Guidelines for Good Governance in Emerging Oil and Gas Producers

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GUIDELINES FOR GOOD GOVERNANCE IN EMERGING OIL AND GAS PRODUCERS

PREFACE AND ACKNOWLEDGMENTS

These Guidelines for Emerging Oil and Gas Producers are drawn from a Chatham House project that gathers petroleum producers and governance experts in annual workshops. Recommendations focus on issues discussed at these workshops and offer firm prescriptions only where broad consensus emerged. As such, the Guidelines presented here do not cover all issues relevant to the situation of new producers, but focus on the topics covered at the workshop held on 5–6 November 2012 at Chatham House – namely how to get a good deal and how to structure institutions. Other topics, to be considered in future workshops, are outlined in this document in order to frame discussions going forward. These are flagged as ‘questions for further discussion’. The Guidelines are a living document.

This is a collaborative project, drawing on the expertise of technical and governance advisory groups: the Commonwealth Secretariat, Revenue Watch Institute, the Natural Resource Charter and PETRAD. Our objective is to improve the advice offered to emerging producers.

Participants in the workshop for this project were invited to draft and review these Guidelines. Many did so, some at length, and all to good effect. We thank all those who responded, in particular Vandana Gangaram Panday from Staatsolie, Rolf Magne Larsen from Statoil, Mark Thurber from Stanford University, Roger Avinaga from Petromin, David Manley from the Natural Resource Charter, Tony Paul from Trinidad and Tobago, Eddy Belle from PetroSeychelles, Sergio Guaso and Alma Quintero Sepulveda from PEMEX, Henry Odwar from the Parliament of South Sudan and Bengt Hope from PETRAD, as well as long-time members of Chatham House’s Good Governance project, Isabelle Rousseau, John Mitchell, Glada Lahn and Keith Myers. The text also benefited from thoughtful contributions from people who were not able to attend the workshop: Sam Addo Nortey from the Ghana National Petroleum Corporation, Charlie Scheiner from Timor-Leste, and Alpa Shah from the Natural Resource Charter. We are very grateful to the project’s co-organizers for their valuable comments and advice throughout the project: Daniel Dumas and Ekpen Omunbude from the Commonwealth Secretariat and Patrick Heller from Revenue Watch Institute. Financial support from these two organizations made this project possible. It was impossible for every word to satisfy all participants, and this was not sought. The editor is solely responsible for any opinions expressed in this document, and for any errors or omissions.

1 The Guidelines also draw on a panel discussion held at the Annual Natural Resource Charter Conference in Kuwait on 7 May 2013. The event showcased the themes covered in the Governance Challenges for Emerging Oil and Gas Producers project.
EXECUTIVE SUMMARY AND RECOMMENDATIONS

Best-practice standards that have been established in successful petroleum-producing countries undoubtedly represent the international gold standard in the oil and gas sector. But while such practices may work well for successful, well-resourced producers, the same policies may be entirely inappropriate for emerging producers, which often face significant development challenges. Indeed, many emerging producers have weak institutional capacity and low knowledge of the petroleum sector, in addition to pressing socio-economic challenges. Thus 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. As capacity grows and greater revenues begin to flow, emerging producers will need to adjust their methods and institutions to promote evolving, and ever higher, standards of good governance.

The Guidelines focus on seven key objectives for the petroleum sector in emerging producing countries. Specific, policy-oriented recommendations are included under each objective.

Objective 1: Attract the most qualified investor for the long run

Emerging producers commonly face the challenge of attracting established companies to a frontier area. The governments of such countries should encourage speculative companies to sample geological data, since data reduce uncertainty for investors. Governments should also set out strong prequalification criteria to weed out any suitors who may be under-qualified for exploration and production. The petroleum law should specify that government approval is necessary for any transfer of control. Disclosure of bidding information to the public will discourage corrupt bidders.

At the same time, emerging 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. However, in a context of frontier exploration, governments must hold direct negotiations until the market interest allows a shift to auctions. 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.

Objective 2: Maximize economic returns to the state through licensing

Emerging producers should design fiscal terms that give the state early revenues for urgent development needs, while ensuring long-term economic benefits via local content requirements. The use of progressive, flexible fiscal formulas and royalties is particularly recommended for new producers.

Emerging producers must overcome the knowledge asymmetries that they face in negotiations with foreign oil companies. When in direct negotiations with companies, governments should work with consultants or technical advisers to evaluate the baseline conditions for the award of acreage. To simplify negotiations, emerging producers should move as many fiscal elements as possible into laws and regulations that apply across licences. Governments should include capacity-building requirements in licence negotiations to redress the knowledge asymmetry over time. Contract transparency too can help to reduce asymmetry.

Emerging producers must develop appropriate tax structures. They must also clearly articulate the fiscal terms that govern upstream petroleum activity. Tax obligations should be defined in the tax code rather than in contractual agreements. This includes provisions for taxing capital gains earned by companies that sell their holdings before they begin production.
Objective 3: Earn and retain public trust and manage public expectations

Emerging producers face the challenge of winning the trust of the public, especially in post-conflict situations and where corruption has been endemic. At the outset of exploration, governments should promptly identify and engage with stakeholders. By doing so, governments can work to build a consensus around what the objectives of the sector should be, and whether there might be any lasting development impacts associated with oil and gas production. Governments should also disclose as much information as possible about the bidding process; in doing so, they can help to build public confidence in the system. The petroleum industry should also communicate with domestic stakeholders to explain its role in the country and to better understand any concerns that those stakeholders may have.

After a discovery has been announced, governments often struggle to moderate public expectations about the sector. This is a critical issue for many emerging producers. Thus, before any oil or gas discoveries are made, governments should begin thinking about how to manage the public’s expectations of the benefits that will emerge from the sector. After discoveries are announced, both the government and opposition figures should be realistic in their statements about the scale and speed of monetizing new discoveries. They should also manage public expectations regarding job creation and profit windfalls. Emerging producers should, at a minimum, make use of the national oil company (NOC) or petroleum ministry website and other means of communication to educate citizens about the scale and nature of discoveries.

Objective 4: Increase local content and benefits to the broader economy

It is particularly important for developing economies to devise petroleum-sector policies that maximize national development. For this purpose, governments should have clear objectives and identify which branches of the government are responsible for upholding the various aspects of the national development goals. Governments should also implement laws that include national content requirements for the goods and services that the NOCs buy, or at a minimum should provide a timetable for a shift from foreign to domestic sourcing. 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 NOCs require.

Abiding by such local content rules is a challenge where domestic industrial or human capacity is low. In order to set achievable local content targets, governments should first develop a thorough understanding of demand-side requirements and supply-side capabilities. They should then focus on capacity-building by requiring investors to develop the workforce and the supply base. They should enlist foreign oil companies to train NOC or local contractor staff and avoid projects in which foreign companies build and operate projects with foreign staff.

Governments of countries where resources are uncertain face challenges in getting foreign oil companies to invest in local content and national development. A country with a small reserve base or low prospectivity is unlikely to attract companies that are suited for substantial investments in national development. Thus governments should focus their capacity-building efforts on services for which the petroleum sector has an immediate need, and which can be used by other sectors of the economy over the long term.

Objective 5: Ensure national oil company participation in the development of the resources

In emerging oil hotspots, there is a growing interest in promoting national participation. This usually takes the form of stakes for NOCs. These Guidelines offer no prescription about when it is appropriate to create an NOC, as the decision in many countries relates to national political aspirations more than industrial need. Rather, the recommendations pertain to the role an NOC should play in an emerging producer country.
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In the case of an NOC taking on an operational role, governments should wait to make significant investments in developing an NOC’s operational capabilities until discoveries have been made that establish a reserves lifespan of at least 15 years. Until this reserve base is established, governments should train nationals to raise general human capacity and state administrative capacity, focus on skills-building within the ministry of petroleum, and provide the NOC with only a limited budget for building operational skills.

Some governments will look to the NOC to represent the state in the sector, rather than to act as a commercial entity. In this role, the NOC can be asked to take minority carried stakes in licences or to take on the more important function of licensing and/or regulating the sector.

If the NOC is tasked with taking a minority stake in licences, the government should require the foreign partners to carry the NOC’s equity stake until production begins. The government should adequately capitalize the NOC to cover its costs. The Guidelines clarify the expected range of these costs in an emerging producer context.

If the NOC is given a licensing or regulatory role, it is critical that it also be given the means to build its capacity to effectively carry out these important roles. Until revenues come from production, the government will need to finance the recruiting and skills development of the NOC.

Objective 6: Build capacity and enable actors to perform their role

Governments of emerging producer countries that have urgent development needs often have limited funds to allocate to capacity-building. 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 NOC and task one of these two organizations with regulatory responsibilities.

Effective taxation design and collection of tax revenues are critical functions. Thus all governments should invest in building capacity at the revenue authority before discoveries are made. From the early days of exploration, governments should centralize geological data management. When discoveries are made, they should allocate more resources to building capacity in auditing and monitoring operations. If discoveries reveal that the country can count on a significant production lifespan, the government must invest in its administrative capabilities and boost its own knowledge of the petroleum sector. This will enable the government to improve the accountability of the sector. When discoveries are sufficiently large to justify the NOC developing an operational role, the NOC should transfer its regulatory responsibilities to government to avoid a conflict of interest.

Countries with low administrative capacity face many challenges in building up a capable regulatory agency to oversee the sector. In such cases, external technical assistance and strong political commitment are critical to the successful establishment of an independent regulatory agency. To recruit and retain skilled staff, governments should make the pay structure at this agency more advantageous than that of the rest of the civil service.

Countries attracting high exploration interest from oil companies often attract a number of foreign donors and technical advisers offering guidance and capacity-building to help prepare the country for the next stages of petroleum development. Governments should coordinate this assistance to avoid confusion and duplication of efforts. Advisers should adapt their recommendations to the national capabilities and resources (as discussed in the Guidelines).

Objective 7: Increase accountability

Various drivers can trigger the need to improve accountability processes in the petroleum sector; one of the most significant triggers is the beginning of the production phase, which brings significant revenues. Reforms aimed at improving accountability are likely to be opposed
if they upset entrenched interests. Indeed, it is important for governments to recognize that once an actor (specifically, the NOC or the ministry of energy) has assumed responsibility for some of these regulatory functions, it can be difficult to take it back.

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. To facilitate the forward planning for the next phase of petroleum-sector governance, a credible, legitimate group should be tasked with directing the pace and shape of incremental reform.

Producers at an early stage of development of their resource base should start by establishing one credible body to manage all aspects of the sector. Over time, they should introduce checks and balances, while building up capacity in other branches of government. 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.
INTRODUCTION

Over the last few years, significant new oil and gas exploration reserves have been discovered in East and West Africa, as well as the Eastern Mediterranean, the Caribbean and the Asia-Pacific region. These discoveries have very quickly added several new countries to the ranks of the world’s oil- and gas-producing nations. These emerging oil and gas producers have shown a strong interest in advice on governance. They are keen to avoid the mistakes that have led to accountability failures in other, more established, producing countries, some of which have prevented those countries from reaping the full economic benefits of their petroleum resources.

While emerging oil and gas producers can learn from the experiences of leading national operators worldwide, capacity constraints often inhibit their ability to implement international ‘best practice’. New or developing producers have limited experience of managing petroleum resources, and many must make petroleum policy decisions without a clear knowledge of the size of their resource base. Thus instead of encouraging emerging producers to pursue ‘best practice’ standards, it may be more helpful to advise them to aim for ‘more appropriate practice’, which acknowledges the realities of the national context, ‘more effective practice’, which seeks to bring about rapid results in a context of urgent need, or ‘better practice’, which aims at incremental improvement of governance processes through aspirational, but achievable, milestones. As capacity grows and greater revenues begin to flow, these producers will need to adjust their methods and institutions to promote evolving (and ever higher) standards of good governance.

The purpose of these Guidelines is to help emerging producers and the groups that advise them think critically about the policy options that are available, and that would be most effective, during the first steps of exploration and development, or during a restructuring of the country’s oil and gas sector. The goal is not to produce a complete guide to governance of the petroleum sector, but rather to offer guidance on making effective decisions about the structure and rules of the petroleum sector in an imperfect context.

What should emerging producers do with these Guidelines?

Each government from an emerging producer country should conduct an open consultation (with concerned ministries and ideally with representatives of the legislature and civil society) to decide priority objectives and establish the appropriate sequence of steps to achieve those objectives.

A notable lesson that emerged from the workshop discussions was that early-stage producers should plan for success. Because circumstances change, governments should devise an investment framework that can adapt. Their objectives may also change over time. Some of the Guidelines’ objectives are ‘early issues’ that need to be addressed at the time of exploration. Some of the objectives may not apply in each country, or at least the situation may not necessitate immediate, dramatic change. These can be flagged for later re-examination. Others may need to be put on hold until the country’s capacity has grown, or industry interest has further developed. In such a scenario, governments should lay out a two- or three-year rolling action plan that allows for punctual reassessment of governance standards and capabilities.

Governments in producer countries need a clear vision of their objectives. This will allow them to focus their energies and scarce resources on the country’s top priorities. They should also undertake an honest appraisal of the state’s available resources and capacity.

Focus on objectives

The Guidelines are structured around the objectives listed below. It should be noted that the order in which the objectives are presented does not necessarily reflect their relative importance. In

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2 Refer to Annex 2 for more holistic guides to good governance in the extractive sector.
fact, some of the key objectives identified here may not be applicable at all in certain contexts. For instance, some countries may opt not to create national oil companies to ensure national participation in the sector.

**Key objectives for the petroleum sector:**

Objective 1: Attract the most qualified investor for the long run  
Objective 2: Maximize economic returns to the state through licensing  
Objective 3: Earn and retain public trust and manage public expectations  
Objective 4: Increase local content and benefits to the broader economy  
Objective 5: Gradually build capacity and enable actors to perform their role  
Objective 6: Ensure national oil company participation in the development of the resources  
Objective 7: Increase accountability

For each objective, the Guidelines discuss challenges related to the national contexts that many emerging producers face. Producers involved in the project offer their 'lessons learned' throughout the document.
OBJECTIVE 1: ATTRACT THE MOST QUALIFIED INVESTOR FOR THE LONG RUN

Challenge: Attracting well-established companies to frontier areas

Many countries that remain in the exploration stage or the early phases of development are considered to be ‘frontier’ oil jurisdictions that present substantial risks for potential investors, for either geological or political reasons.

Regarding the upstream deals awarded before the independence of South Sudan, the Hon. Henry Odwar, Chairperson of the Committee on Energy, Mining, Commerce & Industry in South Sudan, made the following comments, which illustrate the risks of investing in countries that are seen as ‘frontier’ areas for political reasons:

‘The Asian companies dominate because they were there when it was Sudan. Companies were given very large blocks at the time. The Ministry will review all concession blocks and if necessary divide large blocks into smaller blocks in line with international standards. Petroleum agreements entered into before 9 July 2011 shall be brought to the National Legislative Assembly for approval.’

A country’s level of attractiveness to investors will shift as its political situation evolves or as its oil and gas sector moves from early exploration to discovery, development, production and finally production decline. It is of course more challenging to attract the most qualified investors if a country is facing sanctions or if its oil and gas sector is in either very early or very late stages of development.

Prospectivity and information about the geological basin are the most important drivers for exploration. A country with lower prospectivity is likely to attract small exploration companies, while a country with large and easily accessible reserves is more likely to win contracts with larger, more established companies. There are advantages and disadvantages to consider in both cases. Small oil companies may be nimble and ahead of the pack in terms of finding new areas to explore, but they may also be poorly capitalized and unable to finance promised work commitments or execute operations safely on their own.

As Charlie Scheiner from the NGO La’o Hamutuk in Timor-Leste points out, there are other risks involved too:

‘It’s not just well-established companies which should be attracted, but those with records of opacity, negligence, theft or other damaging activities which should be actively kept out. Unfortunately, small countries with weaker regulatory systems and less experience could be easy prey for more rapacious, less responsible corporate actors.’

Recommendations:

- Encourage speculative companies to invest in sampling geological data (with exclusive rights to the data for the host government).

Geological data will reduce uncertainty, attract the best partners and increase the government’s ability to negotiate licence agreements effectively. It is important to understand the resource base before issuing licences.
● It is critical for the government to establish strong prequalification criteria for investors. General terms for prequalification should be laid out in the petroleum law, with more detailed rules to be included in regulations.

Even though it will in many cases be necessary to work with junior companies, the prequalification criteria can help countries select partners that actually have the capacity to carry out the exploration work, and that will not simply sit on the concession or promote their acreage.

● To prevent junior companies from farming out their stake (or part of their stake) to under-qualified companies, the government should specify in the petroleum law that its approval is required for any transfer of control.

● The government should disclose bidding information to the public to discourage corrupt bidders.

**Challenge: Frontier areas are not always attractive enough to hold an auction**

Auctions and open bidding rounds tend to generate the best terms for the government, because this type of sale forces bidders to compete to set the market value of the acreage. They also reduce knowledge asymmetry problems between the state and the investor, while direct negotiation requires greater knowledge and expertise on the part of the government. However, auctions work well only in a context of high investor interest.

**Recommendations:**

● Rely on transparent, open bidding rounds, provided that investor interest is strong enough to create real competition.

● A first-come-first-served licensing process is more appropriate for countries with low exploration interest; this allows them to avoid an open bid that attracts only a few bidders.

● Whether governments choose to use bid rounds or direct negotiations, transparent selection criteria should apply.

● Governments should shift to auctions at the appropriate moment. Officials should analyse the market carefully so that they will know when there is enough investor interest to make competitive bidding possible.

**Challenge: Changing investment terms without scaring off investors**

New geological information can increase a country’s attractiveness to investors. New discoveries in its own fields or in a neighbouring country can lead to a surge of exploration interest from oil companies. These new data may prompt governments to seek to revise the terms of investment to their advantage. However, as Flavio Rodrigues, Government Relations and Regulatory Affairs Director for Shell Brazil, points out, it is preferable to modify the terms of future licensing rounds rather than changing the terms of existing agreements.

‘Unilateral change of conditions and contract terms drives business away. Industry recognizes that a good fiscal system is progressive in nature, able to accommodate different production levels, reserve sizes or oil prices.’
**Recommendations:**

- Governments should revise or renegotiate contracts only in the event of extreme economic unfairness or destabilizing social or environmental provisions. Governments should respect existing contracts, but remain committed to modifying the licensing terms of future contracts.

**Questions for further discussion:**

- What circumstances would justify a unilateral change of terms in a contract?
- Would it be appropriate to include in agreements a clause for renegotiation of terms after a set number of years?

Even with an attractive exploration play within some areas of a country’s territory, other acreage may remain less attractive and require a different licensing regime or at least different investment terms to attract exploration or investment. In such areas, producer governments can enhance the terms of existing licences by adding stronger financial incentives for the introduction of the appropriate technology. They can also design a new licensing formula for different kinds of frontier reserves, adapting each one to reflect the varying levels of attractiveness to investors.

Some established producers with declining reserves are forced to adapt contract terms and tax policies to attract investors to develop their frontier reserves. In this sense, they face challenges similar to those encountered by many emerging producers. This has been the experience of established producers such as Algeria, Mexico and Gabon (refer to Annex 1 for a case study on ‘Adapting licensing to changing geology, Mexico’).
OBJECTIVE 2: MAXIMIZE ECONOMIC RETURNS TO THE STATE THROUGH LICENSING

Challenge: designing fiscal terms that give the state early revenues from development while ensuring long-term benefits

In designing a licensing scheme, producers must choose whether to reward up-front or longer-term cash flows. They must also strike a balance between direct tax revenues and indirect economic benefits, which would be generated via local content requirements.

Recommendations:

● Include progressive, flexible fiscal elements, such as profit-based production-sharing formulas or resource rent taxes.

This approach is typically recommended for most petroleum producers, but it bears particular relevance for new producers. Including flexible fiscal elements makes such countries more attractive to risk-averse investors, since the higher rates are triggered only if a project becomes very profitable. At the same time, such policies can allow the government to capture a substantial share of any eventual windfalls.

● Include royalties or a similar mechanism such as cost-recovery limits, in production-sharing contracts.

These are appropriate fiscal tools for new producers because they bring revenues from the first day of production. Such tools also help to reassure the population about the benefits of resource development (see Objective 3). As a country’s oil and gas sector becomes more developed, a government may put less emphasis on getting cash up front. However, royalties remain an important fiscal tool for the government if development needs are still critical.

Questions for further discussion:

Governments that have urgent economic needs may be inclined to pursue oil and gas revenues in the short term. Such revenues may be sought out to support socio-economic development, to balance the government budget or, in some cases, to line the pockets of corrupt officials. However, governments may be better off pursuing longer-term benefits through a licensing strategy that emphasizes strong technical work programmes. Such an approach may ultimately accelerate the development of the resources that could provide wealth for future generations.

● What are the pros and cons of this approach?

Challenge: Overcoming knowledge asymmetries in negotiations with foreign oil companies

In some cases, government negotiators have insufficient knowledge of the costs and technical requirements of the oil and gas sector. This makes it difficult for them to achieve optimal terms in their negotiations with foreign companies.

Recommendations:

● When in direct negotiations, governments should work with consultants or technical advisers to evaluate the baseline conditions for the award of acreage; these external advisers should also support the state in the negotiations. Governments should make sure that they have access to adequate financial modelling, which is a key negotiating tool.
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- Governments should move as many fiscal elements as possible into standardized laws and regulations that apply across licences. This simplifies administrative functions and minimizes the number of fiscal matters that need to be negotiated with each company. Countries should define the fiscal obligations in the law (i.e., the requirement to pay royalties, taxes, rents, etc.), and then further specify those obligations in the regulations.

- Governments should include capacity-building requirements in licensing agreements.

- Governments should consider making contracts transparent.
  Contract transparency can help reduce knowledge asymmetries between governments and companies. By allowing governments to see what has been agreed in other countries, transparency serves to level the negotiating playing field. Contract transparency can also deter disreputable companies.

Questions for further discussion:

- What would be the best way to establish a database for sharing information on contracts among emerging producers?3

Challenge: Developing appropriate tax structures

The fiscal terms of licensing agreements can serve as important tools for emerging producer governments.

Recommendations:

- Governments should clearly articulate the fiscal terms governing upstream petroleum activity.

- As much as possible, governments should define tax obligations and other imposition criteria in their tax codes. This offers obvious benefits such as transparency and security for foreign investors. Governments should avoid defining such terms in individual contracts, with the exception of fiscal elements that are negotiable. (For example, the profitability thresholds for the imposition of additional profits taxes could be negotiable, while the corresponding tax rates for such thresholds could be fixed.)

- Before licensing, governments should make provisions in the tax code for taxing capital gains by early entrants that later sell out (refer to Annex 1 for a case study on ‘Clarifying taxation, Uganda’).

Questions for further discussion:

- Is it better for governments to choose
  1. to create specific petroleum tax legislation that recognizes the unique characteristics of the oil and gas industry; or
  2. to modify existing tax codes to include specific schedules that cater to these unique characteristics?

3 A future workshop could discuss whether and how to build on efforts such as http://www.resourcecontracts.org, a nascent initiative being organized by the World Bank Institute, Revenue Watch Institute and Vale Columbia Center. The site is meant to serve as a ‘one-stop shop’ for publicly available oil and mining contracts.
OBJECTIVE 3: EARN AND RETAIN PUBLIC TRUST AND MANAGE PUBLIC EXPECTATIONS

Challenge: winning the trust of the public and soliciting inputs from key stakeholders

At the outset of exploration, governments should engage with domestic stakeholders to build consensus around the objectives of the oil and gas sector and to understand any concerns about potential development impacts. Stakeholder engagement is particularly important in post-conflict situations and where corruption has been endemic. However, this enhanced communication should not be seen as a substitute for the actual delivery of windfalls or other sector-related benefits.

Recommendations:

- Governments should identify which groups require specific communication and outreach. These may include people living in producing or non-producing regions, traditional communities, local industry representatives, parliamentarians and other citizen groups.

- Industry representatives need to increase their communication with the public to explain the role that the industry is playing in the country. Policy-makers can support this process by mediating between citizen and industry perspectives.

- Governments should increase the public disclosure of information related to the licensing and tendering processes. Similarly, they should publish the criteria for assessing bids and hold open bidding rounds for both exploration licensing and tendering.4

Increased disclosure will raise public confidence in the system and improve the financial benefit for the producing country. The following comment from Charlie Scheiner at the NGO La’o Hamutuk in Timor-Leste illustrates this point:

‘Transparency about bids, selection criteria and the eventual contract can help convince both companies and citizens that the process is fair.’

That said, the issue of contract transparency is not clear-cut. Some have suggested that certain contract details should be shielded from public view, as this can prevent early-stage producers from being penalized in future negotiations with large oil companies, since the latter would have acquired full knowledge of the previous commercial terms (which may have been negotiated at a time of either low capacity or low prospectivity). Conversely, others have argued that contract disclosure particularly benefits new producers because making the terms publicly available can increase public support for a project. Over time, increased transparency greatly reduces the information asymmetries that cripple low-capacity countries in their negotiations with major foreign corporations.

4 As discussed under Objective 1, Licensing process, a country with low exploration interest may need to follow the open door policy and engage in direct negotiations as companies present themselves. Open bids for tendering are preferable in both situations.
Questions for further discussion:

- What are the benefits of disclosing financial data? Specifically, what can be gained by disclosing audited NOC accounts or revenues collected by government treasuries?
  
  Involving the public in consultations can increase trust and help coordinate state and private efforts in support of the development of the industry and the economy more broadly.

- Can consultations with the public help to prevent government officials from being focused on short-term ‘private’ benefits?

- How should the government manage early engagement with the public so as to reduce the risk that populist pressure will result in excessive emphasis on short-term benefits to the detriment of longer-term public goods?

Challenge: Fair redistribution of wealth to producing and non-producing regions

The question of the redistribution of wealth and opportunities to producing and non-producing regions is salient in both emerging and established producer countries. At stake are issues of fairness, a sense of ownership, and compensation for local negative impacts from the development of the resource. (The case study of ‘Regional distribution of wealth in Brazil’ in Annex 1 illustrates some of these issues.)

Challenge: Moderate public expectations about the sector after discoveries are made

A participant at the workshop commented:

‘The first deal won’t look good once discoveries are made … We have to communicate to the population that the first deal won’t be as good as the second.’

Another participant said:

‘Politicians promise great things to their constituents when oil is being developed. However, in many cases, once production begins, a government’s net oil revenue leaves each constituent with $50 per year! Not enough for all the roads and free education that people expect.’

Abdlatif Y. Al-Hamad, Director General and Chairman of the Arab Fund for Economic and Social Development, and former Minister of Finance and Minister of Planning in Kuwait, warned:

‘In Kuwait, we have been producing for over 40 years … and we still haven’t managed public expectations!’
Moderating public expectations is a critical issue. While further discussions are needed to flesh out specific steps to achieve this objective, initial discussions led to the following recommendations:

**Recommendations:**

- Governments should begin thinking about how to manage expectations before discoveries are made.
- Where significant discoveries have been made, *both the government and the opposition parties* need to be realistic in statements about the scale and speed of monetizing the new discoveries. They must also manage the public’s expectations regarding job creation and profit windfalls. This can be particularly challenging in a post-conflict or conflict situation.
- Governments should use the NOC or ministry of energy website to communicate with citizens about the scale and nature of discoveries, as well as the timeframe for production. They should also provide details of dry wells, to help moderate expectations. Efforts should also be made to educate citizens about the difference between a discovery and a commercially proven discovery, and the steps that must be taken before production can begin.
- Governments should use various other means of communication to target populations that do not have access to the internet. This can take the form of mainstream media, town hall meetings, road shows and the like. Governments should encourage oil companies investing in the country to participate in these communication efforts and to share their knowledge about the resource.
OBJECTIVE 4: INCREASE LOCAL CONTENT AND BENEFITS TO THE BROADER ECONOMY

Challenge: Laying out policies that maximize national development

It is a challenge to develop a macroeconomic policy that maximizes linkages between the capital-intensive, high-tech petroleum sector and other sectors of the economy.

Recommendations:

- Governments must have clear objectives when it comes to national development. They should identify what parties are involved in achieving those objectives (within government, oil companies) and what each will do. Priority sectors for local development should be chosen strategically, and the government should implement an integrated strategy that includes market analysis and skills enhancement.

- Governments should implement laws that include a ‘national content’ requirement for the goods and services the NOC buys, in line with national capacity to provide the services and/or a timetable for transfer of foreign to national capacity.

- The local development plan must ensure that skills, goods, and services will be available to the industry at the time when they are needed.

Timely industrial and skills development is especially challenging in a country where oil and gas reserves are likely to be exhausted within a decade or two.

Challenge: Setting realistic local content targets when domestic industrial or human capacity is low

Tony Paul, Managing Director of the Association of Caribbean Energy Specialists Ltd in Trinidad and Tobago, offers the following advice on how to think about local content:

‘We must change the conversation from asking the investor to do it for me, to give me the capacity to do it myself. Rather than build me a road, show me how to build a road. In so doing, however, we must be strategic in selecting those “roads” that we want to build.’

Experts disagree about how much companies should take over roles typically played by governments. Some say that allowing oil companies to take on responsibilities that usually reside with the state or the local private sector could ultimately undermine their capacity. Such a scenario may also lead oil companies to undertake activities that fall outside their core competence.

That said, each oil company is different. Governments can expect more in terms of broad packages of activities from NOCs from Asia and less from small exploration companies. More significant investments in national development are better suited to NOCs from consuming countries, especially those operating in an industrial cluster with other companies.

Recommendations:

- Governments should first develop a thorough understanding of the local context (demand-side requirements, supply-side capabilities, etc.) in order to define which local content targets would be realistic and achievable.  

- Governments should focus next on capacity-building by requiring investors to develop the workforce and the supply base. For many emerging producers, the starting point in terms of demands on foreign oil companies should be local sourcing of simple on-site services, construction and consumables for workers, for instance.

- As a general rule, governments should enlist foreign oil companies to develop local content. They should avoid the delivery of turnkey projects run by foreign staff.

- Governments should facilitate foreign oil companies’ efforts to develop the local supply industry and workforce.

Questions for further discussion:

- How can producer governments manage investments from Asian NOCs so as to maximize domestic economic benefits?

Some governments require foreign companies to partner with or contract to companies that are domestically based. In countries where local capacity is low, such rules can facilitate the creation of shell companies that benefit financially without actually contributing to or learning from the project operations.

- What can governments do to remedy this?

Challenge: Getting foreign oil companies to invest in local content and national development when resources are uncertain

Local content is often more expensive than content that is sourced outside a producer country, especially where capacity is low. If the reserve base is small, companies might not know whether there will be substantial production over a long period. Thus companies in such a situation may be reluctant to invest in the kind of capacity-building that aims to generate large spillovers into the local economy. The capacity-building costs that are covered by government can be recovered indirectly, because the capacity built by government revenues will be available to other sectors of the local economy. Companies that expect to remain in a country for the medium to long term can also recover the costs of their capacity-building efforts by later making use of that capacity themselves. But otherwise, companies expect to be compensated for the higher costs of hiring or sourcing locally – unless the geology is attractive enough for the company to justify this expenditure as the costs of a ‘licence to operate’. Moreover, a country with low prospectivity will attract small exploration companies, which are not well capitalized. Such companies are not suited for substantial investments in national development.

A comment from Rolf Magne Larsen, Vice President of Development & Production International Asset Management at Statoil:

‘Statoil’s focus when prospectivity is uncertain is to build local capacity in areas where needs are immediate, such as environmental protection (e.g., to minimize damage from potential spills from early exploration wells) and services and logistics (e.g., guards and transport).’

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6 Refer to IPIECA’s ‘Local content strategy’ for further recommendations on setting realistic local content objectives.
**Recommendations:**

- Governments should focus on building local capacity in goods and services for which the petroleum sector has an immediate need. Governments should also prioritize those goods and services that can be used by other sectors of the economy in the long term.

- Governments should collaborate with companies to develop training and hiring programmes. This can help to ensure that such programmes are well integrated into both the companies' operations and the country's local content strategy.
OBJECTIVE 5: ENSURE NATIONAL OIL COMPANY PARTICIPATION IN THE DEVELOPMENT OF THE RESOURCES

In emerging oil hotspots, there is a growing interest in promoting national participation, largely through stakes for countries’ NOCs. From Ghana to Timor-Leste, many new or prospective oil producers are establishing or reforming NOCs. The key questions that emerge in this context are: 1) whether and when it is appropriate to create an NOC; and 2) what role the NOC (and other governing bodies) should have.

The decision to create an NOC at an early stage of development of the petroleum sector will vary from country to country. Some argue that creating an NOC early in the process helps build capacity and sector-specific knowledge that proves very useful if and when discoveries are made later. Others argue that the creation of an NOC simply diverts scarce government resources. In many cases, the decision to create an NOC in oil hotspots is largely motivated by national political aspirations.

Challenge: Can the state afford a national oil company that is an operator?

A lesson learned from Rolf Magne Larsen of Statoil:

‘Building operatorship capacity requires ambition, dedication and stamina by the company and its owner(s). Transparency, cooperation and competition have been key in developing Statoil’s operator capacity.’

A lesson learned in Ghana, from Sam Addo Nortey, Principal Audit Officer, GNPC:

‘GNPC’s ability to operate commercially is hindered by its inability to retain net cash flow adequate to meet current and near-term obligations. NOCs must be able to plan over a reasonable time horizon in an industry that has a very long-term perspective.’

A comment from Roger Avinaga, Manager of Commercial and Strategic Planning at Petromin PNG Holdings Ltd in Papua New Guinea:

‘Petromin’s aspirations to invest in projects and grow as an operator have been impeded by lack of government financial support. Petromin has requested various measures to enable it to secure capital.’

NOCs succeed when governments are clear about the role the NOC is meant to play and are committed to supporting it. To make good decisions about the role the NOC should play, governments require a clear understanding of the capital and time needed for it to develop into an effective player in the national petroleum sector.

Some countries may wish to create an NOC that takes on operating responsibilities such as exploration, development and production of an oil or gas well. Establishing such capabilities is expensive and takes time. The first step is usually for the NOC to take on a minority stake, which is likely to be financially carried by foreign oil partners, unless the NOC is established...
with a strong capitalization or means of generating profits from other activities. If its stake is carried, the next step is often for the NOC to become a contributing equity partner. Once this has happened, NOCs often seek to take on a minor operatorship and then a major one.

The financial and time investments that will be needed to achieve such milestones will depend on a country’s capacity levels in the following fields:

- Primary and secondary national education;
- Specialized higher education in geosciences, geology, engineering – how many graduates of higher education are there per year in these fields?
- The level of oil sector experience of key personnel;
- Existing or potential relationships with foreign oil companies and service providers;
- The availability of financial resources to capitalize the NOC;
- Institutional stability and the stability of (and trust in) the constitutional and administrative laws.

Annex 1 details case studies that provide valuable information on the costs – in terms of both finances and human capital – of helping NOCs take on operational roles. Refer to ‘Case study 4 – How NOCs build operational capacity, Statoil, Pemex, Staatsolie, Sonangol, GNPC’.

Recommendations:

Building capacity to take on a minor operatorship takes between three and seven years – longer if education levels are low and the NOC is not sufficiently financed to support building skills. An NOC may require a capitalization by the state of around $500 million, and no profits will accrue to the NOC until fields are in the production phase and revenues exceed the combined costs of operation and debt repayment. With these facts in mind, we make the following recommendations:

- Governments should wait to make significant investments in developing an NOC’s operational capabilities until discoveries have been made that establish a reserves lifespan of at least 15 years.
- Until this reserve base is established, governments should train nationals to raise general human capacity and state administrative capacity. At the same time, governments should focus skills-building on the most relevant ministry, and provide the NOC with only a limited budget for building operational skills.

Lesson learned in Timor-Leste, from Charlie Scheiner at the NGO La’o Hamutuk:

‘Consider the opportunity cost, especially in small countries with limited oil and gas reserves, of not educating the brightest, most motivated, people in agriculture, civil engineering, public administration, manufacturing, education and other fields which will directly benefit the country’s citizens.’

Challenge: Giving the NOC an effective state agent role

Some governments will want to ensure that the state’s interests are represented in the upstream, without needing the NOC to take on an operating role. In some cases, the NOC’s equity participation in licences will be sufficient to satisfy this goal. To some extent, these NOCs play a symbolic role in representing the state in the upstream. Other governments will want the NOC to actively represent the state. In such cases, it may be given a state agency/concessionaire role, such as acting on behalf of the state to issue licences or monitor operations.
**Policy option: Establish an NOC to represent the state by taking on minority stakes in domestic oil and gas projects**

The government can choose to give the NOC a guaranteed minority stake through the petroleum law or it can leave it to the NOC to negotiate its stake with foreign oil companies. Experts have suggested that an NOC may be empowered *vis-à-vis* its foreign oil company partners if it has the capacity to put up the equity for its share of licences. However, the workshops identified no cases that have validated this idea, and the difficulties that NNPC of Nigeria faces in meeting its cash calls point to the risks of adopting this approach.

**Recommendations:**

- Governments should require foreign partners to carry the NOC’s equity stake until production begins.
- The state should adequately capitalize the NOC to cover its costs, unless a proved resource base allows the NOC to raise finance or until the NOC can generate revenues from production.

Most NOCs in countries *without significant discoveries* typically have a workforce of 30–40 employees and an annual expenditure of $1 million at a minimum. *New non-operating NOCs that are pursuing growth strategies* (taking carried minority stakes in exploration and development licences) in countries with discoveries may have a higher budget, in the area of $2–4 million, with a staff of 60–90. Governments should therefore expect to fund the NOC to the tune of $1–4 million per year for its upstream activities and skills development. Further capitalization would be required if the NOC is to engage in other cost centre activities in the downstream or midstream.

**Policy option: Give the NOC a concessionaire/regulatory role**

The NOC may have a state agency role in data promotion and licensing or in reviewing work programmes and making recommendations to the state on the approval of the programmes. Such roles increase the influence of the NOC *vis-à-vis* international oil companies (IOCs).

A lesson learned in Ghana, from Sam Addo Nortey, GNPC:

> ‘Thanks to provisions in the model petroleum agreement that ensure that GNPC plays an important role through the JMCs [Joint Management Committees], it has had a strong voice in its partnerships with international oil companies.’

A lesson learned from Eddie Belle, CEO of PetroSeychelles:

> ‘The decision to give the role of promotion and supervision to an NOC rather than a ministry was based on three reasons:
> 1. An NOC works more effectively than a ministry;
> 2. An NOC provides a nucleus which can work side by side with an IOC;
> 3. Ministries have to follow a specific remuneration package.’

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7 The newly created NOC TIMOR GAP from Timor-Leste, for instance, received US$2.3 million from the state budget in 2012 and US$4 million in 2013 for a staff of 72 (Source: La’o Hamutuk).

8 It is worth noting that the human resource constraints of the civil service can be bypassed if the government creates a directorate, as was done in Norway.
**Recommendations:**

- The NOC must build its capacity to take on the concessionaire or regulator role effectively.

  An NOC with a concessionaire role needs a more skilled workforce than an NOC that is simply a minority partner in licences. The financial and personnel requirements for a concessionaire or regulatory role vary widely depending on the size of the resource base, the stage of development of the resources (whether promotion, exploration or production) and the type of geology (whether complex fields, offshore or onshore, or in environmentally sensitive areas). In the first steps of taking on a concessionaire or regulatory role in a country without significant discoveries, the NOC is likely to need to increase its specialist staff. This will usually entail hiring in between 10 and 40 additional staff, depending on the exploration activity in the country.

- Until revenues come from production, the state will need to finance the recruiting and skills development of the NOC, which is likely to cost around $1–2 million per year in the medium term over and above existing administrative and procurement costs. Otherwise, the government must give the NOC other means of financing itself (e.g., signature bonuses, import levies, import mandates). Governments should exercise caution in using such tools, however, as they can distort the NOC’s incentives and undermine sound public financial management, particularly in small economies.

  The concessionaire or regulator NOC can be funded from an annual budget, like a state agency. Alternatively, if the NOC has an interest in the licence(s), it will receive its share of the income directly and pay tax as appropriate.

**Questions for further discussion:**

NOCs play various roles, each of which has its own cost.

- What are the precise levels of these costs, and how do they vary across different economic, political, and geological contexts?

- What is the cost of the carried equity stake?

- Do higher financial risks for the IOC translate into less revenue to the state?

NOC budgets can be highly unpredictable, and many NOCs in emerging producer countries struggle with financial uncertainty. The companies are dependent on state financial allocations until discoveries are made, and the government’s commitment to maintaining the NOC’s budget may fluctuate. When they have interests in licences, NOCs must raise finance to meet the cash call once production begins.

- What are the best ways for NOCs to manage such challenging financial situations?
OBJECTIVE 6: GRADUALLY BUILD CAPACITY AND ENABLE ACTORS TO PERFORM THEIR ROLE

The most effective way for an NOC to gain competence is to learn on the job. For instance, an NOC might fill the shoes of a departing IOC or enter into partnerships that allow it to act as an operator. Similarly, government institutions that are given responsibilities can build capacity quickly.

Once an organization secures a role, it requires financial resources, information, human capacity (skills, knowledge, experience) and supporting processes to carry out the role assigned to it. Emerging producing countries often have urgent development needs, and governments in such countries may have limited funds to allocate to capacity-building. Thus governments must determine which tasks and which actor(s) they wish to prioritize in their capacity-building efforts, and how they plan to minimize the associated costs.

Challenge: Where should a state with limited resources concentrate petroleum-sector capacity-building efforts?

Some emerging producers have opted to concentrate responsibilities for the sector among the smallest possible group of actors. Eddie Belle, CEO of PetroSeychelles, commented:

‘In a small island developing country with relatively limited resources, it would be a mistake to duplicate tasks.’

Similarly, in Suriname, Vandana Gangaram Panday, Industrial Engineer, Corporate Planning Department at Staatsolie, offered the following lesson learned:

‘So long as the NOC is the only operator onshore and IOCs are only operating offshore, there is no need for separation of functions. The risk of “conflict of interest” within a professionally run NOC is preferable to the risk of transferring functions to a politically appointed state agent.’

A different lesson emerged in Trinidad and Tobago, where responsibilities have been concentrated in a competent ministry of energy. Tony Paul commented:

‘On start-up, the Ministry was run like a business. They recruited from within the industry.’

Recommendations:

- When capacity is low, governments should concentrate capacity-building efforts in either the ministry of energy or the NOC. Governments should task one of these two bodies with regulatory responsibilities.

It is considered best practice to separate the functions of policy-making, regulation, and operations into three distinct bodies, as this maximizes the clarity of roles and allows for better accountability for the delivery of each function. However, in certain circumstances such a separation is not feasible, since building up the skills
and processes in three distinct bodies requires significant investments of time and money.  

- It is critical that governments establish effective tax policies and efficient means of collecting tax revenues. Governments should invest in building capacity at the revenue authority even in low-capacity contexts and before discoveries are made.

- Countries at the beginning of the process should allocate data, licensing, and promotion authorities to a single entity, either the ministry of energy or the NOC. Going forward, data management should continue to be centralized.

- When discoveries are made, governments must allocate more resources to building capacity in auditing and monitoring operations. If the responsibility for monitoring operations is with the NOC, the NOC must develop this capacity. Subsequently, the government should begin evaluating the NOC’s performance to that effect. If public funds are limited, development agencies (such as the Norwegian Oil for Development programme, Revenue Watch Institute, the Commonwealth Secretariat, the World Bank, the International Monetary Fund and many others) can support capacity-building in the civil service.

- When discoveries allow the government to count on a significant production lifespan, it must invest in its administrative capabilities and boost its own petroleum-sector knowledge.

At some point, it is likely that governments will need to improve accountability in the oil and gas sector in order to better manage revenue flows, control operator costs and strengthen regulations overseeing operations. To do this, governments will need adequate administrative capacity and knowledge of the sector.

- When discoveries are sufficient to justify the NOC developing an operational role (to assess this, see above, Challenge: ‘Can the state afford a NOC that is an operator?’), the NOC should transfer its regulatory role to government to avoid the conflict of interest that results from the NOC regulating its own operations. (For further discussion of how to transfer these responsibilities, see further below ‘Challenge: How to overcome entrenched interests’.)

- When significant revenues flow to the treasury and the size of the reserves allows the government to count on medium- to long-term development, the government should direct substantial and sustained efforts to auditing and monitoring, even when development needs remain great.

A comment made by a workshop participant:

‘In any governance model, building state administrative capacity is critical. It’s another example of planning for success: build administrative capacity now because you’ll need it later.’

**Challenge: How to build a capable regulatory agency**

The following comment made by Charlie Scheiner at the Timorese NGO La’o Hamutuk illustrates the challenge of establishing a strong regulator in an emerging producer:

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‘Timor-Leste’s regulatory National Petroleum Authority has about 100 staff (most of whom graduated from university within the last five years and have never worked anywhere else) and a total annual budget of less than $10 million. ENI, which is only one of the companies which they regulate, has about 80,000 personnel and annual expenditures of more than $90,000 million. How can a balance be achieved between such unequal entities?’

Some regulatory agencies in emerging producers do not have the capacity to truly hold operators to account for their performance. In some places, agencies have not been allocated sufficient autonomy and thus have not been able to establish their independence from the political leadership. This raises the possibility that licences will be awarded to companies that are under-qualified but well-connected politically. Establishing an independent and capable regulator in a low-capacity context is a significant challenge.

However, some countries with low institutional and human resources capacities have successfully adopted the separation of powers model, with good results in terms of transparency and accountability and an effective governance system. Arsenio Mabote, Chairman of the National Institute of Petroleum (INP), the Mozambican regulatory agency, offered the following lesson from his country:

‘The political will was critical to the success of the separation of powers model. The INP in Mozambique had an outreach programme with parliament to build consensus.’

In established producers, multiple entities would normally carry out the various regulatory functions, which include the following:

- Devising regulations and monitoring compliance related to health, safety and the environment (HSE);
- Data management, resource promotion and licensing;
- Technical review of development proposals;
- Tax collection.

However, in a context of low administrative capacity, it is difficult to establish multiple regulatory agencies. In such cases, the establishment of these agencies can be an incremental process that takes into account the specific needs of the industry.

**Recommendations:**

- In countries with low state capacity, external technical assistance is critical to the successful establishment of an independent regulatory agency.\(^{(10)}\)
- Government officials and other stakeholders should work to ensure that there is strong political will to back the governance system.
- Governments should initially create one regulatory agency to take on all of the above regulatory functions. This concentration of responsibilities is especially warranted where state administrative capacity is low and the size of the reserves base is uncertain.

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\(^{(10)}\) Ibid.
● If the civil service has established a sufficient degree of capacity, a specialized unit at the ministry of environment or natural resources can be in charge of environmental monitoring. Similarly, a specialized unit at the ministry of finance can handle tax collection.

● To recruit and retain skilled staff, governments should make the pay structure within this regulatory agency more advantageous than that of the rest of the civil service. To motivate the staff, the government should also foster a corporate culture and sense of mission, as in an NOC.

Questions for further discussion:

The regulatory agency will need sufficient resources, in terms of both staff and revenues, to carry out its role effectively.

● Should the agency be allowed to generate revenues by taxing the NOC or the IOCs for the cost of monitoring those companies’ activities?

The regulatory agency needs a certain degree of autonomy in the appointment of high-level staff.

● Which agencies or individuals (e.g., the head of the executive branch, members of parliament, the ministry of energy) should have a role in the appointment process for the regulatory agency?

Challenge: Coordinating (and getting the most out of) foreign technical advisory services

Emerging producers that have caught the attention of foreign oil companies often attract a number of foreign donors and technical advisers that offer guidance and capacity-building to help prepare the country for the next stages of petroleum development. If the government fails to coordinate this assistance effectively, confusion and duplication of efforts may ensue.

Recommendations:

● To optimize donor coordination, governments must decide what exactly they want and then communicate this to any external advisers.

● Both the users and providers of technical assistance must take into account the country-specific context. Recommendations must be adapted to the national capabilities and resources (as discussed in the Guidelines).

● Advisers should provide technical assistance not only to governments but also to oversight bodies, such as civil society organizations, journalists and parliaments. They should also provide assistance at the lower levels of an organization.

Questions for further discussion:

● Should governments set up a central agency with authority to coordinate the providers of advice? If so, how should that agency adopt and implement a plan to that effect?

● Where such central government coordination of assistance does not exist, should foreign donors and technical advisers take the initiative to coordinate their work themselves?

● Would there be any benefit to establishing a voluntary agreement among international governmental organizations, non-governmental organizations and private advisory groups to coordinate in-country efforts?
OBJECTIVE 7: INCREASE ACCOUNTABILITY

Policy option: Reform oversight institutions: create an independent regulatory agency

To increase accountability in the governance of the petroleum sector, governments can begin to introduce more checks and balances into the system. In effect, this can mean taking some or all regulatory responsibilities away from the national oil company or the ministry of energy.

Various drivers can trigger the creation of an independent regulatory agency:

- If the NOC becomes an operator, the company will want to concentrate on its commercial development instead of on regulation.
- New geological challenges (e.g. frontier reserves, declining reserves) may prompt the government to overhaul the governance of the sector.
- Poor health, safety or environmental records on the part of operators or the NOC could trigger a shift.
- The transition from exploration to discovery to production requires adjustments – and sometimes overhauls – in institutional set-up. Oversight must increase at each step. At exploration, the main responsibility is promotion, but more production brings more responsibilities.

Challenge: How to overcome entrenched interests

Proposed reforms that upset entrenched interests are likely to be opposed – whether by parliament, as in Nigeria, or by the NOC, as in Algeria. Indeed, it is important for governments to recognize that once an actor (specifically, the NOC or the ministry of energy) has assumed responsibility for some regulatory functions, it can be difficult to take them back. Some are a source of influence and tend to be fought over; these include licensing, technical review of development proposals and tax collection.

Who initiates the reform, what triggers the need for reform, and how the reform is carried out are all factors that determine the level of resistance and ultimately the success of the reform process. Reform that is driven by the NOC's desire to focus on its business typically provokes the least resistance from government officials. Reform that is government-led tends to provoke more resistance from the NOC. That said, NOCs tend to be less resistant to reform when it is driven by a larger representative or legitimate constituency (e.g. parliament) or when there is consultation with civil society. These differences are illustrated in Case study 5 in Annex 1, ‘Contrasting experiences with institutional reform, Brazil and Algeria’.

Emerging producers do not need to set a ‘final’ institutional structure from day one. Instead, they can follow a phased approach and engage in incremental changes. Producers can think a step or two ahead and anticipate future needs. Reform does not always need to be introduced rapidly; it can be construed as a process of continual evolution.

Recommendations:

- Producers at an early stage of development of their resource base should start with one credible body that is responsible for all administrative and regulatory functions. Over time, governments should build up capacity elsewhere and introduce checks and balance into the system.

  The introduction of checks and balance is particularly important in small countries that have few qualified people to oversee the sector. In such cases, a handful of people may dominate the governance system by accumulating multiple roles.
● 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.

● Where responsibilities for the oversight of the sector have been concentrated in one organization (e.g., the ministry of energy or the NOC), the departments responsible for regulation should be set up as functionally distinct units. This will allow these departments to be spun off as independent regulatory agencies when the time comes.

● Governments should also require that personnel from the regulatory authority be seconded to the new body that is due to take on these responsibilities, as this will help with the transfer of skills.

● To facilitate forward planning for the next phase of petroleum-sector governance, government should establish a credible, legitimate group to direct the pace and shape of incremental reform. This group can be a type of petroleum governing council, which establishes means of consultation with civil society and appropriate state institutions.

**Policy option: Increase public disclosure of data**

Accurate information and the right levels of transparency are essential for accountability and making good decisions. Whatever the precise mechanisms of governance and accountability in a particular national context, their effectiveness depends on reliable, relevant and timely information. Transparency removes the cover for possible corruption, builds trust, enables good decisions and allows for rapid intervention to correct problems in the system. There is a large body of literature on this topic.\(^{11}\)

**Recommendations:**

● Governments should increase public disclosure of data to improve public trust and manage public expectations (see **Objective 3**).

**Questions for further discussion:**

● What other steps can governments take to increase accountability?\(^{12}\)

  One option is to invest in institutional capacity-building to create stronger checks and balances. Whatever the existing governance model for the petroleum sector, accountability can be bolstered by increasing the capability of existing actors in the system to ask the right questions of those with responsibilities in the sector.\(^ {13}\)

  Capacity-building reduces the knowledge asymmetry between the operators and decision-makers on the one hand and stakeholders on the other.

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\(^{11}\) Detailed advice on improving transparency and accountability can be found in the EI Sourcebook, Available at [http://www.eisourcebook.org/625_4TransparencyandAccountability.html](http://www.eisourcebook.org/625_4TransparencyandAccountability.html). Revenue Watch Institute has published widely on transparency issues, including via the Resource Governance Index, which measures the quality of transparency and governance in 58 oil- and mineral-producing countries, available at [http://www.revenuemwatch.org/rgi](http://www.revenuemwatch.org/rgi).

\(^{12}\) Another important means of increasing accountability is to strengthen the reporting requirements of the NOC and auditing capacity of the ministry of finance. Accountability of performance is crucial at every level of a governance system. Once production begins, it is particularly important that the government can assess the NOC’s financial and operational performance.

\(^{13}\) The Natural Resource Charter’s Precept 2 discusses the value of a well-informed public; see [http://naturalresourcecharter.org/content/precept-2](http://naturalresourcecharter.org/content/precept-2).
● What is the value of building capacity in parliament, the media, civil society and the general public?

**Challenge: Ensure sufficient investor accountability**

Emerging producers want oil companies to be accountable in the event of accidents or failure to perform. Introducing the appropriate mechanisms for making investors accountable can be a challenge in a context of low capacity and low sector knowledge. Moreover, frontier producers will want to be sure that they maintain their attractiveness to investors.

*Questions for further discussion:*

- What provisions should be made at the licensing stage regarding possible environmental impacts?
- Should producers embed the ‘polluter pays’ principle in legislation and contracts?
- Can emerging producers benefit from sharing information on the most adapted environmental and safety regulations for exploration and production (most notably regarding offshore operations)?
ANNEX 1: CASE STUDIES

Case study 1: Adapting licensing to changing geology, Mexico
Sergio Guaso, Vice President for Business Development at Pemex, made the following statement:

‘With the opening of the Mexican economy in the 1990s and the decline of [Mexico’s giant oil field] Cantarell, Pemex was motivated to reactivate exploration and ramp up production from new fields. In this regard, the new “Integrated EP Contracts” were designed after the 2008 energy reform as a mechanism to attract the private sector to Mexico. There are several important lessons learned from the Integrated EP Contracts. First, EP opportunities are not attracting all potential players because the legal regime is too restrictive in terms of its fiscal regime and linkage to oil prices, and this makes the current contracts less competitive. Second, the bidding variables should change according the kind of frontier reserves (brown fields, unconventional onshore field such as Chicontepec and deep water); this was successfully done in the first two rounds under the new regime. Third, the implementation of the contract is as important as the contract itself. The relationship between the national oil company and the operator should be well defined in terms of roles, responsibilities, management and conflict resolution.’

Case study 2: Clarifying taxation, Uganda
Uganda provides a useful example of the consequences of insufficient clarification of applicable taxes.

2010: Heritage Oil sold its stake in exploration assets in Uganda to Tullow Oil for a deal valued at US$1.45 billion. The Uganda Revenue Authority (URA) sought to levy and claim a capital gains tax of 30 per cent on the assessable capital gain arising from the sale. This was initially disputed by Heritage. The resolution of this dispute has been complex, with Tullow Oil paying the tax to the URA and seeking compensation from Heritage, which was also disputed by Heritage as without base.

What is evident from the dispute is that the agreements signed between Heritage Oil and the Government of Uganda did not explicitly require the imposition of capital gains tax on any value gained from the disposal or transfer of rights. It is important to recall that Uganda had very little hope of finding oil at the time of negotiation and wanted to attract investors. Other producers may learn from Uganda’s experience the importance of including specific provisions for capital gains in the income tax legislation.

Case study 3: Regional redistribution of wealth in Brazil
The pending Royalties Bill has been the subject of heated debate in Brazil. The intent of the bill was to redistribute royalties more evenly throughout the country, in order to ensure that non-producing states also reap the benefits of producing the massive new offshore oil discoveries. The bill was contested by oil-producing states such as Rio de Janeiro and Espirito Santo. The government of Rio de Janeiro says it stands to lose Reals 27 billion (US$13.6 billion) in revenue by 2020. A presidential veto that preserved existing income for producing states was overturned by Congress. The impasse over the bill will be difficult to resolve.

Case study 4: How NOCs build operational capacity – Statoil, Pemex, Staatsolie, Sonangol, GNPC

Statoil, Norway:
It took seven years to take on a minor operatorship and 14 years to become a major operator. Over 17 years, Statoil built a workforce of 8,000 people. Between 1972 and 1989, it received a
capitalization from government of 3 billion kroner ($533 million). Initially Statoil was 50 per cent carried by foreign partners. It borrowed from IOC partners and from banks. It took eight years before the company earned a profit. At an early stage it hired Americans as VP of Exploration, VP of Production, etc. to accelerate competence building. It is useful to recall that Norway already had high education levels and state administrative capacity when the petroleum sector was created.

**Pemex, Mexico:**

Pemex was created in 1938 and was given a monopoly over Mexico’s upstream. The company produced and also imported oil during the first period of its history. A major discovery (Cantarell) led to an oil boom and the company’s ‘insular model’ began. From 1970 to 1990, the company focused on developing its operational capabilities. It was funded through a high level of debt (US$5–10 billion), which it had to reduce following the Mexican financial crisis of 1982. The third phase, ‘consolidation and diversification’, was characterized by the decline of its large field, Cantarell, from 2004, which prompted the company to change. Pemex realized that the company had to invest in its operational skills to tackle depletion and explore and develop frontier reserves. In 2009 a fund was established for petroleum research and development. Today Pemex has 5000 geoscientists, and yet the company faces a skills shortage as its oil engineers retire at a quicker pace than they are trained. Three out of ten workers are not Mexican. Debt levels remain a challenge for the company.

**Staatsolie, Suriname:**

Staatsolie is a competent NOC acting as a state agent and has also been operating since 1980. The government had created the NOC with the intention for it to be an agent of the state, without giving it the goal of becoming an operator. The operator role originated from within the company. When the IOCs found no attractive resources, they left Suriname, and Staatsolie became an operator by filling their shoes. Staatsolie’s leader believed in developing an operator’s role within the NOC. Some of the Gulf Oil personnel were asked to stay on and assist in building up Staatsolie’s capacity. Later the company used consultants. The initial years focused on learning from experienced professionals, enabled by personal appeal and inspired by strong leadership. Having non-political professional executives was vital to overcoming internal and external challenges. Staatsolie received a small government loan to get it started but has not relied on government financing ever since. Even if it would be desirable to do so, the NOC is unable to transfer state agency functions back to the state because of the government’s low administrative capacity.

**Sonangol P&P, Angola:**

Sonangol’s exploration and production subsidiary, Sonangol P&P, took on its first major operatorship with the transfer of Block 3. Before this it was involved in minor exploration and production operator activities since the 1990s. However, this activity was on an extremely small scale and most of the work was outsourced. It did provide embryo capacity through which to develop skills for the Block 3 transfer to Sonangol P&P, but the step change was so large that the company decided to hire Schlumberger Business Consulting to build up competences quickly and second the Sonangol staff through the process. It did so with a good degree of success in three years, at an undisclosed cost. Sonangol P&P continues to rely on outsourcing and the hiring of foreign staff to shore up its operational capabilities (for instance, in its operations in Iraq, where it operates two heavy oil fields with the assistance of retired Iraqi oil sector personnel).

**GNPC, Ghana:**

GNPC’s mission was initially to represent the state in all licences. However, there has always been the desire for the corporation take on the more challenging role of an operator. In pursuing its goal of operatorship, GNPC has adopted a strategy of acquiring a commercial interest in new licences. Strategically these increases in participation will help the company build capacity to conduct petroleum operations on its own through joint operatorship with global industry experts. Joint ventures with global industry experts such as Technip and E&P partners are critical to building capacity.
Case study 5: Contrasting experiences with institutional reform, Brazil and Algeria

The successful introduction of a regulatory agency in Brazil in 1997 can be contrasted with the relative failure of a similar reform in Algeria in 2005.

In Brazil during the period of NOC dominance over the sector (1953–97), other institutions and the economy as a whole developed significantly, creating conditions that enabled a separation-of-powers model to function effectively. In Algeria, by contrast, when the attempt to separate power began in 2005, other institutions had not progressed as far and were not ready to take on the additional responsibilities. Also, Brazil had become a functioning democracy by 1997 and the decision to remove regulatory powers from Petrobras was sanctioned by popular legitimacy. In Algeria, the reform was controversial and attracted wide opposition. Many executives of the Algerian NOC, Sonatrach, saw the reform effort as a government refutation of their accomplishments.\(^a\)

\(^a\) Heller and Marcel, ‘Institutional Design in Low-Capacity Oil Hotspots’. 
ANNEX 2: FURTHER READING AND USEFUL GOVERNANCE TOOLS

Norway’s Oil for Development programme has developed a practical checklist for assessing the state of petroleum-related governance in a given country. This draws on the principles and indicators developed by Chatham House’s Good Governance of the National Petroleum Sector Project. It is available at:


The Natural Resource Charter, available at: http://naturalresourcecharter.org. The Charter is a set of principles for governments and societies on how best to harness the opportunities created by extractive resources for development. It does not offer a blueprint for the policies and institutions countries must build; instead, it lists the ingredients that countries have used successfully. It offers 12 precepts that run through the stages of development of the petroleum sector.

The World Bank’s Extractive Industries Source Book, available at: http://www.eisourcebook.org. The EI Source Book is an online interactive resource that is built upon a coherent narrative analysis of the sector as a whole, supplemented by hundreds of downloads and other web resources, including specially commissioned reports, summaries and briefs. Its objective is to provide developing states with technical understanding and practical options around development issues in the oil, gas and mining sectors. A central premise of the EI Source Book is that good technical knowledge can better inform political, economic and social choices with respect to sector development and the related risks and opportunities. It takes into account that effective choices will depend on institutional capacity and country context.

Revenue Watch Institute’s Resource Governance Index, available at: http://www.revenuewatch.org/rgi
The Resource Governance Index measures the quality of the oil, gas and mining sectors of 58 countries, representing 85 per cent of the world’s petroleum. It scores and ranks the countries, relying on a detailed questionnaire completed by researchers with expertise in the extractive industries. The Index assesses the quality of four key governance components: institutional and legal setting; reporting practices; safeguards and quality controls; and enabling environment. It also includes information on three special mechanisms commonly used to govern oil, gas and minerals: state-owned companies, natural resource funds and subnational revenue transfers.