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Governance Challenges for Emerging Oil and Gas Producers

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INTRODUCTION

This paper presents key questions of concern to emerging oil and gas producers and lays out possible policy options. The focus is on new oil and gas producers, countries that are attracting exploration interest or have recently made discoveries, as well as more established small producers that plan to restructure their sector.

These producers face a particular set of governance challenges because they are often faced with capacity constraints and have limited information on their resource base. There is a wide variety of national circumstances that affect which policy and investment options are available to them, such as the size of the resource base, state administrative capabilities and oil and gas experience. A typology of producers will help clarify what distinguishes them

The paper focuses on two sets of policy challenges. One relates to designing the licensing terms and sector legislation in a manner that attracts the most qualified investors under terms that are beneficial to the country in the long term. The second is to set up capable institutions to oversee and monitor resource development. This challenge is compounded in a context of uncertainty about the size and lifespan of reserves and, therefore, also about future revenues.

Policy options depend on geology and capacity

Producers' national circumstances vary widely, most notably with regard to geology and capacity. These circumstances shape the optimal policy options.

Attractive geology

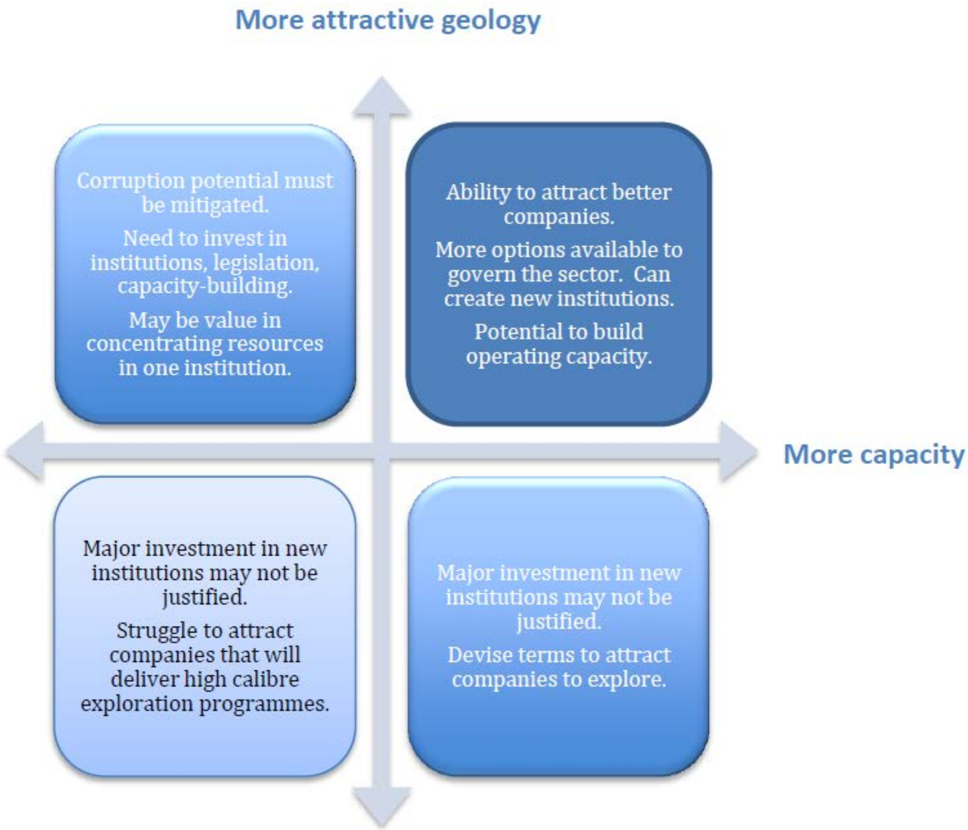
The size of reserves determines economies of scale and the attractiveness of the country to large or small foreign oil companies. The certainty of proved reserves reduces risk and allows the government greater power in licensing.

Capacity

- State capacity: capacity of the state to effectively legislate and monitor the sector's activities and performance, to collect taxes.
- Human capacity: how many graduates come out of its universities with the appropriate skills to man the national oil company (NOC) and/or the ministries?

- Sector knowledge: knowledge that comes with experience in licensing design, contract negotiation, regulations for health, safety and environment, exploration programmes, development plans, etc.
- Local business capacity: Are there companies and capital available nationally to create supply chains?

Figure 1. Capacity and geology shape options



These elements play a large role in shaping how a state is able to shape its goals, and how it seeks to balance the need to generate effective investment in the short term against possible goals of longer-term development of national skills and interests.

LICENSING: HOW TO GET A GOOD DEAL

The challenge for emerging producers with low sector knowledge is to design the licensing process and terms in a manner that attracts the most qualified companies and the most favourable bids.

Licensing in a low capacity context

Getting a good deal with direct negotiations

The process of licensing can be as important as its content. Some producers have adopted a transparent pre-qualification process and a public submission of sealed bids, whereas others have chosen bilateral, closed-door negotiations.

Transparent processes can increase competition and raise the standards of work programmes and generate more investment. Countries such as Brazil, Venezuela, Algeria, Libya and Nigeria have introduced more transparency into the competition for awards of production sharing contracts.

Transparency in licensing and contracting is important but does not necessarily mean that a country has to run an open bidding process in every circumstance. Direct negotiations can be beneficial when tailored to the individual parameters of a given project. The challenge for an emerging producer engaged in negotiations with investors relates to the knowledge asymmetry. Open bidding involves competition between bidders, which lessens the burden on the host government to set the appropriate terms. In either case, the pre-bid qualification process is key in ensuring the most suitable candidates for licences actually bid. This is especially important for projects with specific technical needs.[1]

Financial aspects of licensing

In determining the financial terms to govern licenses (either via mandatory legislation or by shaping the parameters for negotiation), a new or near producer must seek terms that provide sufficient incentives for investors to take risks while providing for a fair state take in the event that oil is produced. One of the major challenges for these countries is effectively analysing what degree of leverage they have in negotiations. As a country moves from being perceived as a high-risk ‘frontier state’ to a site of major interest for competing international companies, its ability to seek more competitive fiscal terms increases. But it is often difficult for governments to know how attractive their acreage is, and they must be leery of pushing so far as to discourage investors.

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1 Lahn, G., V. Marcel, J. Mitchell, K. Myers and P. Stevens, ‘Report on Good Governance of the National Petroleum Sector’, Chatham House, April 2007. http://www.chathamhouse.org/publications/papers/view/108468

New or near producers often must also balance a need for short-term infusions of revenues against fiscal regimes oriented toward greater long-term returns, and weigh revenue streams that provide some guarantees in the event of any commercial production against more progressive fiscal instruments that increase state share as project profitability rises. Finally, new producers often have to assess the proper role for state ownership in oil ventures, and which other revenue streams might be reduced or sacrificed in the pursuit of state equity.

A fair process for managing change in terms of existing projects

Circumstances are bound to change after a country’s first licensing round. The oil or gas price may go up, there may be cost overruns, public expectations and national prosperity issues may become more pressing or large discoveries may be made. Initial contract terms may have been inadequate to deal with some of these issues. The problem in these cases is how to manage change in a manner that can be regarded as ‘fair’ while promoting transparency maintaining or enhancing the reputation of the producing government?

Change related to geology

Some established producers face declining reserves and must adapt contract terms and taxation to attract investors to develop their frontier reserves (e.g. deep water, unconventional oil or gas). This has been the experience in Algeria, Mexico and Gabon.

New geological information can increase the attractiveness to investors. New discoveries in a country’s own fields or in a neighbouring country can lead to a surge of exploration interest by oil companies (e.g. Kenya, Mozambique, Sierra Leone, Liberia and Uganda). This new data may prompt governments to seek to revise the terms of investment to their advantage.

Change related to the political situation

Some states may be confronted with legacy contracts and legislation dating back to the previous national entity (e.g. South Sudan) or to the previous regime (e.g. Libya and Egypt). New states have nascent legislation and institutions (e.g. South Sudan and Timor-Leste), which creates uncertainty for investors as the new terms of investment are drawn up.

Change related to market conditions and price

Countries want to reap their fair share of the profit windfall when the oil or gas price surges. This was the case in Algeria, which in 2006 introduced a profit windfall tax, prompting a legal battle with some foreign operators in the country.

HOW TO STRUCTURE INSTITUTIONS?

Creating an NOC: What is involved?

After an NOC is first established, it will progressively take on more responsibilities. It will first take minority stakes, which are 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 to become a contributing equity partner. Following this, companies often seek to take on a minor operatorship and then a major operatorship.

The financial and time investment necessary to achieve these milestones will depend on the existing capacity levels:

- 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 available resources of the state.

The investment required depends also on the objectives that are to be given to the NOC:

- Operator: significant investments will be needed in the technical skills of the company, usually over a period of approximately 10 years;
- Concessionaire: the NOC may be the authority in charge of promotion of national resources and licensing during the

exploration phase and/or the authority in charge of monitoring operators in the development phase. Human resource investments will be necessary for the NOC to be in a position to design adequate terms of investment and negotiate with credible foreign counterparts. Monitoring operators to a high standard requires greater sector capacity levels;

- Minority, self-financing stakes: the NOC must have revenue-generating activities to finance its stakes in exploration licenses. Once development begins, the NOC must have the capability to raise finance;

- Minority-carried stake to represent the state's interests: lighter investments in human resources are required.

The expected lifespan of the reserves sets the timeframe for investing in developing NOC capacity. The revenues estimated from future petroleum development set the scope of the NOC's objectives. The difficulty for emerging producers is that this information is often not known.

Empowering a non-operating NOC

Developing operational capacity is a high-risk investment when the resource base is uncertain. In certain instances, the state may achieve its objectives with a non-operator NOC that takes minority stakes in licenses.

An NOC may derive influence from:

- A state role: for instance, an NOC can have a guaranteed minority stake in licenses, which obliges foreign oil companies to engage with it. The NOC may have a concessionaire role, which makes it the go-to institution nationally for geological data, approval of licenses, or monitoring of performance. Foreign oil companies will seek to impress the concessionaire. A poor concessionaire NOC would not capitalize on this potential to learn skills and would manage the sector poorly.

- Good capitalisation that allows it to finance its stakes in licenses.

- Operational capabilities that allow the NOC to hold its own in development committees.

Which body should regulate?

There are three main models for the assignment of powers to regulate and oversee the sector:

- Separation-of-powers model (also referred to as the 'Norwegian model'): an independent technocratic agency has regulatory powers.
- 'Ministry-dominated model': the petroleum ministry or an equivalent executive body is charged with regulation and oversight.
- 'NOC-dominated model': the NOC has de jure or de facto responsibility for day-to-day regulation, sometimes including the power to award exploration/production licenses.

The petroleum governance literature has generally advocated the separation-of-powers model as the most likely to bring about clarity in roles and responsibilities by separating the licensing/monitoring/regulatory body from the policy-maker. By doing so, a government privileges the development of technocratic skills and encourages its neutrality by keeping the agency at arm's length. Also, because the agency has no commercial interest in licenses, it reduces the risk of conflict of interest, ensuring that the priorities of the state, not the company, are driving oversight.[2]

However, in a low-capacity context, governments may choose to concentrate resources within one institution, usually the ministry of energy or the NOC. This set-up may provide countries with low institutional and human capacity a way to build sector capacity and exert effective national control over the sector more quickly. NOCs are able to establish their own hiring procedures, training and benefits packages and meritocratic promotion procedures and, in a number of cases, this has enabled NOCs to make employment in the company more lucrative than is the case within the civil service.[3]

There are risks associated with the concentration of responsibilities. In cases of weak capacity in particular, this poses risks in terms of accountability processes. Governments face the dilemma of concentrating responsibilities and resources in order to build capacity quickly within a single institution, or separating functions to build the foundations for good governance.

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2 Heller, P. and V. Marcel, 'Institutional Design in Low-Capacity Oil Hotspots', Revenue Watch Institute, 31 August 2012.
http://www.revenuewatch.org/publications/institutional-design-low-capacity-oil-hotspots
3 Ibid.

ABOUT THE AUTHORS

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Patrick Heller is Senior Legal Advisor at Revenue Watch Institute. He has worked on governance and anti-corruption initiatives in the developing world for more than ten years, for organizations including USAID, the US State Department, the Asian Development Bank, Creative Associates International, and the International Center for Transitional Justice. He is a Research Affiliate with the Program on Energy and Sustainable Development at Stanford University, where he focuses on the political economy of National Oil Companies, with special attention to Angola and Nigeria. At Revenue Watch, he focuses on governance and oversight of oil sectors, legislative and contract reform, transparency, and the promotion of government-citizen dialogue. He is working closely with partners from the African Center for Economic Transformation and the Norwegian government's Oil for Development program to develop a technical assistance programme based in Ghana that will help African governments manage their extractive resources more effectively.

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