



## **Good Governance of the National Petroleum Sector** **Workshop III: Consolidation** **1-2 June 2006, British Academy, London**

### **Introduction**

The following is a summary of discussions at the third Good Governance workshop hosted by Chatham House at the British Academy in London.

In workshops I and II, we established broad consensus over principles, objectives and certain best practices for the sector, recognizing that there will be variation in organization and implementation depending on the country's environmental, political, social, economic and historical context. However, context is not static. Key variables in the evolution of governance priorities and limitations are: the level of economic dependence on oil, the presence and capability of governance institutions and the national oil company's level of technical sophistication. At this workshop, discussion focused on understanding how the national context shapes governance systems. The aim for stakeholders was threefold:

- to consider the present status of governance in their petroleum sector;
- to identify what needs to be improved;
- to discuss how they can move up the good governance curve.

Please note that summaries do not follow the precise order of the discussion but rather are grouped by topic.

### **ROLES AND RESPONSIBILITIES**

The evolution of the NOC's mission generated a great deal of interest amongst participants. Many of them argued against presenting 'national' and 'commercial' missions as being in conflict. Maximising the value of the resource was considered a commercial objective which was part of the national mission. Discussions showed that the meaning of 'national mission' was unclear, or at least not consistently defined.

### **National mission**

#### **Different definitions of "national mission"**

"National mission" –additional to the commercial objective- was discussed in two ways at the workshop: as a concept and in its substance (what activities are included in 'national mission').

#### **The concept of national mission:**

Participants used the term "national mission" to refer to different things:

1. Non-commercial directives that the government gives to the NOC i.e. to employ more nationals, to build infrastructure, schools, hospitals etc.;
2. Strategic industry directives that the government gives to the NOC - to integrate the company, invest downstream; partner with specific companies;
3. NOC-initiated investments that raise the standard of national/local development in order to support operations and the company's strategy (e.g. providing services for employees, transport routes, healthcare to the local community where the government does not

provide these). However, many considered this as simply good commercial practice, not a “national mission”;

4. NOC-initiated investments not directly related to the industry and guided by a historic sense of responsibility for the long-term welfare of society;
5. The shared vision of NOC and government in fulfilling the country's development agenda with the NOC playing the role of a 'government partner'.

### **National mission activities**

National mission activities were perceived in both positive and negative terms by the NOCs. The positive perception divided national development activities into two categories:

1. Activities that give direct benefits to the industry: building local capacity; helping to establish local service companies; funding oil-related research etc.
2. Activities that have an indirect returns: investments in national education; health and promoting diversification of the economy.

The most prevalent ‘negative’ cases fall into two groups:

- 1) The ‘government gives non-commercial directives to the company ‘in the national interest’ which burden its operations.
- 2) The goods, services and infrastructure the NOC is ‘forced to provide’ by virtue of the lack of development and/or negligent or weak government.

### **Making the national and commercial complimentary**

Many identified the commercial mission as the one guided by the logic of the market, seeking maximum profit and efficiency and the national mission as “sustainability” – taking account of the wider, and longer-term industry needs and dependencies.<sup>1</sup> If the NOC has a monopoly over natural resources, it will have a national mission.

Most participants thought that ‘commercial’ and ‘national’ missions could be complimentary investment drivers. The question however, would be how to balance the two when deciding where to allocate resources. Some argue that the key driver for the NOC ought to be commercial, on the basis of which an NOC asks itself: what is the “price tag” for a national mission activity? And the government asks: what sort of governance is needed to allow the NOC to perform its role on a commercial basis but also be consistent with the overall national development plan?

To balance the two missions, the NOC will need to employ strict benchmarks and measures to ensure business effectiveness and the appropriate analytical tools to calculate the impact/cost of all non-commercial activities. The NOC will then be in a position either to make the economic case for its investments, or, when that is not possible, to explain the price tag of non-commercial activities to the government. This was equated with the existing methodology in economic analysis of the 'private project appraisal approach' and the 'social cost benefit analysis'.

### **Government intervention in investment decisions**

Some government intervention in petroleum industry investment decisions is likely - particularly the case in developing countries where basic needs must be addressed. Most agreed that there were cases where the 'long-term national rationale' overrode the 'short-term commercial rationale' and made good business sense.

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<sup>1</sup> To take this one step further than the discussion would be to look at the shelf-life of the industry itself in countries where resources are depleting or reaching a plateau. In this case, sustainability would mean diversification away from petroleum and perhaps a downscaling and eventual closure of the industry itself.

One NOC was asked to build a refinery by its government in order to lower the cost of domestic fuel even though at the time, it would have been more profitable to sell the crude oil on international markets than to refine it. The price of refined products has since risen and the NOC felt that the strategy had proven commercially as well as nationally prudent.

In another country, the majors each wanted to build their own natural gas pipelines and terminals whereas it would be in the national interest to have a single, unified system. In this case, government intervention would have been beneficial to national economic interests.

### **Divesting from non-core activities**

For NOCs, the process of divesting from certain activities once they cease to be essential to business is very important for national development.

One company said that because of the lack of services and goods available to the industry, it was obliged to create companies that could provide certain foods, transportation and telecommunication services. This practice did lead to some criticism of the NOC from society for "taking everything" and not leaving room for other (private) businesses. Some argue, however, that NOC intervention was the last resort since no other company or agency was either willing or able to step in.

The petroleum sector may also be disadvantaged by an NOC with excessive rights and responsibilities. In certain cases, the NOC defines its own commercial and national mission and presents them to the government for approval. Since the government in question either lacks the technical expertise to exercise critical assessment of the plans or has complete trust in the NOC, it becomes a rubber-stamping agency. This has negative implications for accountability since the government's regulatory function is weakened.

Where the NOC is engaged in non-core or government activities, the question is: how can the NOC help the private sector and/or government bodies build the competence to assume control of these activities? Participants agreed that this is a process, which requires from the outset a plan for an exit strategy for the NOC.

### **How much should the NOC provide?**

While most participants agreed that the NOC may in the beginning have to provide the goods and services for its own employee community, there was contention over the extent to which the NOC should take on a 'government role' at the level of infrastructure development and provision of social goods for the wider community, even if this was needed and the NOC was the most skilled national operator.

One view was that, "if it is national the government must take responsibility for it". Others thought that it was often necessary for the NOC to undertake 'national' activities until the appropriate level of state competence had been established. The fear expressed, however, was that the NOC could take responsibility for social development away from the government. A poorly performing government could not then be held directly accountable for its failure to provide these services.

The requirements of setting the national mission:

- Clear mutual understanding between government and NOC of what the objectives of the national mission are;
- Mutual understanding of the potential and the limitations of the NOC;
- Mapping costs, benefits, local capacity and an exit strategy in which ownership of the process is transferred to government or the private sector;

- Where the NOC is taking a large role in national development, there should be a clear definition of the responsibilities and remit of each party and *shared accountability* with government.

### **The influence of actors outside the petroleum sector in decision-making**

The influence of carefully selected outside actors – from the local private sector, academia, retired foreign oil company executives, etc. - in industry decision-making appeared to be positive. These actors can bring international and specialised expertise while adding a critical dimension to decision-making. Where an NOC had private shareholders, their inclusion had to a great extent, ensured de-politicization of the oil sector and therefore, more independence for the company.

### **Regulation**

#### **Delegation of authority and separation of powers**

Participants emphasised the distinction between the rule-setting, monitoring and correcting functions of regulation. Ideally, responsibilities for monitoring and ensuring compliance should be independent of the rule setter and the complier. However, the NOC often has more knowledge about the necessary standards and achievable goals than the government. The NOC may set its rules of practice according to international standards and set its own standards above those but to enable monitoring and correction, the government will need to formalise these standards and create separate centres of knowledge and the appropriate legal framework to give the regulators teeth.

A key point made in this discussion was that many technical standards (such as International Standards Organization standards) and targets for the sector could be set by the NOCs without prejudice or conflict of interest because these were determined by international industry practice or agreements. Adherence to these could also be monitored without the intervention of the state thanks to independent international auditors. Objectives on the other hand are of a more political nature and require government involvement in setting and monitoring them. Similarly, broad oversight for the sector is a political responsibility, often given to the Ministry.

#### **Some key questions**

- What are the processes for transferring knowledge and capacity from the company to a separate agency?
- What are the processes and checks and balances necessary to ensure there is no conflict of interest between rule-setter, monitor and operator?
- What kind of legal framework is needed to ensure the regulating body has the necessary authority?
- What are the processes for continuous re-evaluation and improvement of standards?
- What are the different regulatory functions and which functions need to be housed in separate agencies?

## **ENABLEMENT**

### **Financial Autonomy - how important is it? How can it be created?**

#### **Access to capital**

##### *Borrowing on international markets*

Some companies have no need to borrow. If the company can retain profits (usually after royalties, tax and dividends), self-financing can be the cheapest option, providing the government itself either does not borrow or can borrow as cheaply as the company.

Some NOCs borrow from capital markets, and pay higher dividends to the government to finance national development. This can offer the government cheaper capital, where the government would otherwise borrow at higher rates but it constrains the NOC financially. One participant argued that where an NOC pays tax and royalties to the government, the shareholder must be prepared to accept fluctuations in income from the oil industry to enable the NOC to budget for a stable development plan.

Having to borrow on international markets usually forces the NOC and government into applying best practices and complying with international standards and this was seen in a positive light.

Problems occur in some countries where the government wants the NOC to have a very high share of a joint venture but the NOC/government cannot pay for it up front. The IOCs may end up carrying the government's share of the financing in the early stages, and are compensated at the expense of the NOC in the profit and cost sharing terms.

In an IOC, finance is a route to profit. In an NOC, this is not necessarily the case because the cost of capital is amalgamated with the national capital. As the volumes pumped and the price per barrel are set outside the NOC, the NOC's objective is greater cost management and operational discipline to produce optimum performance.

#### *Securing the budget*

If all revenue automatically goes to the state and the NOC budget comes annually from the government, the NOC cannot plan long-term investments with confidence. Privatization is one way of securing financial insulation. In Norway, Parliament would often increase the dividend level agreed between the Ministry of Petroleum and the Board of Statoil. When Statoil became partially privatized, Parliament lost its ability to influence the dividend level.

#### **Benchmarking**

NOCs are in a different league to IOCs and operate under unique parameters relating to the national context, political structure and geology. Clearly, if the NOC operates alongside other private companies or has been partially privatised itself, benchmarking will be made easier. For the 100% state-owned NOC with a total monopoly the answer might be to create "virtual business units" or a "virtual profit centre" - instead of reorganizing the sector (i.e. with competition in the upstream). This would involve calculating profits and losses based on pure financial reporting and also on performance management reporting and thus "testing the NOC against a normal situation" so that performance could be assessed relative to the standard benchmarks of IOCs. According to one participant, the vital question for the NOC should be "Do you have a mechanism for to benchmark yourself in your value chain - refining, petrochemicals etc. - against the best companies in each field?"

Under a regime of "simulated competition", some cautioned that the NOC is not actually risking losing its customers or shareholders – it retains the option to negotiate with the government if its performance suffers: that alternative does not exist in an unprotected market.

A question also arose as to how the target rate of return for an NOC should be calculated. One system was described whereby the NOC imputed tax, debt and simulated return on capital employed (RoCE) as if the company were an IOC. However, it was difficult to compare returns on capital at the margin because neither IOCs nor NOCs publish returns on individual projects.

### **Competence, best practice and technological transfer**

There were many examples of NOCs benefiting from working with IOCs. In some cases, the international arm of the company had been the conduit for the transfer of best practices from JVs abroad to the NOC working at home. In others, NOCs themselves decided to form strategic partnerships on national territory in order to learn from the IOCs and encourage them to invest in training locals and establishing centres of research in country. However, some objected to promoting such partnerships as part of 'good governance': "If the objective is to help countries that are just starting" said one person, "you need to ask what governance and practices are best to optimize their resources for the people then leave it to them to decide whether or not they need IOCs to do that".

Others raised the issue of whether the NOC had the capacity to absorb the IOC's technological and best practice. There is a minimum level of competence an NOC must have before it can benefit from JVs and other kinds of partnerships with IOCs. Some of the major companies find it difficult to implement their own codes of best practice due to the incompatible organization and methods of the local service providers and NOCs in host countries.

Others argued that NOCs can be stimulated by the challenge of operating under a monopoly in early stages of development. It can push the company to be self-sufficient and better prepared when the market is opened to foreign investors. "There is a window of opportunity for learning from other companies" and the next step may be for the NOC to go international in partnership with IOCs, as Petrobras and Petronas have done.

A key strength of the NOC is its knowledge of the country. Some argued that if the IOC spent time getting to know "the culture of the NOC", it would be more successful in its partnerships.

### **TRANSPARENCY & ACCOUNTABILITY**

The NOC is directly accountable to the government and in some cases private shareholders. Developing effective mechanisms for holding the NOC to account is crucial. These include, but are not limited to, ways to measure NOC performance and creating open channels of communication between NOC, the shareholder(s) and society.

Transparency in the form of the NOC annual report and other industry information is an important means of making companies accountable. However, the extent and detail of disclosure remain contentious and participants acknowledged that the system of accountability stretches beyond the NOC. With this in mind, participants agreed that we should first ask "What are the most effective ways of holding the relevant actors to account?" One suggestion was to posit the following checklist of accountability mechanisms which any petroleum sector should comprise:

- the delineation of duties and standards
- checks and balances to ensure the above are complied with
- internal and external auditing
- a way to incorporate international standards
- reviews of the financial reporting system itself
- government assessment of the company reports
- correction for under-performance or malpractice.

In terms of assessing company performance, some discussed the difficulty of measuring return on capital employed (RoCE). This is more complex for an NOC than for a private company but a formulation will need to be adopted to prove to government that targets are being met and the company is being run effectively.

For the NOC choosing to list on the stock exchange, the challenge is to assure financial analysts that it is as efficient and accountable as an IOC. This will usually require a complete revision of reporting mechanisms to bring them in line with international standards.

### **Transparency and Society**

The discussion on transparency and society considered what oil sector information needs to be made 'public'. Firstly, what sort of reporting the sector needs to provide the public to show them that the NOC is working effectively? And secondly, what sort of relations the NOC needs to form with society's representatives (the media, NGOs and local communities).

Several participants expressed concern over this issue, citing cases where the public and the media were distrustful of the sector because they did not have access to the relevant information to make intelligent analysis. In some cases, the government was held responsible for not making figures public where the NOC would prefer that they were. In others, the NOC is considered the obstacle to transparency due to its reluctance to disclose information or its un-standardized accounting procedures.

Some argued that what the majority of local communities care about is social investment, not technological terminology and detail. The sector can be very badly run but if the public see the benefits, it is unlikely that they will complain said one participant. However, many participants agreed that simply publishing and discussing reports "makes a huge difference" and can increase trust. There was general agreement that the 'macro-numbers' – the production, export, industry revenue and government take should be made public. In all cases, appointing auditors independent of NOC and government for finance and health, safety and environment (HSE) were considered positive in building trust between NOC and society.

We heard examples of countries involved in the Extractive Industries Transparency Initiative (EITI) where thorough auditing and published reports are building public trust and confidence in the system. Besides corruption, major problems inhibiting accountability in these countries were the lack of communication between agencies, bad book-keeping and very slow processes. The first hurdle in building a more transparent system is often to gain the appropriate knowledge in order to discuss publicly the reconciliation between company and government accounts.

Participants also discussed the potential pitfalls of transparency measures. One NOC was dealing with "over-reporting" whereby a large number of its staff were internal auditors. Moreover, a transparency act made it mandatory for the NOC to address numerous and time consuming information requests from the public. Providing this information can be a challenge for the NOC for it must ensure that it does not breach confidentiality or undermine its advantage with regard to competitors.

### **What makes an effective NOC board?**

The company board is the body ultimately accountable for business decisions. The NOC board differs from the private company board because the major or sole shareholder is the government. Therefore, the shareholder will often be represented by the minister of petroleum, and perhaps other political figures (e.g. the prime minister, the minister of finance). This poses problems of a) accountability (who holds the board to account when senior ministers sit on it?) and b) political influence in decision-making.

In addition to chairing the board, the minister of petroleum may also be a member of the Supreme Petroleum Council (SPC), Chair of the NOC and OPEC governor. While this

overlap can confuse external investors as to the priorities of their partner in negotiations, some participants argued that their oil minister's power is subordinate to the requirements and priorities of each of his/her roles so there was no conflict of interest.

Where the minister does not sit on the NOC board, regular communication between board and ministry is essential. In one case, the minister can only nominate a number of company executives to the board to represent the ministry. The drawback of this 'executive board' model is that the chairman can become too powerful and checks and balances ensuring the shareholders' interest may be lacking. In another case, neither government ministers nor company executives sit on the NOC board since a major mining accident led to the resignation of the minister in charge. This non-executive board model 'protects the government' from direct accountability for operational performance whilst enabling executives to be accountable to a professional board of directors

A central concern in the delegation of authority from government to the NOC board is that the composition must achieve an adequate balance of authority and capability. Otherwise, it cannot properly be held accountable for its decisions. This will entail internal auditing and a clear definition of the precise responsibilities of the board - perhaps in the form of an explicit contract with the government. One participant cautioned that while the board may have ultimate authority over commercial decisions 'on paper', in some cases, this can be overridden or influenced by the minister or the state leader who *informally* dominate the decision-making process.

Some agreed that the board must be able to authorize or delegate authority for service contracts and spending necessary for the business. In turn, the necessary policy-making, regulating and legal bodies must be vested with the powers to hold the board to account – taking them to court and convicting its members if necessary.

### **Transparency in licensing**

Transparency in licensing is important, but does not necessarily mean that a country has to run an open bidding process. One participant said that flexible bidding could ensure long-term value for the country and this will depend on the objective in any given project. For example:

1. In big projects, direct negotiations with potential investors can be beneficial;
2. Pre-bid qualification is a key process to ensure the most suitable candidates for licenses have a chance to bid. This is especially important for projects with specific technical needs;
3. Where there are national development objectives – e.g. infrastructure - the government influence will be stronger and strategic partners may be chosen by direct negotiations and influenced by country to country memorandums of understanding.

It was suggested that direct negotiation can still satisfy transparency concerns as long as the, selection criteria (e.g. the investment commitment, operations record, transfer of technology, best practices, standards of business conduct, etc.) and reasons for the choice of company are explained publicly.

## **SUSTAINABILITY**

Sustainability issues surfaced at various times during the workshop and covered four aspects: sustainability of resources; ensuring the industry links back into the local economy; the industry's role in diversification of the economy away from petroleum and the potential for IOC corporate social responsibility programmes and their links to the NOC "national mission". While it was acknowledged that how the revenues were spent

was a key part of the sustainability story, since this was not the direct responsibility of the actors in the petroleum sector it was excluded from the discussion.

### **Depletion**

Deciding how fast to deplete resources is determined by technology, economics and the environment as well as government policy. The depletion rate will be affected by new technology and the market will ultimately inform the best policy - the government can only regulate so much.

For some countries, the issue is not 'depleting resources' but 'transforming oil wealth in the ground to financial wealth above ground' - the future will be provided for in funds that will last beyond depletion. In another case we heard that the IOC working in a country wants to extract as much gas as possible as quickly as possible and parts of the government do not yet have the information and understanding necessary to set a sustainability policy for gas depletion.

### **Local content**

Examples were given of the NOCs themselves initiating and driving sustainability policies including creating local linkages to the industry and building local capacity.

Where government sets targets for the company to follow, the main challenges are to ensure that a) these activities are aligned with operating as a commercial company and b) that they genuinely encourage local efficiency and development (by allowing the right element of competition) so as not to give preference to inadequate companies or companies local 'by name only'. There needs to be a 'phased, strategic approach' to target setting and preferential percentages given to local companies.

One participant said that engineering companies could be the key to encouraging the IOCs to build local capacity. If IOCs can be strongly encouraged, through recognition in the licensing system or policy investment laws, to team their engineering companies with local yards, the result will be a beneficial national linkage. This was another example where some government pressure can be beneficial when oil industry development is in its early stages.

Some points made:

- When there are local content targets, IOCs must research whether a country has the capacity to deliver a qualified labour force and managerial personnel;
- We should bear in mind that the petroleum industry is not labour intensive and is therefore limited in its capacity to address national unemployment, .

### **Education**

This debate looked at what the petroleum sector can offer in terms of education and training that benefit the wider economy. This would depend on the maturity of the industry and its supply base. If the industry lacks a qualified national supply base, it must concentrate on satisfying its own requirements, once that need is satisfied, the industry can contribute to other sectors.

### **Corporate Social Responsibility**

CSR, considered to be the company's initiative beyond tax and any contractual obligations to provide social goods, has been criticised for being a form of bribery to host governments or to local communities to allow the company a freer reign. This was refuted by most participants who recognised the potential long-term national benefits of CSR programmes. CSR "is earning the license to operate every day", said one participant.

Oil and gas resources are often concentrated in underdeveloped regions. The question for governments is how to distribute the oil wealth? Many participants agreed that these regions should get a bigger share of the revenues to 'compensate' for the impact of the industry on their environment.—However, there were concerns where the regional agency or local government was corrupt or spent the revenues poorly. The oil companies may have no say over spending at this stage but may still get the blame for the resulting inequalities. Oil companies are often 'soft targets' where a host government lacks the necessary channels for voicing opposition and employs repressive tactics.

Local dissatisfaction with the level of development may be an incentive for the oil company - NOC or IOC who has no influence over the spending of revenue paid in taxes - to try to take as much control over the social development programme as possible. It was pointed out that this avoids dealing with the core issue: if development is failing, it is the government's fault. Allowing IOCs to develop as proxy-government entities is dangerous.

It was argued that CSR programmes work best where the company researches and evaluates the specific needs of a community thoroughly and develops an *ad hoc* CSR programme in cooperation with local government and through consultation with local communities.

### **Consensus**

- National laws should ensure that investing companies contribute constructively to the local economy.
- The NOC's national mission needs to be integrated into the government's development vision and this will also guide the IOC's programme. IOCs coordinate their CSR with the NOC to ensure that projects fit with the NOC's national mission spending as part of the country's overall development goals.

### **WHAT NEXT?**

Over Summer 2006, the project organizers will draft a document aimed at producing country policy makers. This will document the project's main conclusions and offer guidance on governance issues. After consultation with the advisory committee, the organizers proposed the following outline for the document:

- Explain the relevant governance principle
- Define terms
- Describe governance practice
- Use the national context to explain the differences between producers
- Suggest how to improve governance within the parameters of existing national context

### **Suggestions from participants**

Some stakeholders were in favour of the continuation of the project in the form of an annual forum for the exchange of experience and ideas amongst producers. Many said that they would like the document to be a 'living document' on governance in the sector. This would enable the addition of new information and consensus building as the priorities and challenges for the petroleum sector changed over time. NOCs were interested in guidelines that would describe elements of good governance so the NOC could benchmark itself against these and address the question: "what should be done to reach targets we set for ourselves?" Others cautioned that the document should concentrate on universal principles which can be applied after due adaptation and avoid structural conclusions and recommendations because all countries have local laws and social structures that will dictate certain rules and organization. These views will be used as input to the formal project planning process.