



Good Governance of the National Petroleum Sector

Workshop II: The Case Studies

Summary of discussions and lessons learned DRAFT

Chatham House and the Centre for Energy, Petroleum and Mineral Law Policy (CEPMLP) held the second Good Governance of the National Petroleum Sector workshop 21st - 23rd September 2005 at the British Academy in London. The purpose was to consider a number of case studies on key governance issues presented by producing countries and to draw from them useful lessons that could be applied elsewhere. Thirteen producing countries were represented. The meeting was held under the Chatham House rule so we summarize here what was discussed but not who said it or their affiliation.

Throughout discussions, the importance of the national context on systems of governance was emphasized. This was a strong conclusion of the first workshop and the September discussions developed the point further.

Successful changes in governance of the national petroleum sector depend on the following national elements:

- National culture – in particular the way power and authority is exercised and the patterns of behaviour that are encouraged or incentivized;
- Institutional capacity – is each actor equipped/ skilled/ informed enough to manage their (new) role? If not, how can this be built? Where can they get help?
- Dependence of the economy on petroleum revenue – this will dictate how heavy a hand the government will put on the operator for non-core activities and how much political interest the sector will attract;
- Level of country's general development, system of government and administrative structure. The petroleum sector is intimately connected with the rest of the country and the development of one will impact on the other;
- Changes in the role and nature of the petroleum sector as the needs of society, the market and the lifespan of the resource evolve over time.

DAY I

Session 1 – RESPONSIBILITY

Many producing countries are in the process of demarcating the roles and responsibilities of the various entities involved in oil and gas sector governance. A critical issue for most is determining who makes policy for the sector and who regulates the industry. This session examined the formal and informal lines of

responsibility for the oil and gas sector, with a special focus on the relationship between the ministry of petroleum, the NOC and the petroleum governance council where one exists. It considered the transfer of the regulatory function from NOC to ministry and the restructuring process driven by the policy of introducing international oil companies (IOCs) into the country.

Session 2 – ENABLEMENT

This session examined the requirements for developing a *corporatized* NOC. This entails the national company being given space and the necessary regulatory framework to operate like a commercial entity. Discussion centred on how a government could ‘let go’ of an NOC and spread ownership, and the conditions and incentives required for this transition. More stringent separation of roles and greater ability of each institution to carry out its function were the key recommendations.

Debate in Sessions 1 and 2 focused on:

- Determining which entity is best suited for regulating the industry
- The complex and pivotal role of the minister of energy
- How to facilitate the NOC’s decision-making and approval processes
- The damage that a lack of clear definition of roles and responsibilities between NOC and Ministry could do to the sector in terms of efficiency and competitiveness
- How to improve definition and appropriate allocation of roles and the necessary prerequisites of restructuring the sector to divide responsibilities
- What drives change and what incentives can be given to institutions and individuals to engage in this process?
- What role for Parliament?

LESSONS LEARNED ON RESPONSIBILITY AND ENABLEMENT

Definition of roles and responsibilities

- Clarity of definition. There are many different organizational models that work but **clarity between agencies and their responsibilities** is crucial, as is introducing **mechanisms to ensure practice and boundaries are adhered to**. Both require a high level of transparency and inter-agency communication in the workings of the sector. Because sector models evolve, there is no ‘one-size fits all’ model;
- Need to define roles and areas of responsibility in both formal processes (bylaws, constitution) and informal processes (the practice);
- Important **distinction between state as sovereign and owner**. The government bodies in charge of the petroleum sector must understand the differences in their roles and objectives and behave according to the appropriate objectives in each. The role of the minister is particularly complex: s/he will mediate between the Government and the sector and be responsible for policy (including licensing and production strategy and external negotiations such as those at OPEC) and some regulation while

also being the “Shareholder” (sometimes in the form of Chairman of the Board);

Pitfalls of lack of definition

- A minister-led NOC can bring instability as ministers change and are not always industry experts;
- If an autonomous NOC becomes too powerful, it may no longer use resources in the best interests of the country, and/or carry out a political role at odds with the authority of the government.

Opening up the petroleum sector to competition

- For countries considering opening up their petroleum sector to competition, introducing a strong regulator is recommended;
- Who will supervise the IOC? A “clean solution” would be a government regulator autonomous from the petroleum ministry and the NOC. If the NOC supervises the investment, it must demonstrate a capacity to demarcate its roles as operator and regulator effectively.

Regulating operations/ creating a regulator

- What is the role of the regulator? HSE, reserve management, technical supervision. Regulator will often play a role in setting rules and standards, not just supervising and enforcing them;
- How to distribute expertise between the regulator and operator? Have to ensure that a new regulator (or regulating administration) has the capacity to do the job;
- Ensuring the quality and integrity of the regulatory body: whether the regulator is a separate body or an arm of the Ministry, its personnel must be paid adequately (equal to or higher than the operators who they are regulating) – otherwise they will neither attract the best skilled, nor command authority over the operator;
- Different regulators for upstream and downstream are essential. The downstream regulator should be separate from government because of potential conflicts of interest in dealing with pipeline issues and product subsidies. There are special problems when the upstream NOC’s cash flow is used to subsidize the downstream operations – including controlled prices- to avoid subsidies appearing in the Government budget.

Restructuring process

- Sector restructuring needs carefully thought-out strategy and empowerment of the individuals/ bodies charged with managing change;
- Movements of key personnel may facilitate change but it is necessary to avoid their taking responsibilities with them when this runs against the restructuring design;
- Importance of explanation and education to all concerned (especially during the process of change).

DAY 2 – TRANSPARENCY & ACCOUNTABILITY

The discussion was structured around three topics – fiscal and revenue management transparency, transparency in upstream licensing, and accountability to society.

Petroleum resources are a national asset and the state therefore has an interest in knowing how much revenue is being generated and ensuring that the shareholder's entitlement is fair and correct. There was much discussion of the knowledge gap within the NOC, between the NOC and the Ministry/ Regulator, between the Ministry of Petroleum and other government departments and between the petroleum sector and the people.

Without transparency, there cannot be proper accountability. Rigour in assessing and checking revenue flows is essential for both the efficient running of operations, to ensure that government demands on the NOC are fair, and to earn the trust and support of society at large. However, the extent to which figures need to be made transparent is debateable. In our discussions, a distinction was drawn between internal (amongst institutions directly involved in petroleum governance) and external (sector to public) transparency.

Debate focused on three questions:

- How to make accountable the institutions generating and handling that revenue?
- What to do with data once collected and the benefits and drawbacks of making it public?
- What are the carrots or sticks for industry compliance? (Most agreed that a combination of education on the benefits of transparency, incentives to make profits and a desire not to attract negative attention of top government was essential. Others added that conformity with international standards of transparency offered the added bonus of 'legitimacy' for both company and government).

LESSONS LEARNED ON FISCAL & REVENUE MANAGEMENT TRANSPARENCY

The requirements of transparency initiatives:

- An initial admission (usually from the Ministry of Finance or Petroleum) of lack of knowledge about industry revenue and spending. Secondly, a concerted effort by government to instigate transparency initiatives. Thirdly, the body carrying out investigation and monitoring must be given the authority and means to carry out their work;
- Very strong political support (a crisis may provoke resolution);
- Authorities in charge of auditing/monitoring/investigating to know what kind of numbers they are looking for, what numbers should look like, how they are generated and why?

- Mechanisms by which information can be shared in a neutral way, flows of information are maintained and any new agency does not become a data sink. Avoid recreating asymmetry of information;
- Compromise between agencies in sharing knowledge and mutual trust fostered in order to decrease the sense of vulnerability in agencies revealing numbers;
- Checking processes to ensure data is accurate and to show up any discrepancies e.g. use of first principles to make sure revenue generated equates with oil produced

Incentives for government

- Gaining social stability and security. Making data available confers sense of ownership and therefore support;
- Ability to respond more effectively to failure in the system.

Incentives for company

- Schemes to ensure that, when savings are made, NOC employees benefit;
- Company gets to keep money in excess of taxes and royalties;
- External benchmarking and expectation of annual efficiency improvement;
- Punishments for obstruction.

What to do with the data

- First stage to establish reliable numbers on a consistent basis: external auditing and accounting standards can help;
- Data need to be presented in a useful and meaningful way. Need to develop way of turning data into information that people can understand. The same data should be good for both private and public use and be comparable from year to year so that agencies can be made accountable externally;
- Benchmarking important but difficult in the upstream because of the difference in geology and lack of comparable data.

Transparency in licensing

There is a general move away from discretionary license awards to open bidding. Two recent licensing rounds were considered and questions and issues raised were:

- What kind of criteria that should be set for assessing bids - signature bonus, work programme, profit share, local content?
- Local content is becoming a biddable item;
- How to balance short-term vs. long-term gain, e.g. signature bonus v production share;
- How are the bid criteria decided? Is it enough that the bidding is transparent – should the criteria-creation decision-making also be subject to scrutiny? By whom?
- Interference of state-to-state negotiations where internationally active NOCs are bidding. Should the state prioritize petroleum E&D bids which include other contributions to national infrastructure building?
- Interference of foreign investors appealing to bodies or to political leadership outside the formal licensing process.

LESSONS LEARNED ON TRANSPARENCY IN LICENSING included:

- The use of independent observers can be helpful;
- The media is very important in explaining the process to the public;
- Model contracts available on the web – this can increase transparency and make negotiations quicker – only the biddable items vary from contract to contract.
- Transparency of licensing alone is not a guarantee of the contract most beneficial to the nation. That depends on how well devised the bidding criteria are.

Accountability to society

Discussion centred on the role of civil society and parliament in holding the petroleum sector to account. Civil society was defined as non-governmental institutions that represent an interest group in society and is not directly involved in petroleum sector governance. Civil society's role may increase in situations where there is a low level of trust in government institutions and a need for independent scrutiny without financial interest. In a parliamentary democracy, parliamentary committees can carry out this role. However, most MPs do not have specialist knowledge and need to rely on expert advice.

In some cases civil society is not well developed and cannot fulfil the role without a commitment to capacity building (often this may come from outside – e.g. the Open Society Institute funded revenue watch initiatives). A coalition of civil society groups may need to be built so that a single body with clout and capacity holds the sector accountable (the Extractive Industries Transparency Initiative requires a civil society coalition for example).

The role was defined as:

- To ensure that the oil and gas sector is being run to the benefit of society;
- To involve the people in the process;
- To provide independent information;
- Provide assurance on structure, process and controls;
- Provide checks and balances.

LESSONS LEARNED ON ACCOUNTABILITY TO SOCIETY

Education

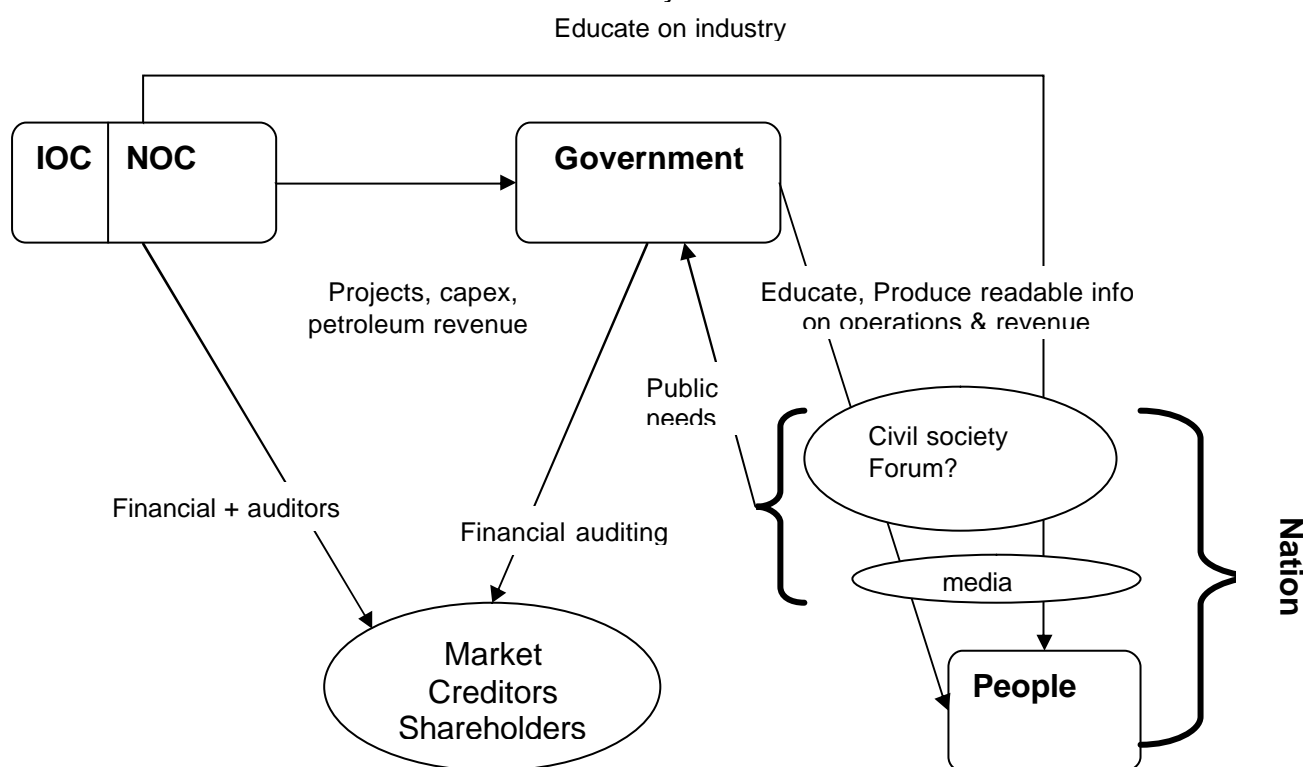
- More information allows greater accountability;
- The petroleum sector has to play in educating society (including the media) on mechanisms and timing of rent transfer;
- Civil society groups can be developed and engaged as intermediaries between the sector and the public. There was debate over whether it was right or helpful for the petroleum sector to choose particular civil society groups to work with or whether it should simply accept groups as they present themselves. This was really a question of the level of a society's development and democratization. In countries with authoritarian rule, the sector cannot not be expected to form such a relationship due to the lack of

active civil society. Countries with a reforming polity may face problems with the competency levels of groups in their early stages of development;

- Data disclosure (geological and financial) should include commentaries to increase the public, parliament or government bodies' capacity to understand the information and interpret it.
- Producers who have not opened up to a range of foreign investors don't know to measure the value of different types of investors (e.g., in terms of investment in technology, commitment to building local content, quality of operations).

How do you build capacity to make transparency and accountability work?

The model below illustrates the necessary roles and flows of information.



Thickness of the flow lines and arrows will depend on each country's situation; for instance:

- The degree of development and education of civil society, media and private sector will affect the extent of the 'nation's role. This role is also affected by the type of political system;
- The role of shareholders will depend on the percentage of state ownership of the NOC;
- To improve the quality of information flows (and increase the thickness of the arrows) skilled people are needed – for instance, government needs accountants, engineers, geophysicists; the national media will need industry analysts.

Drivers for model

- Competition
- Market requirements
- Anti corruption initiatives
- Efficiency gains

How Civil Society holds the Sector to account

- Questioning
 - Pointing out problems
 - Making population aware
 - Members of the coalition need to commit to learning about the sector
 - Training is required before joining
 - Government support is required

The role of the media? The media plays a key role by informing society and so need to be part of the system of accountability

DAY 3 – SUSTAINABILITY

The classic (Brundtland) definition given for sustainability was “the ability to meet today’s needs without diminishing the capacity of future generations to meet theirs”.

As a capital rather than labour-intensive industry, dependent on finite resources, sustainability has to be at the heart of petroleum sector policy-making. **For the NOCs, the expansion of recoverable reserves, the efficient and careful management of reservoirs and minimising environmental impacts are their principal contribution to the sustainable development of their country**

While the government is responsible for prudent distribution of wealth within society and the promoting of the non-petroleum economy, there are other ways in which the sector can generate value and strengthen the economy. Education, training, experience and business opportunities at operating level can feed into the development of the nation as a whole, developing human capital, promoting the local private sector and helping to diversify the economy away from petroleum.

The first two sessions essentially considered how government policies and company initiatives could encourage national capacity building through education and training; and through increasing local content through employment of nationals and contracting local companies – while maintaining their commercial integrity. This looked not only at the obligations of the NOC but also of IOCs working in developing host countries.

The final session looked at the benefits and potential pit-falls of IOC behaviour in host countries. It asked what corporate social responsibility CSR meant to both company and host government and how the two agendas could be made compatible.

Training & Education

Education is key to building national and industry capacity. Companies (whether national or private) can play an important role in this through training programmes. Their investment in capacity building will be best harnessed when the government has a strong vision to drive the whole country toward success.

Local Content Policy

The emphasis in the presentations had been on knowing the strengths and limitations of the petroleum sector in building national capacity and having a clear strategy to develop capacity transferable to the non-petroleum sector, where more use can be made of private capital and strengthen the country's economic in the international market. A key question was how to capture value for the long-term at the front end stage? Initial investments in operations are huge so it is important to consider the benefits of increasing taxes and spending more on local content in the initial stage.

LESSONS LEARNED ON HUMAN CAPACITY BUILDING

Long and slow processes:

- Schools and training
- Scholarships
- Try to control the brain-drain by repatriation of skilled individuals and offering incentives
- Opportunities and arenas for exchange between operators and stakeholders

Local content policy

- Local content policy needs a very high level champion of the in government;
- Think strategically, act practically: see capability development as an investment;
- Healthy to have a regional focus where private capital and participation of local companies is involved
 - "Do it in Country" first. "Do it with locals", will come next;
- The question to be asked is not: "what can we do with existing local capability?" Rather: "what can we build with existing and projected demand, so as to enhance local capability and allow us to capture more value in the future?"
- Where there is no local capacity, NOC and IOC can share expertise to help set up/ train/ build alliances with smaller private local companies until they are able to compete for contracts (locally & globally);
- BUT, problem with cyclical nature of the business: e.g. specialist contractors will be needed for certain time-limited operations. If NOC helps establish local companies to perform these tasks, their services may not be continuously required.
- Identify current capability and gaps
 - Set Targets
 - Build capability

- strengthen or build institutions
- set and maintain high standards
- Don't remain static (monitor, change and improve);
- Regulate local content and knowledge and technology transfer – it doesn't work if it's an option to the IOCs and International service companies;
- Pick partners who support your strategy and will help deliver it;
- **Measure performance - Report it - Learn from it - Build on it.**

CSR in host countries

- **What is CSR? Various ideas were expressed:**
 - Obligations written into the contract?
 - Compensation for disruptions to the environment?
 - Enlightened self-interest?
 - Bribery or company PR?

Other definitions offered

- “The delivery of goods beyond tax” (replacing or additional to government delivery?)
- “Mitigation of risk and a legitimacy to operate”

LESSONS LEARNED ON CSR

- CSR will have different priorities, depending on the host country's stage of development. In a state of early development, non core infrastructure (roads, hospitals, water and electricity networks) may be both in the national and the company's direct interest. If there are few skilled workers available locally, there will be a demand for training;
- CSR is the company's initiative but generosity and well-executed CSR projects may well improve its chances of further opportunities;
- The behaviour of the company may be able to help decrease levels of corruption;
- IOC should be fully aware of the political situation before investing – knowing on whom operations will impact, with whom to work and how to guarantee security are crucial;
- In the case of military conflict, important to assess in what way the company could be held accountable (e.g. through security contract with the army);
- Productive CSR projects ought to be community's initiative, not company (company invited to support projects but not leading them);
- Need to work with local communities, build trust and support for involvement;
- BUT, be aware of uneven development in the country – necessary to balance local impact and wider impact;
- Coordination between government and company on direction of CSR is essential – needs good channels of communication necessary e.g. monthly forums. The question is how best to coordinate local government, national government and company's core business interests?