pereira
STR Holding GmbH
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Oil, Gas & Energy Law Intelligence

National Oil Companies Operating in Upstream Petroleum Projects and Participating in Joint Operating Agreements

by M.K. Kanervisto and E.G. Pereira

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NATIONAL OIL COMPANIES OPERATING IN UPSTREAM PETROLEUM PROJECTS AND PARTICIPATING IN JOINT OPERATING AGREEMENTS

Meri-Katriina Kanervisto, Krogerus / University of Eastern Finland

Dr. Eduardo Pereira, STR Holding GmbH

1 INTRODUCTION

The roles of national oil companies (NOC) and international oil companies (IOC) have changed over the history of the petroleum sector. The upstream activities used to be largely the business of the IOCs, but along the nationalisation the governments and NOCs have tightened up their grip on their natural resources. Above all, NOCs have become more capable of controlling the upstream activities, thus gaining ground from the IOCs.

The cooperation between NOCs and IOCs has increased, as both parties, after all, need each other. Governments need foreign investments and know-how of the IOCs, whereas the IOCs search for profitable business. The organisations are still, however, quite far from each other. The NOCs may have several non-commercial interests imposed by their governments, while the IOCs' principal task is to maximize the shareholder value.

The cooperation between a NOC and an IOC is often managed by a joint operating agreement (JOA). This situation might come as a result of voluntarily decision (e.g. easier to deal with local communities and governmental authorities) but the reality is that such cooperation tend to occur as a legal requirement be the host government jurisdiction.

JOA typically includes several parties, who share the rights and responsibilities of the joint operation in question. Having a NOC as a party to this kind of legal relationship – which more often is concluded between private parties – brings along some special questions and challenges.

The objective of this paper is, firstly, to have a look at the development of the NOCs, then at the JOA as an agreement type and finally, examine the way how

NOCs participate in JOAs. It should be noted, however, that the nature of NOCs depends a lot on the development stage of the host country and its petroleum sector. For example at one hand Saudi Aramco, Gazprom and Petrobras are likely to have similar views as they all share strong financial and technical capabilities. On the other hand NOCs more recently created in developing countries might not have strong finance or technical capabilities. Naturally they might have different views over certain provisions of the JOA (i.e. conduct of operations) but some basic issues all of them should share the same view (i.e. access to information and control of operations). This paper will focus in the common views of the NOCs as described below.

2 NATIONAL OIL COMPANIES

2.1 Background

Oil and gas are an integral part of the national security and wealth. The functioning of the infrastructure in all countries is largely dependent on oil. Oil and gas reserves are of huge values in countries, where such reserves exist. The value of hydrocarbon isn't dependent on the country's wealth or economy otherwise, quite the contrary: oil and gas are often produced and developed in countries, where the economic infrastructure and capabilities are less developed. This is possible, because oil producers can bring all necessary skills and know-how to the country from elsewhere.¹

In most countries of the world natural subsoil resources are owned by the state.² State ownership gives the state the possibility to control the oil reserves and set their own rules for oil production. In large oil producing countries the share of oil revenue may be highly significant in the state budget. In Venezuela, for example, oil makes up more than 50 % of the government's budget revenues.³ Hence, it is not insignificant, how the state plays its role in its oil production.

¹ Inkpen, A. & Moffet, M. H., The Global Oil & Gas industry – Management, Strategy & Finance, PennWell 2011, p. 42-43.

² US and Canada are exception to this rule.

³ Inkpen, A. & Moffet, M. H., The Global Oil & Gas industry – Management, Strategy & Finance, PennWell 2011, p.49

The regulatory framework for upstream petroleum operations is typically based on the country's national constitution.⁴ The government's role in the oil sector is often comprehensive: the government may decide and control who has the access to the country's hydrocarbon reserves, i.e. who is allowed to explore, develop and produce hydrocarbon resources. Governments can impact their political, economic and social agendas through regulations and legislation. The regulation is the tool to influence on many civil society concerns, such as health, safety and environment. The national system often includes also other legislative instruments, such as pricing, taxation and redistribution of economic resources. In summary, the interest of the government is a combination of wealth and security.⁵

In many countries governments have transferred the management of the oil and gas resources to the state owned NOC, which operates in the oil sector on behalf of the state.⁶ The initial reason for creating NOCs was the national security of the major industrialized consuming countries. The partial or wholly state owned enterprises were meant to assure them petroleum-based fuels for their military and civilian fleets.⁷ The nationalist movements gave rise to several major oil producing nations to nationalize their oil reserves in order to take back control from the foreign oil companies that were not serving the national interests of the host governments.⁸ Legislation and regulation were not, however, considered to suffice in this respect. The key was to participate directly in oil exploration and production. Besides the state control, the main motivation for the creation of NOCs was the large shares of the economic rents resulting from oil production and transfer of knowledge.⁹

⁴ Upstream Law and Regulation – A Global Guide, Pereira, G.E. & Talus, K. (eds.), Globe Business Publishing Ltd 2013, p. 9.

⁵ Inkpen, A. & Moffet, M. H., The Global Oil & Gas industry – Management, Strategy & Finance, PennWell 2011, p.50-51.

⁶ Upstream Law and Regulation – A Global Guide, Pereira, G.E. & Talus, K. (eds.), Globe Business Publishing Ltd, London (2013), p. 9.

⁷ Inkpen, A. & Moffet, M. H., The Global Oil & Gas industry – Management, Strategy & Finance, PennWell 2011, p.54.

⁸ The Changing Role of National Oil Companies in International Energy Markets, Baker Institute Policy Report, Public Policy of Rice University, No. 35, April 2007, p. 3.

⁹ McPherson, C., National Oil Companies – Evolution, Issues, Outlook, Vol. 2, No. 2, Ogel, April 2004, p. 2.

2.2 Objectives

Especially in the developing countries NOCs' role has been to accomplish both non-commercial and commercial objectives. The dual roles of NOCs explain the different functioning model compared to privately held companies. Instead of mainly maximizing the shareholder value, NOCs might aim to, amongst other, creating jobs, developing local capacity, supporting the social infrastructure and regional development as well as redistributing and transferring income resulting from the oil production.¹⁰

The objectives vary, however, depending on how developed the nation is. In less developed countries like Nigeria and Venezuela, the non-commercial objectives often supplant the commercial ones. In Norway or Malaysia, on the other hand, the NOCs, Statoil and Petronas, are highly privatized and the domestic industries well developed. The operational environment is quite different, which enables corporate management structures to operate quite independently from their governments. In these cases the focus is rather on wealth creation than in non-commercial objectives.¹¹

To give an overview of the common objectives of NOCs, the following grouping has been used:

2.2.1 Wealth Distribution

One of the main purposes of state owned oil companies is to redistribute the oil wealth to the society. Many times governments require that petroleum products are sold locally at prices that are remarkably below the market level¹², even though the cost of the fuel subsidies is enormous. While the subsidies reduce the petroleum price for the local population and have some positive impacts on the industry and transportation, the disadvantages include not only the lost revenues for the NOC, but also corruption and inefficient use of fuels that the artificially low

¹⁰ McPherson, C., National Oil Companies – Evolution, Issues, Outlook, Vol. 2, No. 2, Ogel, April 2004, p. 5.

¹¹ The Changing Role of National Oil Companies in International Energy Markets, Baker Institute Policy Report, No. 35, Public Policy of Rice University, April 2007, p. 5.

¹² McPherson, C., National Oil Companies – Evolution, Issues, Outlook, Vol. 2, No. 2, Ogel, April 2004, p. 5.

prices bring about.¹³ In developed countries the subsidized petroleum prices are not typical, but the retail prices are normally driven by the market mechanism.¹⁴

Other ways to redistribute the oil income are different types of employment policies and social welfare programs.¹⁵ The programs may be related, for example, to education, healthcare and food distribution.¹⁶

2.2.2 Job creation

Despite the high capital intensity of the oil sector, governments have managed to employ a significant number of their citizens to the oil sector. NOCs create jobs for thousands of local people in order to increase local employment. Job creation has been researched for example by data showing the ratio of employees to the oil produced. For example, in one of China's NOCs, PetroChina, the number of total employees per million barrels equivalent produced is 267. The corresponding number of Saudi Arabia's NOC, Saudi Aramco, is only 11.¹⁷ The differences can be quite remarkable. The ratio varies among the NOCs because of several reasons, but one obvious reason, at least in PetroChina's case, is that China's state oil companies intentionally employ hundreds of thousands of people more than needed in the country's oil production.¹⁸ It is a way of supporting local people and achieving social and political goals.

2.2.3 Economic Development

The NOC's role in the nation's economic development can be significant. In some countries, it is the petroleum industry that has opened the nation's doors to international trade and world economy. The oil reserves attract foreign investors, who may bring about more sophisticated business acumen to the country.

¹³ CRS Report for Congress, The Role of National Oil Companies in the International Oil Market, Robert Pirog, Congressional Research Service, 21.8.2007, p. 9. Available at <https://www.fas.org/sgp/crs/misc/RL34137.pdf>. Latest access on 8 July 2013.

¹⁴ The Changing Role of National Oil Companies in International Energy Markets, Baker Institute Policy Report, No. 35, Public Policy of Rice University, April 2007, p. 7.

¹⁵ CRS Report for Congress, The Role of National Oil Companies in the International Oil Market, Robert Pirog, Congressional Research Service, 21.8.2007, p. 9.

¹⁶ The Changing Role of National Oil Companies in International Energy Markets, Baker Institute Policy Report, No. 35, Public Policy of Rice University, April 2007, p. 8.

¹⁷ CRS Report for Congress, The Role of National Oil Companies in the International Oil Market, Robert Pirog, Congressional Research Service, 21.8.2007, p. 9.

¹⁸ The Changing Role of National Oil Companies in International Energy Markets, Baker Institute Policy Report, No. 35, Public Policy of Rice University, April 2007, p. 8.

Not only is the oil sector developed: ancillary service businesses are needed along the development. For example public infrastructure, such as roads and pipelines, are developed as well.¹⁹ NOCs are expected to develop local technical, commercial and managerial capacity in the oil sector and beyond.²⁰ In general, NOCs are required to be the sponsors and role models for economic development and industrialization.²¹

2.2.4 Energy Security

Each country's interest is to secure its energy supply. Energy security is an integral part of national security (especially when there are no real substitutes for petroleum), stable oil (and gas) supply is of utmost importance in every country. Some oil producing countries have strived to strengthen their supply security by ownership or exclusive rights to desired supplies of oil.

Energy security is also about secure oil and gas demand of the customers. The customer base should be wide enough, so that the oil and gas companies wouldn't be dependent on single customers. Undesirable dependence can cause exposure to e.g. strong economic fluctuations. A wide customer base in different economies can bring security and increased stability in this respect.²²

2.3 The relationship between NOCs and IOCs

Still in the 1970s the oil industry was dominated by international oil companies.²³ Nowadays the situation is quite the opposite: NOCs and the national governments control approximately 77% of the world's total oil reserves. Western international oil companies, such as ExxonMobil, BP, Chevron and the Royal Dutch Shell Group, control less than 10 percent of the world's oil and gas resource base, while the remaining part is explored jointly by IOCs and NOCs.²⁴ Some NOCs, such as

¹⁹ Ibid.

²⁰ McPherson, C., National Oil Companies – Evolution, Issues, Outlook, Vol. 2, No. 2, Ogel, April 2004, p 5.

²¹ The Changing Role of National Oil Companies in International Energy Markets, Baker Institute Policy Report, No. 35, Public Policy of Rice University, April 2007, p. 9.

²² CRS Report for Congress, The Role of National Oil Companies in the International Oil Market, Robert Pirog, Congressional Research Service, 21.8.2007, p. 11.

²³ Inkpen, A. & Moffet, M. H., The Global Oil & Gas industry – Management, Strategy & Finance, PennWell 2011, p. 63.

²⁴ The Changing Role of National Oil Companies in International Energy Markets, Baker Institute Policy Report, No. 35, Public Policy of Rice University, April 2007, p.1.

Statoil and Petronas, have many similar features in their operations as the IOCs and they are even expanding their businesses outside the national borders.²⁵

Despite the strengthened position of NOCs, IOCs and NOCs still need each other. IOCs are in a much better position to provide the capital needed in the highly risky and long-term investments.²⁶ The non-commercial obligations imposed to NOCs hinder their ability to raise external capital and to compete at international standards. Lack of capital has obviously led to inability to maintain or grow oil and gas production capacities.²⁷

All in all, NOCs no longer give the IOCs the possibility to lead the way. In order to gain access to the oil reserves, IOCs must provide fair enough deals for NOCs, which expect the IOCs to have the ability to manage complex large-scale projects, unique technologies and project integration beyond discrete oil and gas project development and production. Many NOCs require additionally that the IOCs develop the in-country capabilities and enhance the quality of the local workforce known as local content. The value of IOCs from a NOCs' perspective is in the IOCs' managerial and technical expertise and access to international capital markets.²⁸

In order to gain investments in the country, the host governments must be able to assure the IOCs that their investments will turn into expected profit. Internationally accepted regulatory and contractual provisions in the regulatory framework for upstream petroleum are therefore essential for the IOCs in order to enter into an agreement with NOCs. Investors require also transparency, predictability and stability.²⁹ Without these conditions, the investments may be too risky. With proper negotiations and contracting, the common interest can, after all, be found.

²⁵ Inkpen, A. & Moffet, M. H., *The Global Oil & Gas industry – Management, Strategy & Finance*, PennWell 2011, p. 63.

²⁶ *The Changing Role of National Oil Companies in International Energy Markets*, Baker Institute Policy Report, No. 35, Public Policy of Rice University, April 2007, p.1.

²⁷ *The Changing Role of National Oil Companies in International Energy Markets*, Baker Institute Policy Report, No. 35, Public Policy of Rice University, April 2007, p.2.

²⁸ Inkpen, A. & Moffet, M. H., *The Global Oil & Gas industry – Management, Strategy & Finance*, PennWell 2011, p. 63-64.

²⁹ *Upstream Law and Regulation – A Global Guide*, Pereira, G.E. & Talus, K. (eds.), Globe Law and Business 2013, p. 8-9.

To manage the cooperation between a NOC and IOC in oil exploration and production, the parties may choose to enter into a JOA. This agreement type will be examined in the next chapter.

3 NATIONAL OIL COMPANY AS A PARTY TO A JOINT OPERATING AGREEMENT

Upstream projects typically involves a large variety of risks (e.g. geological, technical, political, etc.) and requires large amount of investments, which encourage companies to combine efforts through a joint venture.³⁰ There are different types of consortium but the petroleum industry tends to prefer for an unincorporated joint venture know as a JOA.

A JOA identifies the mutual interests of the parties and defines the respective responsibilities.³¹ A JOA serves two main functions:

- (1) The parties' proportions of interest are defined in the JOA. That will be the legal basis for the sharing of rights and liabilities under the production licence and during the joint venture. The rights and liabilities under the production licence are shared between the licensees in proportion to their percentage interest.
- (2) The contractual duties of performance are divided between the parties to the JOA. The parties have two different roles: the role of the operator and the non-operators. The operator is responsible for the day-to-day operations, while the non-operators participate in the decision-making without conducting the operations in action.³²

Conventionally governments' participation in JOAs has been rather limited. As a matter of fact the AIPN is one of the few standard forms with a special provision covering a government or NOC participation.

Governments may have required reporting, audit and approval rights in relation to the parties to the JOA, but otherwise their role has merely been to grant the

³⁰ Roberts, P., Joint Operating Agreements: A Practical Guide, Globe Law and Business 2010, p. 16.

³¹ Inkpen, A. & Moffet, M. H., The Global Oil & Gas industry – Management, Strategy & Finance, PennWell 2011, p. 200.

³² Ibid.

licences and concessions. Along with the nationalisation the governments have started taking a bigger role in JOAs. The government's right to participate may be expressed in the concession, through which the government, or the NOC as the representative of the government, can enter into the JOA and secure a direct share of the produced petroleum for the government.³³

Being a party to the JOA the government can gain valuable information about the other parties' actions and observe how the technical, financial and management decisions are made under the JOA. This type of information can be essential and helpful for the government in order to develop the nation's petroleum sector further.³⁴

It is possible that the government doesn't enter into the JOA right in the beginning, but reserves a right to do so in a later phase. JOA can therefore include a specific clause stating that the government has an option to join the JOA during the term of the agreement. If the government chooses to do that, it usually happens after the exploration and appraisal phases, when the risks, uncertainty and expenses related to the exploration have been lived through and the time for revenue generation has come.³⁵

If the government enters into the JOA in a later phase and the concession is held by several parties, the percentage interests must be adjusted so that the government's participation is accounted for. The government's maximum amount of participation may have been limited in the concession or in the national petroleum legislation, in which case the size of the government's percentage interest is based on the said amount. The participation of the NOC is not the main issue but rather the conditions for such right. The NOC might insist it will get the participation free of charge. Morocco is a good example as ONHYM commonly obtain a free carry without the obligation to pay back with production. But Morocco has one of the lowest fiscal terms in Africa and this might balance other attractiveness. But commonly a NOC has to pay back the carry or the assignment with its share of production.

³³ Roberts, P., *Joint Operating Agreements: A Practical Guide*, Globe Law and Business 2010, p. 49.

³⁴ Roberts, P., *Joint Operating Agreements: A Practical Guide*, Globe Law and Business 2010, p. 49.

³⁵ Roberts, P., *Joint Operating Agreements: A Practical Guide*, Globe Law and Business 2010, p. 50.

The appointment of the operator may be based on the parties' licence interest or financial resources. Naturally, the operator must also be capable of conducting the operations and have enough technical capacity. This might be a hot debate between an IOC and NOC to constitute a JOA. The operator has a special position in the JOA as commonly the operations are conducted by one party on the behalf of the entire consortium. This gives the operator the full control of the operations from real and instant access to information to preparation of work programs. A large NOC is unlikely to waive the operatorship to an IOC but a junior NOC is more likely to accept an IOC as operator due to lack of financial and technical capabilities. In some cases the operatorship is not given to any individual member of the consortium but rather to a special purposes vehicle created only to conduct the operations. The shareholders of this company should be the members of the JOA. Although this approach provides a more balanced solution to conduct the operations it also creates more bureaucracy in terms of approvals and documentation.

If the JOA appoints one party as the operator, then the other parties shall be non-operators. The main function of this party is to contribute to the required financial commitments in accordance to its participating interest. As a natural consequence the control of the operation is a key concern for any non-operator.

A large number of JOAs implement a higher authority to determine the key issues and decision-making process of the consortium. This body is called operating committee and they should have representatives of all parties to the JOA.

³⁶ Through the operating committee the non-operating parties can have access to information about the performance of the joint operations and represent their interests before the operator. The competence of the committee varies depending on the terms in the JOA. When entering into the JOA, the parties may define that the operator shall strictly act under the supervision and control of the operating committee. On the other hand, not all JOAs have a provision for an operating committee. For example the American Association of Petroleum Landmen and the

³⁶ Abidemi, A., *Swinging the Pendulum of Privity in favour of the Non-operators in a Joint Operating Agreement*, University of Dundee, p. 2.

Canadian Association of Petroleum Landmen provide JOAs without a supervisory body in the agreement..³⁷

It is very unlikely that a NOC will accept to sign a JOA without an operating committee, as this is a key mechanism to control the operations. But the IOC might argue that the NOC is already protected as commonly the host instrument has a management committee with a compulsory participation of the government.

The implementation of an operating committee shall not be a difficult topic during a negotiation between an IOC and NOC. But the main challenge is the voting procedures. The NOC is likely to request special rights to veto or to approve certain activities. The IOC is likely to prefer the exactly the opposite as it might be in a difficult position if the NOC reject a work program as a sole risk project against a NOC might be extremely complicated operationally and politically speaking.

Therefore, having a NOC party to a JOA can bring some challenges to the cooperation, as well as to the viability and stability of the project. As NOC is a representative of the state, the financial difficulties that the state may face will be reflected to the NOC's ability to raise the funds for the development of the project. The financing difficulties related to the problems of country debt may constitute a financing risk for the upstream project.³⁸ In case the NOC fails to comply with the financial obligations, then the IOC might face a real challenge to implement whatever the default mechanism established in their JOA (forfeiture, buy-out, withering, etc.).

Another issue is the different kind of character of NOCs and IOCs in respect of their goals, business culture and the structure of their internal organisation. A relationship between a public and private company may be rather uneasy in jointly controlled and managed projects. If the relationship doesn't function appropriately, the result is often in increased administrative or other costs.³⁹ The key in the cooperation is often in the detailed terms of the JOA. Many times obstacles can be avoided by proper preparation and awareness of the possible differences in the

³⁷ Roberts, P., Joint Operating Agreements: A Practical Guide, Globe Law and Business 2010, p. 95-96.

³⁸ Wälde, T. W., The Current Status of International Petroleum Investment: Regulating, Licensing, Taxing and Contracting, Vol I, Special OGEL Archive Issue, July 1995, section C. Joint Ventures & Hybrids.

³⁹ Ibid.

parties' perceptions and course of actions. Therefore, it is not insignificant, how the details of the provisions in a JOA look like.

The role of a NOC under a JOA is certainly special. It has been argued that if the responsibilities of the NOC differ a lot from those of the IOC under a JOA, the NOC's role should merely be consultative even though this is not necessarily the case. If the NOC has, or gains, a more commercialized character and, for example, contributes to the risk capital, the differences in the roles of the NOC and IOC should gradually disappear.⁴⁰ This question is definitely of utmost importance, since it affects, in a very profound manner, the rights and responsibilities of the parties. It is also a question that cannot necessarily be negotiated, if the negotiation powers are not equally shared. If the NOC has more say in its rights than the IOC, the balance may not necessarily be found between the parties.

The challenges may not, however, be a bad thing. It means that the industry must develop further and new practices will be formed.

4 CONCLUSION

The strengthening of NOCs has changed the dynamics of the oil industry. As we have seen, NOCs control the majority of the world's oil and gas reserves today. In that position, the NOCs naturally want to have their fair shares from the nation's hydrocarbon exploration and production and in order to do so, they have become more involved in the business.

What makes a NOC special in respect to a JOA, is that apart from being a party to the agreement, in practice the NOC is the representative of the government (even though some NOC strongly believe they are a separate legal entity), which grants the petroleum title, the object of the JOA. In relation to the other parties of the JOA, this creates an evident imbalance in the equilibrium of the parties unless

⁴⁰ Wälde, T. W., The Current Status of International Petroleum Investment: Regulating, Licensing, Taxing and Contracting, Vol I, Special OGEL Archive Issue, July 1995, section C. Joint Ventures & Hybrids.

when the requirement for private capital and expertise is critical, then the balance is more likely to occur.

The natural expectation is that NOC acquire more knowledge and experience from IOCs throughout exploration and productions phases. This trend should favour efficiency and profitability as their primary goals. But the main question is, is it purposeful to turn the NOCs purely commercial or should they hold on to the civil objectives imposed by the governments. There are too many variables to provide a clear opinion on that, but it is surely interesting to see, how the industry develops during the coming decades.