

# Guidelines for Good Governance in Emerging Oil and Gas Producers



For the full text of the Guidelines for Good Governance in Emerging Oil and Gas Producers (September 2013), please visit the [Chatham House website](http://www.chathamhouse.org).

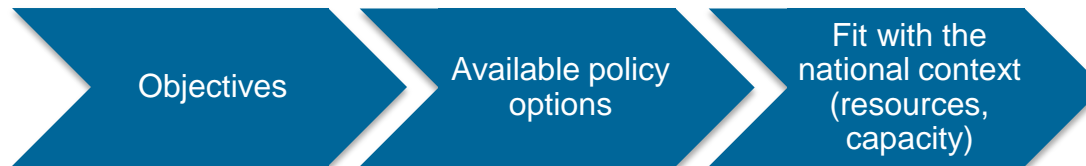
Materials provided by Chatham House (c) The Royal Institute of International Affairs.

# Introduction

- The *New Petroleum Producers Discussion Group* seeks to help emerging producers and the advisory groups who guide them to think critically about the various policy options available during the early stages of exploration and development or when restructuring the sector
- These countries often have weak institutional and sector capacity and are uncertain about the size of the resource base
- This sometimes makes international ‘best-practice’ ill-suited to their needs and resources
- The project has published *Guidelines for Good Governance in Emerging Oil and Gas Producers*. These advise countries on practices that are adapted to their national context

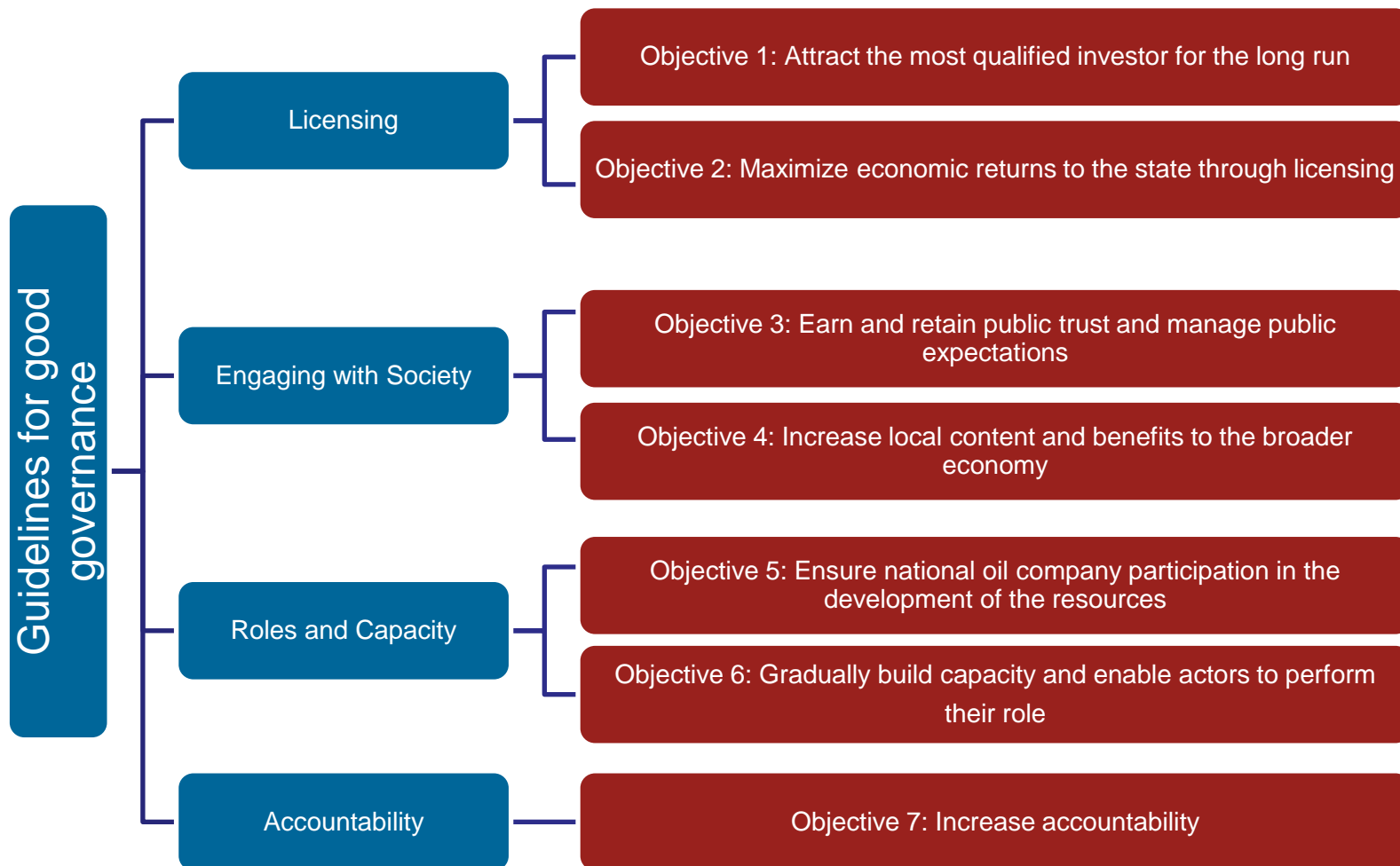
# Introduction

- The guidelines are structured around seven key objectives for the petroleum sector in an emerging producer context
- The guidelines review common challenges faced and offer policy oriented recommendations
- All objectives may not be a priority for all countries and some objectives can be put on hold until the country's capacity is developed
- Governments should determine priority objectives and put forward a sequence of steps to achieve them



# Presentation Map

❖ This is an interactive presentation. Please click on the red boxes, icons and text throughout to navigate to specific topics.



# Objective 1: Attracting the most qualified investors for the long run

Recommendations for attracting well-established companies

Recommendations for the licensing format

Recommendations for changing investment terms

# Challenge 1: Attracting qualified companies to frontier areas

Political Stability  
Geological data/Prospectivity



Attractive to larger, more  
established companies

Sanctions/war  
Poor knowledge of the  
geological basin



Attractive to smaller and less  
qualified companies

Recommendations to attract qualified companies to frontier areas

# Recommendations to attract qualified companies

When geological or political risks make your country less attractive:

- Encourage speculative companies to invest in sampling geological data
- Establish a strong prequalification criteria for investors to help select companies that have the capacity to carry out the exploration work and that will not sit on the concession or promote their acreage
- Specify in the Petroleum Law that government approval is required for any transfer of stakes or licenses, to avoid entry of under-qualified companies
- Disclose bidding information to the public to deter corrupt bidders

## Challenge 2: Frontier areas not always attractive enough to hold an auction

### Benefits of auctions:

1. Auctions, or open bidding rounds, generate the best terms for the government because they force bidders to compete to set the market value of the acreage

2. Auctions reduce knowledge asymmetry problems between the state and the investor, in contrast to direct negotiations

But only suitable when high investor interest

## Recommendations for the licensing format

# Recommendations for the licensing format

- When there is sufficient investor interest, use transparent, open bidding rounds to create real competition
- Avoid open bid formats when insufficient interest. Rely instead on first-come-first-served licensing format
- Use transparent selection criteria in both bid rounds and direct negotiations
- Shift to auction when basin becomes more attractive

## Challenge 3: Changing investment terms without scaring off investors

Discoveries may prompt governments to revise the terms of investment to their advantage, but...

*“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.”*

– Flavio Rodrigues,  
Government Relations and Regulatory Affairs Director for Shell, Brazil

## Recommendations for changing investment terms

# Recommendations for changing investment terms

- Governments should revise contracts only in the case of extreme economic unfairness or destabilizing social or environmental provisions
- Governments can change the terms for **future** licenses to reflect changing circumstances
  - They can be enhanced by adding stronger financial incentives for the introduction of an appropriate technology
  - Different licensing formula can be designed to match the level of risk of specific types of reserves. But governments should keep the licensing framework as simple as possible

Questions  
for future  
workshops

# Changing terms without scaring off investors

- *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?

Objective 2:  
Maximize  
economic  
returns to the  
state through  
licensing

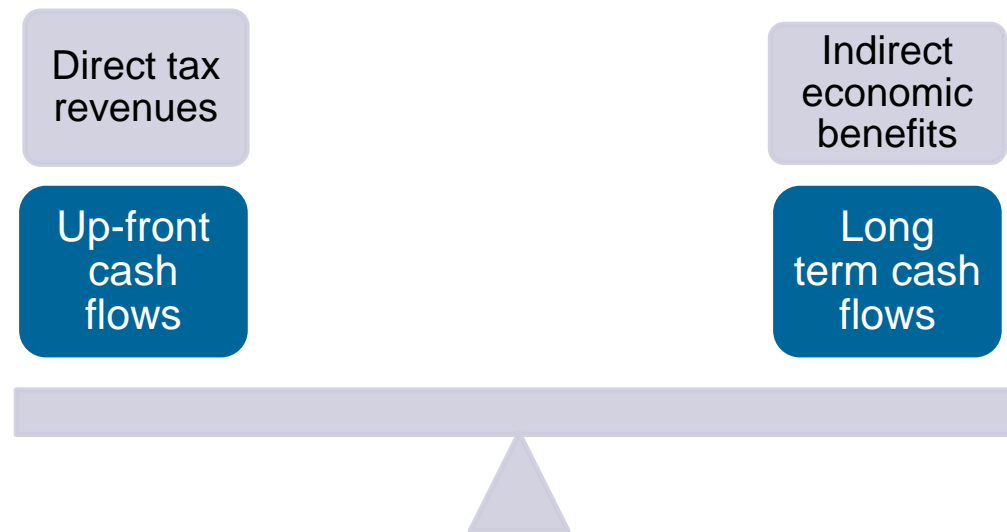
Recommendations for designing fiscal terms

Recommendations for overcoming knowledge asymmetries in negotiations

Recommendations for developing appropriate tax structures

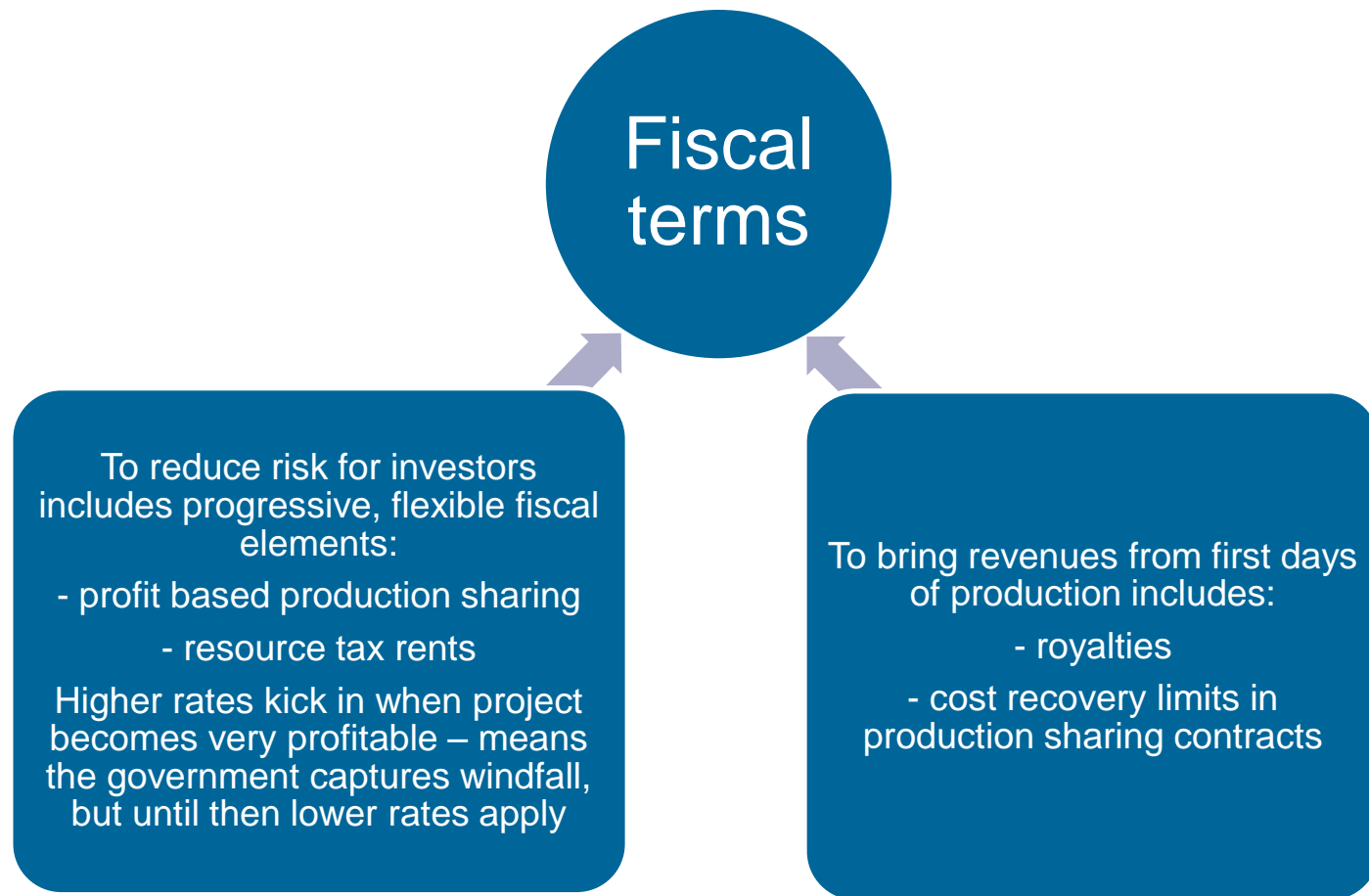
# Challenge 1: Maximizing Economic Returns to the State through Licensing

In designing fiscal terms, producers must balance early revenues and long-term benefits



Recommendations for fiscal design

# Recommendations for designing fiscal terms that provide early revenues and ensure long-term benefits



Questions  
for future  
workshops

# Designing fiscal terms that reward early revenues and ensure long-term benefits

- *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 2: Overcoming knowledge asymmetries in negotiations

Government negotiators may have insufficient knowledge of the costs and technical requirements of oil and gas sector to get optimal terms in negotiations

*“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?”*

- Charlie Scheiner at the Timorese NGO La’o Hamutuk

Recommendations to overcome knowledge asymmetries

# Recommendations to overcome knowledge asymmetries in negotiations

- Get help: when in direct negotiations, governments should work with consultants or technical advisers to evaluate the baseline conditions for the award of acreage and to support the state in negotiations
- Keep it simple: move as many fiscal elements as possible into laws and regulations, to limit the items to be negotiated
- Include capacity-building requirements in licensing agreements
- Help your neighbor: consider making contracts transparent

Questions  
for future  
workshops

# Overcoming knowledge asymmetries in negotiations

- *Questions for further discussion:*
  - What would be the best way to establish a database for sharing information on contracts among emerging producers?

## Challenge 3: Developing appropriate tax structures

Governments of emerging producers often develop tax structures before discoveries are made. These must both attract investors and ensure adequate fiscal returns to the state in the event of significant production.

### Recommendations for developing appropriate tax structures

# Recommendations for developing appropriate tax structures

- Clearly articulate the fiscal terms governing upstream petroleum activity
- Define tax obligations and other imposition criteria in the tax codes rather than in contracts (except negotiable fiscal elements)
- Make provisions in the tax code for taxing capital gains by early entrants that later sell out

Questions  
for future  
workshops

# Developing appropriate tax structures

- *Questions for further discussion:*
  - How unique is the petroleum sector? Should governments:
    1. create specific petroleum tax legislation that recognizes the unique characteristics of the oil and gas industry;  
Or
    2. modify existing tax codes to include specific schedules that cater to these unique characteristics?

Objective 3:  
Earn and  
retain public  
trust and  
manage public  
expectations

Recommendations for winning the trust of the public

The challenge of fair redistribution of wealth to producing and non-producing regions

Recommendations for moderating public expectations after discoveries

## Challenge 1: Winning the trust of the public

- Stakeholder engagement is difficult – but particularly important - in post-conflict situations and where public trust in state institutions is low
- This engagement should not be seen as a substitute for the actual delivery of windfalls or other sector-related benefits

## Recommendations for winning the trust of the public

# Recommendations for winning the trust of the public

- Governments should identify which groups require specific communication and outreach
- Governments should increase the public disclosure of information related to licensing and tendering processes
  - Issue of contract transparency: Some producers feel that some contract details should be shielded from public view, to prevent early-stage producers from being penalized in future negotiations, while others argue that contract disclosure can increase public trust
- Educate: Industry representatives need to increase their communication with the public and explain the role that the industry plays in the country

Questions  
for future  
workshops

# Winning the trust of the public and soliciting inputs from key stakeholders

- *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 2: Fair redistribution of wealth to producing and non-producing regions

Topic for future workshops:

- The fair redistribution of wealth is an important issue 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

Jump to case study of 'Regional distribution of wealth in Brazil' that illustrates some of these issues

## Case study 1: 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.*

## Challenge 3: Moderate public expectations after discoveries

Moderating public expectations about the windfalls of the petroleum sector is a critical challenge for emerging producers

*“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.”*

*A participant at the 2012 Discussion Group*

## Recommendations for moderating public expectations

## Recommendations for moderating public expectations after discoveries

- Governments should begin thinking about how to manage expectations before discoveries are made
- Both governments and the opposition parties need to be realistic about the scale and speed of monetizing new discoveries
- Governments and NOCs should use their websites to educate citizens about the scale and nature of discoveries and the timeframe for production
  - Provide information about dry wells and not just successes
  - Explain the difference between a discovery and a commercially proven discovery
- Use a variety of means to communicate with the public

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

Recommendations for maximizing national development

Recommendations for setting realistic local content targets

Recommendations for getting foreign oil companies to invest in local content and national development when resources are uncertain

## Challenge 1: Laying out policies that maximize national development

It is a challenge to foster linkages to the petroleum sector in an economy with low levels of industrialization – especially when the reserves lifespan is only 10-20 years



Recommendations for policies that maximise national development

# Recommendations for maximizing national development

- Government should choose priority sectors for local development
- Identify what parties (within government and industry) are involved in achieving national development objectives
- Government should implement laws that include a national content requirement for the goods and services that the NOC buys, in line with national capacity or a timetable for transfer of foreign to national capacity
- The national development plan should ensure that skills, goods, and services are available to the industry when needed

## Challenge 2: Setting realistic local content targets

- Governments often struggle to set realistic local content targets when domestic industrial or human capacity is low
- There was some debate in the 2012 Discussion Group on the responsibility of companies for local content development

## Recommendations for local content targets

# Recommendations for setting realistic local content targets

- Governments should develop a thorough understanding of the local context in order to define realistic and achievable targets
- Governments should focus on capacity building
- Governments should enlist foreign oil companies to develop local content and avoid turnkey projects run by foreign staff
- Governments should facilitate foreign oil companies' efforts to develop the local supply industry and workforce

Questions  
for future  
workshops

# Setting realistic local content targets

- *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 3: Getting foreign oil companies to invest in national development when resources are uncertain

- Local content is often more expensive
- Companies may be reluctant to invest substantially in capacity-building if the resource is small or uncertain
- Government's capacity-building can be recovered indirectly, because the capacity built will be available to other sectors of the local economy
- Companies can also recover these costs if they are in the country for the medium- to long-term. But they will otherwise expect to be compensated for the higher costs of hiring or sourcing locally

Recommendations for getting investment in national development

## Recommendations for getting foreign oil companies to invest in national development when resources are uncertain

- Focus on building local capacity in goods and services for which the petroleum sector has an immediate need
- Prioritize goods and services that can be utilized by other sectors in the long term
- Governments should collaborate with companies to develop training and hiring programs

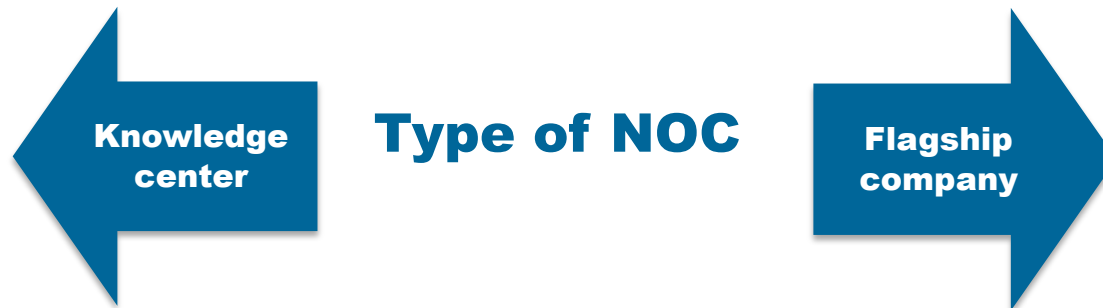
Objective 5:  
Ensure NOC  
participation  
in the  
development  
of resources

Recommendations for investing in the NOC's operational capabilities

Recommendations for giving an non-operating NOC an effective role

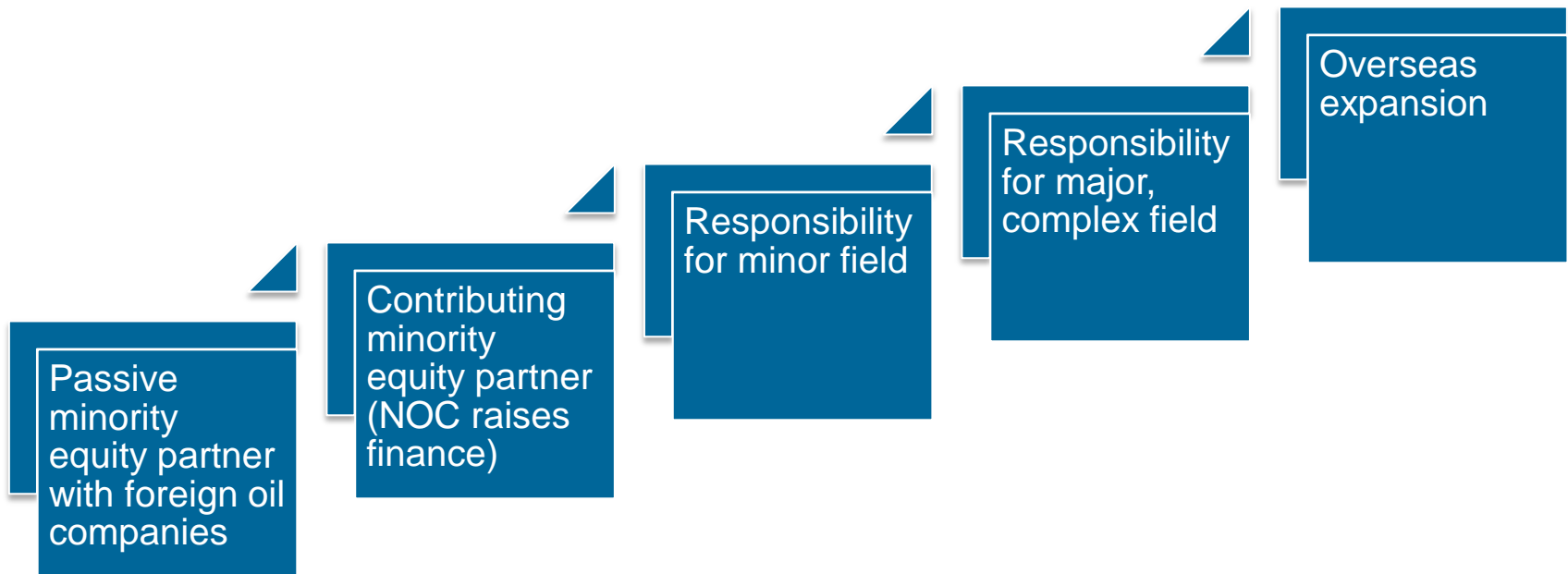
## Challenge 1: Can the state afford an NOC that is an operator?

- There is a growing interest in national participation, particularly through license stakes and an operational role for the NOC
- But the government should first consider whether it can afford an NOC that is an **operator** ⓘ ?



Recommendations for establishing an operator NOC

# What steps are involved in developing operational capabilities?



An **operator** has legal authority to explore for and produce petroleum resources in a given field. It must be able to select the appropriate technology, propose a development plan, raise finance, manage a large project, and assess geological and financial risks.

# Recommendations for establishing an operator NOC

Establishing operational skills is expensive and takes time

- Wait to make significant investments in developing an NOC's operational capabilities until discoveries establish a reserves lifespan of at least 15 years
- Until this reserve base is established, train nationals to raise general human and state capacity. Provide the NOC with only a limited budget for building operational skills



## Challenge 2: Giving an non-operator NOC an effective upstream role

- NOCs with little operational skills that have minority stakes in domestic oil and gas projects play a largely symbolic role in the sector. They represent the state, but are not equipped to ensure “national control” of foreign operators and lack influence in the upstream

### Recommendations for an effective non-operating NOC

## Recommendations for an effective non-operating NOC

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

A policy option is to give the NOC a *Governance Role*  to increase the NOC's influence in the sector and ensure effective national control over foreign operators

- Government must give the NOC financial means to build its capacity to take on this critical role effectively

# What are 'governance roles'?

## Potential governance roles

Advising government on  
oversight of sector

Monitoring operators

Managing data

Promotion of resources

Negotiation of licenses

Objective 6:  
Gradually build  
capacity and  
enable actors to  
perform their role

Recommendations for capacity-building efforts

Recommendations for establishing an independent and capable  
regulator in a low-capacity context

Recommendations for coordinating (and getting the most out of)  
foreign technical advisory services



## Challenge 1: Where should a state with limited resources concentrate petroleum sector capacity building efforts?

- Bodies with responsibility for governing the sector require financial resources, information, human capacity, and supporting processes
- Government with limited resources must determine which functions and which actors to prioritize in capacity building efforts

*“In a small island developing country with relatively limited resources, it would be a mistake to duplicate tasks”*

– Eddie Belle,  
CEO of PetroSeychelles

## Recommendations for capacity building efforts

# Recommendations for capacity-building efforts

- When capacity is low, concentrate responsibilities in either the ministry of energy or the NOC
- At an early stage of development, invest in building capacity at the revenue authority in order to establish effective tax policies
- Allocate data, licensing and promotion authorities to a single entity
- After discoveries, focus on capacity to audit and monitor operations
- When discoveries significant, invest in administrative capabilities and boost petroleum-sector knowledge in government
- When discoveries are large enough for the NOC to aspire to operational role, transfer its regulatory responsibilities to the government to avoid a conflict of interest

## Challenge 2: Establishing an independent and capable regulator in a low-capacity context

- Some regulators in emerging producers lack the capacity to hold foreign operators to account
- They need resources to build up their competence
- They may also struggle to establish sufficient independence from other state or non-state actors
- In a context of low administrative capacity it is difficult to build capacity in all areas of responsibility (regulations, monitoring, data, licensing)

### Recommendations for establishing a regulator

# Recommendations for establishing an independent and capable regulator in a low-capacity context

- External technical assistance is critical to the establishment of a regulatory agency where state capacity is low
- Strong political will is needed to back the governance system
- Concentrate regulatory functions: create one agency to take on data management, licensing, devising regulations, monitoring operations and technical review of development proposals – especially when capacity is low and the resources uncertain
- When there is sufficient state capacity, establish specialized units at the appropriate ministries for environmental monitoring and tax collection
- Make the pay more advantageous in the regulatory agency than in general civil service and foster a sense of mission, to recruit and retain skilled staff

Questions  
for future  
workshops

# Establishing an independent and capable regulator in a low-capacity context

## *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 3: Coordinating (and getting the most out of) foreign technical advisory services

- Oil and gas hotspots attract foreign donors, technical advisers and consultants that offer guidance and capacity building to help prepare the country for production
- Failure to coordinate advisory services leads to policy confusion and duplication of efforts

### Recommendations for coordinating advisory services

## Recommendations for coordinating (and getting the most out of) foreign technical advisory services

- Governments must decide what they want and communicate this to external advisers
- Users and providers of technical assistance must take into account national capabilities and resources. Recommendations and policies should be adapted to the national context
- Advisers should provide technical assistance not only to government but also to oversight bodies i.e. civil society organizations, journalists, parliaments, and at the lower level of an organization

Questions  
for future  
workshops

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

- *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 1:  
*Reform oversight  
institutions*

Policy Option 2:  
*Increase public  
disclosure of data*

## Policy Option 1: Reforming oversight institutions

- To increase accountability, governments can introduce more checks and balances into the system
- This can mean taking some or all governance roles away from the NOC and creating an independent regulatory agency

Challenge of overcoming entrenched interests

## Policy Option 1: Reforming oversight institutions: creating an independent regulatory agency

### Challenge: Overcoming entrenched interests

- Reforms that upset entrenched interests are likely to be opposed
- The level of resistance and success of the reform process depends on  
who initiates the reform, what triggers the reform, and  
how the reform is carried out ⓘ
- Emerging producers can follow a phased approach and engage in incremental changes

### Recommendations for reforming oversight institutions

## Case study 2: 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. (Heller and Marcel, 'Institutional Design in Low-Capacity Oil Hotspots')

# Recommendations for reforming oversight institutions and creating an independent regulatory agency

- Producers should start with one credible body that is responsible for all regulatory functions and introduce checks and balance into the system as capacity grows
- Introduce key mechanism for public accountability i.e. audits of state agencies and NOC, with regular disclosures
- Where oversight responsibilities are concentrated in regulatory agency or NOC, house these functions in distinct units that can be more easily spun off when reform needed
- Require personnel from the regulatory authority to second staff in the new body, to help transfer skills in preparation of reform
- Government should establish a credible, legitimate group to direct the pace and shape of the incremental reform

## Policy Option 2: Increasing public disclosure of data

Accurate information and transparency are essential for accountability and making good decisions

Recommendation:

- Government should increase public disclosure of data and manage public expectations (See Objective 3)

Questions  
for future  
workshops

# Capacity building for increase accountability

- *Questions for further discussion:*

- What other steps can governments take to increase accountability?

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.

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

- What is the value of building capacity in parliament, the media, civil society and the general public?

For the full text of the Guidelines for Good Governance in Emerging Oil and Gas Producers (September 2013) please visit the [Chatham House website](http://www.chathamhouse.org).

This is a collaborative project benefiting from contributions from the following partner organisations



CHATHAM HOUSE

REVENUE WATCH  
INSTITUTE



COMMONWEALTH  
SECRETARIAT



NATURAL  
RESOURCE  
CHARTER



CHATHAM HOUSE