IGF

INTERGOVERNMENTAL FORUM
on Mining, Minerals, Metals and
Sustainable Development

IGF Guidance For Governments:
Leveraging Local Content Decisions
for Sustainable Development

CASE STUDY

SAUDI ARABIA: NATIONAL CAPACITY

SAUDI ARAMCO—A STATE-OWNED GLOBAL OIL GIANT

OVERVIEW

LEVEL OF OPERATION:
National

GOVERNMENT ROLE:
Full responsibility

FOR MORE INFORMATION:
See Saudi Aramco website

KEY COMMODITIES:
Oil (world leader), natural gas, phosphate, gold, bauxite[1]

TOTAL NATURAL RESOURCE RENTS (AS % OF GDP) (2015):
23.4 per cent[2]

NATIONAL EXTRACTIVES COMPANY:
Saudi Aramco (oil and gas)

UNDP HUMAN DEVELOPMENT INDEX VALUE (2016):
0.847 (Global Rank 38)[3]

The Kingdom of Saudi Arabia (KSA) is the world's largest oil exporter, and the oil industry is easily the largest sector of its economy, accounting for 43 per cent of GDP.[4] Saudi Aramco, the state-owned oil producer, plays a major role in the KSA's economy and has therefore played an important role in many development programs. Recently, the KSA government has recognized the importance of moving its economy away from its historic reliance on oil, a shift partly driven by sustained low oil prices. In 2016, the new Crown Prince introduced "Vision 2030," a radical shift toward diversification and economic reform. Saudi Aramco also recently introduced localization targets to expand the Kingdom's industrial base and manufacture a larger share of products domestically.

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[1] Chadwick, J. (2012). Mining in the oil kingdom. *International Mining*. Retrieved from http://www.saudi-mining.com/images/uploads/documents/Mining_Report.pdf

[2] World Bank Group. (2017). *Total natural resource rents (% of GDP)*. Washington, DC. Retrieved from https://data.worldbank.org/indicator/NY.GDP.TOTL.RT.ZS

[3] United Nations Development Programme. (2016). *Human Development Reports: Norway*. Geneva, Switzerland. Retrieved from http://hdr.undp.org/en/countries/profiles/SAU

[4] Walt, V. (2017). Inside Saudi Aramco's kingdom of oil. *Fortune*. Retrieved from http://fortune.com/2017/10/24/saudi-arabia-aramco-oil/

THE HISTORY OF STATE CONTROL OF THE OIL SECTOR IN THE KSA: PETROMIN VS. SAUDI ARAMCO

The Arabian American Oil Company (Aramco) was established in 1938 after American explorers from Standard Oil Company of California (SoCal) struck oil. Aramco was privately owned by American oil companies (e.g., Standard Oil of California, Texas Co., later also Standard Oil of New Jersey and Sonocy-Vacuum) and was basically a joint operation between the current Exxon Mobil and Chevron until the 1970s. In 1980, it became fully owned by the KSA government (and was renamed Saudi Arabian Oil Company but kept its acronym Saudi Aramco). Since SoCal originally had exclusive drilling rights over large areas of the country and the remainder were owned by Petromin,[5] this purchase effectively nationalized the entire oil and gas sector.

Petromin was established in 1962 as the KSA's national vehicle for exploration, refining, and distribution of all petroleum and mineral resources that were not already in the domain of then U.S. firm-controlled Aramco.[6] Petromin was supposed to become a governmental equivalent of Aramco—the implicit idea being that it could one day take Aramco's place. Petromin started petrochemical projects, oil refineries in Saudi Arabia and abroad, glass and steel plants as well as power generation projects. While it built some capacity, there were several issues with Petromin. The organization followed an administrative trajectory that many developing country government entities take: politicized or cronyist recruitment which tended to serve the political needs of elites.[7] The state-owned company became inefficient, with a bloated staff. Much of Petromin's exploration had disappointing results, and most minerals projects never took off; meanwhile, it was reaching into areas that diverged from its core mandate (mainly promoting industrialization) with a flurry of poorly designed and overambitious projects. Petromin's projects were beset by delays, and the company did not turn a profit.

The fates of Saudi Aramco and Petromin took a different course when the government started buying stakes in Saudi Aramco from its U.S. parent companies in 1973. Instead of aggressive nationalization—which would have likely led to Petromin taking over Saudi Aramco's assets—the government went for consensual, staged nationalization of Saudi Aramco. The Saudi government bought a 25 per cent interest in Saudi Aramco in 1973, increasing to 60 per cent the following year, and then to 100 per cent in 1980 with retroactive financial effect to 1976. While ceding company ownership rights, Saudi Aramco's U.S.-based parent companies did not immediately give up managerial control. Instead, they progressively introduced increasing numbers of Saudis into management, training them for executive positions. To maintain their leading roles in what was one of the best-run companies in the Middle East, these U.S.-educated Saudis came to form a committed anti-Petromin group in the Kingdom.[8]

Instead of aggressive nationalization, the government went for consensual, staged nationalization of Saudi Aramco.

In the 1980s, by which time the KSA had acquired 100 per cent ownership of Saudi Aramco, the possibility of Saudi Aramco falling under Petromin's

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[5] Ibid.

[6] Hertog, S. (2008). Petromin: The slow death of statist oil development in Saudi Arabia. *Business History, 50* (5), pp. 645–667. Retrieved from http://eprints.lse.ac.uk/29865/1/Petromin_the_Slow_Death_of_Statist_Oil_Development_in_Saudi_Arabia_(LSERO).pdf

[7] Ibid.

[8] Ibid.

control was again considered, despite the latter not turning a profit and experiencing many delays at its large refinery projects. Proponents of Saudi Aramco eventually won the political battle to retain its assets and operational independence. While its operations grew, Petromin's role diminished over the following decades, eventually ending in dissolution in 2005 with its assets being taken over by Saudi Aramco. It is important to mention that the leadership battle between Petromin and Saudi Aramco was also a reflection of turf wars within the Saudi Royal family and government. There was an element of chance in the successive developments and the eventual outcome was far from predictable.

Saudi Aramco's investments in staff make it the most attractive employer in Saudi Arabia.

The KSA's experience highlights both the potential and the risks in building national capacity through state-owned enterprises (SOEs). While Petromin was struggling to fulfill its mandate, the KSA began taking over ownership and operations at Saudi Aramco. This was done gradually—over eight years for ownership—and with buy-in from the sellers, which saw the benefit of transferring skills and technologies. The former parents of Saudi Aramco likely wanted to preserve their relationship with what was an important global oil giant while obviating the possibility of more aggressive nationalization. The parent companies' cooperation meant that American managerial structures remained in place and many foreigners remained in the company—something that would not have been possible in a nationalistic environment. The outcome was that Saudi Aramco became a globally competitive firm, contributing to large-scale development of capacity in the KSA and generating significant revenue for the country.

THE ACHIEVEMENTS OF SAUDI ARAMCO

Saudi Aramco's development over the past three decades has been remarkable. Through sustained long-term investments, it remains technologically advanced and economically viable. For example, its investments in staff make it the most attractive employer in Saudi Arabia, and its recovery rates—the share of oil recouped from what is available in a field—average about 50 per cent, but can rise as high as 70 per cent, compared with a global average of about 33 per cent.[9] It is arguably the best-run national oil company (NOC) in the Organization of the Petroleum Exporting Countries (OPEC).[10]

Saudi Aramco's operations have grown to gigantic proportions. Today, it produces more oil than any other company in the world; it produces about 1 in every 9 barrels globally.[11] Saudi Aramco's oil reserves, officially estimated at 261 billion barrels, represent almost 10 times the combined reserves of the next four largest energy companies (Exxon, Chevron, Shell, CNOOC).[12] The company also explores for crude oil, refines it into oil products such as gasoline and chemicals, and buys and sells other companies' petroleum as an independent trader.

One of Saudi Aramco's core strengths is that despite its size, it has been relatively insulated from politics in Riyadh. Despite being state-owned, and in contrast to other OPEC members'

[9] The Economist. (2017). *Behind the veil of Saudi Aramco*. Retrieved from https://www.economist.com/news/business/21729472-biggest-oil-company-has-good-story-tellif-it-can-disentangle-its-image

[10] Hertog, S. (2016). The one thing in Saudi Arabia that works well is under threat. *Reuters*. Retrieved from http://blogs.reuters.com/great-debate/2016/02/03/the-one-thing-in-saudi-arabia-that-works-well-is-under-threat/

[11] Walt (2017), Id. note 4.

[12] Barnett, A., French, J., & Said, S. (2016). How big is Aramco? *Wall Street Journal*. Retrieved from https://graphics.wsj.com/what-is-aramco/

NOCs,[13] it has retained a high level of operational autonomy. Saudi Aramco has also kept a degree of cultural autonomy: for example, in its compounds, genders can mix and women can drive.[14] Its senior management is composed mainly of engineers rather than politicians. The company remains primarily accountable to the King, who has been the guarantor of its autonomy. However, political independence could become harder to maintain going forward, as the new Crown Prince and the government see the company as critical to their industrial development objectives. This could be somewhat balanced by the proposed listing of 5 per cent of Saudi Aramco's equity, which could promote further transparency and private sector principles in terms of its business and investment decisions.

This highlights a paradox or trade-off in the developmental role of SOEs. To remain efficient and competitive, an SOE needs some insulation from political forces that generally lead to uneconomic management. This independence means that the SOE can play less of a role in terms of implementation of the government's economic policies (less of a "developmental" role and more a private sector approach), thus negating some of the benefits pursued in having an SOE in the first place.

RECENT SHIFTS: SAUDI ARAMCO AS AN AGENT OF NATIONAL DEVELOPMENT?

The size of Saudi Aramco means that it dominates the economy. It oversees assets that generate more than 85 per cent of Saudi exports and more than 90 per cent of government revenue. As such it has been a critical agent for the social, economic and infrastructural development of the country.[15]

The SOE played a relatively limited role in the country's economy during the 1980s and 1990s, but its interventions and ambitions have since expanded into new sectors, including heavy industry, renewable energy, educational reform, infrastructure building and general industrial development. Saudi Aramco has rapidly increased its natural gas production and, in a joint venture with Dow Chemical, opened a USD 20 billion plastics plant in 2016. To diversify beyond oil production, Saudi Aramco has expanded the Red Sea refinery it runs with China's Sinopec, and in 2017 took full control of the biggest refinery in the United States (in Port Arthur, Texas) which had been a joint venture with Royal Dutch Shell.[16] This expansion into new sectors helps diversify the economy and build greater industrial capacity, although it concentrates power in the hands of Saudi Aramco. It is too early to say how these expansions beyond its core business will fare for Saudi Aramco.

Saudi Aramco has also made a large contribution to the skills base of the economy in the KSA. While its employment footprint is relatively small compared to other OPEC NOCs (arguably since it faces less pressure to create jobs), it invests considerably in internal staff development. More than 3,000 industrial workers were undergoing training in 2012, and more than 1,000 employees were studying on scholarships in the US.[17] Many former employees use the experience gained at Saudi Aramco to start their own companies. The SOE supports training beyond its employees. For example, it has launched a "youth enrichment" program in cooperation with various local organizations which aims to train 2 million Saudis by 2020.[18]

Over the years, the KSA's government has handed Saudi Aramco large projects, as it has a reputation for world-class project management. For example, when the late King Abdullah decided to create the country's first co-ed university near Jeddah a decade ago, he tapped Saudi Aramco to manage the USD 20 billion construction. While this leverages Saudi Aramco's skills, it also entrenches its dominance of the economy. Like

[13] Hertog (2008), Id. note 6.

[14] Hertog (2013). *Saudi Aramco as a national development agent: recent shifts* (Norwegian Peacebuilding Resource Centre. Policy Brief). Retrieved from https://www.perchingtree.com/wp-content/uploads/2017/07/Saudi-ARAMCO-Program-Office.pdf

[15] Ibid.

[16] Walt (2017), Id. note 4.

[17] Hertog (2013), Id. note 6.

[18] Ibid.

many monopolies, this can stifle innovation and result in barriers to entry for small businesses.

The size of Saudi Aramco means it can exert significant pressure on suppliers and have a large impact on the rest of the economy. In a further attempt to build domestic capacity, Saudi Aramco introduced the In-Kingdom Total Value Add (IKTVA) program in 2015. The aim of this program is to drive, measure and monitor the value-add brought to the Kingdom by a contractor. Ultimately Saudi Aramco aims to achieve 70 per cent localization by 2021. The IKTVA program uses a formula to assess local content in terms of the value of localized goods and services in procurement, the value of salaries paid to Saudis, and the value of training and development of Saudis.[19]

KEY LESSONS

- Insulation against political pressure is important for an SOE to operate efficiently and plan for the long term. Despite the centralized Saudi government, Saudi Aramco has remained relatively free from political influence. This includes management and board roles, which are generally filled by highly skilled engineers.
- An SOE pursuing its core mandate (in this case oil exploration and production) may develop capabilities that can be applied to other sectors (e.g., infrastructure and construction). However, timing is important: the SOE needs to first be efficient and competitive in its core mandate before venturing into new sectors.
- However, SOEs can also pose risks to the economy. If they are inefficient, as was the case with Petromin, they are a drain on resources. Even well-run Saudi Aramco's dominance of the economy means that the entire economy is at risk if Saudi Aramco falters from failed or poor investments, inefficiency or volatile markets.
- SOEs can help to promote local content development. The size of Saudi Aramco relative to the economy means that it can have a large impact on local suppliers by transforming its own processes.

[19] Olawuyi, D. (2017) *Local content and procurement requirements in oil and gas contracts: Regional trends in the Middle East and North Africa.* Oxford Institute for Energy Studies. Retrieved from https://www.oxfordenergy.org/wpcms/wp-content/uploads/2017/11/Local-content-and-procurement-requirements-in-oil-and-gas-contracts-regional-trends-in-the-Middle-East-and-North-Africa-MEP-18.pdf

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