Guidelines for Good Governance in Emerging Oil and Gas Producers
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Summary

The Guidelines for Good Governance in Emerging Oil and Gas Producers, compiled under the auspices of the New Petroleum Producers Discussion Group, review common challenges facing emerging producer countries in the phases of exploration, recent discoveries and early production. The following are the Guidelines' broad recommendations for addressing these challenges.

• International best practice may not be appropriate in the case of emerging producers in the oil and gas sector. Instead, the aim should be for more appropriate practice, taking account of the national context; more effective practice, in the interests of achieving rapid results; and better practice, allowing incremental improvements to governance.

• In order to attract the most qualified oil company to a country with an unproven resource base, the host government can invest in geological data, strengthen its prequalification criteria and ensure transparency. It should also plan for success and anticipate the implications of hydrocarbon discoveries in its tax code.

• Licensing is a key mechanism whereby government can reap early revenues and maximize long-term national benefits. Government must ensure that it simplifies both negotiations and tax structures to mitigate knowledge asymmetries with oil companies.

• Government and industry must engage and share information with affected communities to manage local expectations regarding the petroleum sector and build trust.

• In emerging producers, budgets for local content may be small and timelines for building capacity short. In this context, the focus should be on the potential for repeat use of any local capacity developed.

• Meaningful participation of national organizations in resource development is a central objective of many emerging producers. Capacity is needed to enable this, and the Guidelines examine where and how best to develop that capacity.

• Incremental improvements to the governance of the national petroleum sector will allow emerging producers to increase accountability. The focus in this regard should be on building up capacity in checks and balances as resources become proven.
Preface

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

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

The purpose of these Guidelines is to help emerging producers and the groups that advise them to think critically about the policy options that are available, and that would be most effective, during the first stages of exploration and development, or during a restructuring of the country's oil and gas sector. The goal is not to produce a complete guide to governance of the petroleum sector, but rather to offer guidance on making effective decisions about the structure and rules of the sector in an imperfect context. The Guidelines represent the consensus views developed among the officials from emerging producing countries who have participated in the New Petroleum Producers Discussion Group workshops held at Chatham House in November 2012 and May 2014.

What should emerging producers do with these Guidelines?

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

A notable lesson that emerged from the workshop discussions was that early-stage producers should plan for success. Given that circumstances are likely to change, governments should devise an investment framework that can adapt. Producers’ objectives will also likely change over time. Some of the Guidelines’ objectives relate to ‘early issues’ that need to be addressed at the time of exploration. Some of the objectives may not apply in each country, or at least certain specific situations may not

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1 Refer to Annex 1 for more holistic guides to good governance in the extractive sector.
necessitate immediate, dramatic change. These objectives can be flagged for later re-examination. Others may need to be put on hold until the country's capacity has grown, or industry interest has further developed. In such a scenario, governments should lay out a two- or three-year rolling action plan that allows for punctual reassessment of governance standards and capabilities.

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

Focus on objectives

The Guidelines are structured around the objectives listed below. It should be noted that the order in which the objectives are presented does not necessarily reflect their relative importance. In fact, some of the key objectives identified here may not be applicable at all in certain contexts.

Key objectives for the petroleum sector

Objective 1: Attract the most qualified investor for the long run
Objective 2: Maximize economic returns to the state through licensing
Objective 3: Earn and retain public trust and manage public expectations
Objective 4: Increase local content and benefits to the broader economy
Objective 5: Build capable national organizations to participate in and oversee the development of the resources
Objective 6: Increase accountability

For each objective, the Guidelines discuss specific challenges related to the national contexts that face many emerging producers. Producers involved in the project offer their 'lessons learned' throughout this document.
Overview: Establishing Good Governance in Emerging Producers

Best practices that have been established in successful petroleum-producing countries undoubtedly represent the international 'gold standard' in the oil and gas sector. But while such practices may work well for successful, well-resourced producers, they can also be entirely inappropriate for emerging producers, which are often faced with significant development challenges. Indeed, many emerging producers have weak institutional capacity and low knowledge of the petroleum sector, in addition to pressing socio-economic constraints. Thus, emerging producers should pursue policies that acknowledge the realities of their national contexts, that can bring about rapid results in a context of urgent need, and that allow for incremental improvements to their governance processes. As capacity grows and greater revenues begin to flow, emerging producers will need to adjust their methods and institutions to promote evolving – and ever higher – standards of good governance.

The Guidelines focus on six key objectives for the petroleum sector in emerging producing countries. Specific, policy-oriented recommendations are included under each objective. Recommendations emerged from consensus views among the officials from emerging producer nations who participated in the workshops held at Chatham House in November 2012 and May 2014.

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

Countries without proven reserves have the challenge of attracting competent companies to explore, develop and produce their subsurface resources.

It makes sense for the governments of such countries to invest in collecting geological data before licensing so as better to understand the value of what they intend to license, and to reduce the risk for investing companies. Governments should also actively explore funding options for the acquisition of richer data about their own acreage.

It is critical that governments set out strong prequalification criteria to weed out any applicants who do not have the capacity to carry out the work programme. Disclosure of bidding criteria to the public will discourage corrupt bidders.

Governments should recognize that licensees are likely to comprise consortia of companies, and that individual companies are likely to trade their interests in a licence as it progresses from exploration to development and production. The petroleum law should specify that government approval is necessary for any transfer of title, and should provide transparent and comprehensive criteria for the transfer. The tax code should provide for the treatment of any capital gains resulting from such transfers, and should be aligned with individual licence agreements.

Emerging producers that are operating in a context of low industry interest often struggle to issue licences through auctions. In this situation, a government may have no alternative but to conduct direct negotiations with individual companies. To achieve good results with direct negotiations, producers must apply transparent selection criteria and ensure that agreements reached do not preclude future licensing through auction.
Governments want to ensure that oil companies are encouraged to manage operational risk effectively and to provide accountability in the event of accidents or failure to perform. However, they lack the technical capacity to regulate operators and usually rely on them to self-regulate. In such circumstances, governments should adopt a ‘goals-based’, performance-focused regulatory regime, although risks will remain if the operators are not highly technically competent. In any case, governments must invest in their own technical capacity in order to understand the technical risks involved in operations. Pending the acquisition of a satisfactory level of technical competence, the Guidelines propose a number of means to fill that capacity gap and suggest some important provisions which should be included in regulations.

**Objective 2: Maximize economic returns to the state through licensing**

Emerging producers should design fiscal terms that give the state early revenues for urgent development needs, while ensuring long-term economic benefits. The use of progressive, flexible fiscal formulas and royalties is particularly recommended for new producers. Local content provisions, when well designed, can help maximize long-term economic benefits. Poorly designed local content policies, however, can provide cover for rent-seeking behaviour.

Emerging producers must strive to reduce the knowledge asymmetries they encounter in negotiations with foreign oil companies. For example, governments can engage consultants or technical advisers to evaluate the baseline conditions for the award of acreage. To simplify negotiations, emerging producers should move as many contract elements as possible into laws and regulations that apply across licences.

Emerging producers must develop simple tax structures. They must also clearly articulate the fiscal terms that govern upstream petroleum activity. Tax obligations should be defined in the tax code rather than in contractual agreements. This includes provisions for taxing capital gains earned by companies that sell or assign their rights or part of their rights before or during production.

New circumstances, such as a major discovery being made, or a rise in commodity prices, may prompt many producers to seek to change the terms of their contracts with foreign companies. Governments should respect existing contracts, and their first remedy when changes become needed should be to amend future licensing.

Yet the refusal to review terms can be destabilizing and unfair to some countries, and so renegotiation has sometimes been necessary.

To avoid this outcome, governments should ensure from the start that licence agreements and fiscal terms are flexible enough to provide for a fair distribution of rent under the foreseeable range of circumstances. This will help the country to maintain investor interest in the long term. Governments may also consider introducing renegotiation, economic balancing and adaptation clauses from the outset, which would allow renegotiation when specific triggers are activated.

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

Governments often have to mediate between competing interests. When communities don’t see their views reflected in documents and final decisions after consultations, they feel that they were not really consulted. To avoid misunderstandings and overcome mistrust, governments and industry
should engage meaningfully with communities. This involves real listening. Governments will need an engagement plan that clarifies the situation with respect to all stakeholders who will be consulted and in terms of how decisions will be taken. Oil companies will need to draw on specialized staff for community engagement and increase their communication with the public.

Trust is a key ingredient in community engagement. But it is lacking in post-conflict situations and where corruption has been endemic. Marginalized communities also may not trust the messages that are being conveyed about a project. To build trust, government representatives should travel to the concerned communities to meet with them. They should be mindful of possible misperceptions about interests and intentions. Governments and oil companies should help communities to access information about the project and to communicate frankly over its potential negative impacts and related mitigation measures.

Governments should report on exploration activity as it occurs (seismic surveys, drilling plans, drilling results, etc.). Both successes and failures should be reported. After a discovery has been announced, governments often struggle to moderate public expectations about the sector. This is a critical issue for many emerging producers. Thus, before any oil or gas discoveries are made, governments should begin thinking about how to inform the public and how to ensure that expectations of the benefits that will emerge from the sector are realistic. After new discoveries are announced, both government and opposition should be realistic in their statements about the scale and speed of monetizing them. They should also manage public expectations regarding job creation and profit windfalls. Emerging producers should, at a minimum, make use of the national oil company (NOC) or petroleum ministry website and other means of communication to educate citizens about the scale and nature of discoveries.

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

It is particularly important for developing economies to devise petroleum-sector policies that maximize national development. For this purpose, governments must have clear objectives and identify which branches of government are responsible for upholding the various aspects of the national development goals. Governments should also implement laws that include national content requirements for the goods and services that oil companies buy, or at a minimum they should provide a timetable for a shift from foreign to domestic sourcing. At the same time, governments should enact capacity-building plans to ensure that domestic producers are capable of supplying the skills, goods and services that the oil companies require. Governments, via the oil companies, should promote import substitution in the oil and gas sector.

Abiding by such local content rules is a challenge where domestic industrial or human capacity is low. Local content can be more expensive than content that is sourced outside a producer country when oil operators, service companies or engineering, procurement and construction (EPC) contractors are required to build the capacity of local hires or local suppliers. In a context of geological uncertainty, it is a challenge to get foreign oil companies to invest in local content. Governments should require foreign oil companies and the NOC to invest in developing local capacity in goods and services for which the petroleum sector has an immediate need, or preferably in those that have ‘dual use’ applications and can also be used in other sectors of the economy. Governments should collaborate with companies to develop training and hiring programmes to ensure that they are well integrated into the petroleum projects’ life cycle and into the national local content strategy.
Objective 5: Build capable national organizations to participate in and oversee the development of the resources

Assigning appropriate roles and responsibilities for this important sector is a critical question for emerging producers. Without capacity, those institutions will be unable to carry out the role assigned to them. Foreign technical advisory services can be invaluable in helping emerging producers to establish appropriate rules and institutions to oversee the development of resources and build capacity to be successful. But some governments – especially post-discovery – receive too much unsolicited advice. This results in ‘advice fatigue’ and confusion. Governments and advisers need to move from supply-led advice to demand-led advice. Advisers should allow a government space and time to reflect on its national strategy and to formulate what its needs are, especially when circumstances change dramatically. To guide assistance effectively, a government should draft a ‘Terms of Reference’ document outlining requirements, and should speak with one voice. Advisers should listen to government needs, and ask which other organizations are providing (or have provided) assistance, with a view to avoiding duplication of efforts and contradictory advice. Both users and providers of assistance should adapt their recommendations to the national capabilities and resources (as discussed in the Guidelines). Emerging producers can seek technical advice from and share experience with more established producers.

Governments of emerging producer countries that have urgent development needs often have limited funds to allocate to capacity-building. It is particularly important in these cases to speed up the capacity-building process to obtain capable oversight institutions. In cases where the resource base is uncertain and human and administrative capacity is limited, the government should concentrate capacity-building efforts in either the ministry of energy or the NOC, and should task one of these two organizations with regulatory responsibilities.

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

If the NOC is given a licensing or regulatory role, it is critical that government defines the scope and limits of the NOC’s state agency role. It should also clarify when the state will take back regulatory responsibilities. An NOC with a concessionaire role needs a more skilled workforce than does an NOC that is simply a minority partner in licences. Government must approve an explicit financial model for the NOC that allows the NOC to build its capacity to take on the concessionaire or regulator role effectively. Government must invest in its audit capabilities and introduce strong reporting and accounting standards.

Successfully establishing a strong new independent regulatory agency in a context of low state capacity is challenging. In such cases, external technical assistance and strong political commitment are critical. To recruit and retain skilled staff, governments should make the pay structure at this agency more advantageous than that of the rest of the civil service.
In emerging oil hotspots, governments and NOCs have in recent years demonstrated much ambition with regard to the technical role of the NOC. Governments must understand what different NOC roles cost in their specific national context. The Guidelines clarify the expected range of these costs in emerging producers. Governments and NOCs should review the state of the resource base, assessing what financial and technical resources are available, and task the NOC with a role that it has the capacity to execute and which the state can afford. Governments should wait to make significant investments in developing an NOC’s operational capabilities until discoveries have been made that establish that a reserve has a lifespan of at least 15 years. Until this reserve base is established, governments should train nationals to raise general human and state administrative capacity, focus on skills-building within the ministry of petroleum, and provide the NOC with only a limited budget for building operational skills. When a significant reserve base warrants the development of operational capabilities, it is critical that governments approve an explicit financing model for the NOC and introduce strong accounting and reporting standards in order to improve the governance of the NOC.

Some NOCs are mandated only to take on minority stakes in upstream licences. Without a state agency role, these companies often struggle to establish themselves financially and technically. Until the NOC is able to generate revenues from production, the government should grant it a revenue stream that covers the operating costs expected to be necessary to fulfil its mandate. Some non-operating NOCs pursue growth strategies by increasing their stakes in exploration and development licences and investing in technical capacity development. NOCs should only pursue a growth strategy under the direction of the government, and this strategy should be in line with available resources – both geological and financial.

Objective 6: Increase accountability

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

Emerging producers do not necessarily need to set a ‘final’ institutional structure from day one. Emerging producers should follow a phased approach and make incremental changes, structuring their reforms as a continual evolution. To facilitate the forward planning for the next phase of petroleum-sector governance, a credible, legitimate group should be tasked with directing the pace and shape of incremental reform.

Producers at an early stage of development of their resource base should start by establishing one credible body to manage all aspects of the sector. Over time, they should introduce checks and balances, while building up capacity in other branches of government. Governments should immediately introduce key mechanisms for public accountability, including audits of agencies and state-owned companies and regular disclosure of information to the public.

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2 These Guidelines offer no prescription about when it is appropriate to create an NOC, as in many countries this decision relates to national political aspirations more than to industrial need. Rather, the recommendations pertain to the role that an NOC should play in an emerging producer country.
Objectives, Challenges and Policy Recommendations

Objective 1: Attract the Most Qualified Investor for the Long Run

Challenge: Attracting well-established companies to ‘frontier’ areas

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

Regarding the upstream deals awarded before the independence of South Sudan, the Hon. Henry Odwar, chairperson of the Committee on Energy, Mining, Commerce and Industry in South Sudan, made the following comments in 2012 which illustrate the risks of investing in countries that are seen as ‘frontier’ areas for political reasons:

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

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

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

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

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

• Government should consider investing in collecting geological data before licensing, to better understand the value of what it intends to licence and to reduce the risk for investing companies.

• Government should also actively explore funding options for the acquisition of richer data about their own acreage. Investment in geological surveying can be supported through the budget, via joint ventures with specialist geoscience companies, or with external development aid funding.

• It is critical for government to establish strong prequalification criteria for investors. General terms for prequalification should be laid out in the petroleum law, with more detailed rules to be included in regulations. Government should recognize that individual companies are likely to trade their interests in a licence as it progresses from exploration to development and production. The prequalification criteria can help weed out companies that do not have the capacity to carry out the work programme.

• To prevent junior companies from farming out their stake (or part of their stake) to under-qualified companies, the government should specify in the petroleum law that its approval is required for any direct or indirect transfer of title. It should set out transparent and comprehensive criteria for the transfer. The incoming company should be made to meet the same (or stronger) conditions for the issuance of a licence/right as those to which the existing holder is subject.

• Government should also establish provisions on capital gains taxation, so as to be able to benefit if one company transfers its interests to another at a premium.

• Government should disclose bidding information to the public to discourage corrupt bidders. Government may also require beneficial ownership disclosure, as that is one way to discourage underqualified companies relying on political connections to win licences.

Challenge: ‘Frontier’ areas are not always attractive enough to hold investor interest at an auction

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

Recommendations

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

• A first-come-first-served licensing process may be more appropriate for countries with low exploration interest; this allows them to avoid an open bid that fails to generate strong competition.
• Whether government chooses to use bidding rounds or direct negotiations, transparent selection criteria should apply.

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

  Government may consider the open-file system, which is a cross between auctioning and first-come-first-served: a 90-day window is used by the government to invite bids to compete for an application that has just been made by a company.

**Challenge: Regulating to minimize operational risk in a low-capacity setting**

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

‘We are just lucky that nothing has happened,’ said one participant.

Risks are high. Governments need more capacity to regulate operators effectively. In practice, it appears that many governments must rely on foreign oil company operators to self-regulate.

**Recommendations**

• Government should adopt a ‘goals-based’, performance-focused regulatory regime, which incentivizes operators to aim for higher standards of operations, as opposed to a rules-based ‘check box’ regulatory framework, which involves higher risk, given that establishing the right regulations requires a high degree of technical knowledge.

  In the event of an accident under a goals-based regime, the operator cannot blame the failure on the regulatory standards set by government (as could happen under a rules-based regime). Enforcement remains a challenge in a goals-based system, however, if the government has no means to punish poor performance or inadequate risk assessment. It should be noted, too, that in a ‘frontier’ context it can be difficult to attract experienced, highly technically competent companies, and this poses a particular challenge for countries relying on an individual company’s ability to self-regulate.

• Government must invest in capacity-building, in order to increase the regulators’ ability to understand the technical risks involved in operations.

• Until regulatory capacity is sufficiently established, governments should devise other means of accessing the necessary technical knowledge to design the regulatory regime and to monitor performance. The following means were recommended by our group:

  • Governments can create a network of regulators for greater exchange of ideas and information among emerging producers.

  • Governments can map out the available technical expertise across their continent (or region) and set up a system to share available technical experts.
• Governments can ask oil companies for their advice on regulations. They can request opportunities for secondment of staff to the companies to build capacity.

• Governments can seek support from consultants to oversee the regulatory regime. However, this support should not be a substitute for developing national capacity.

• Governments and regulators should draw on international standards to write their regulations.³

• Governments should introduce provisions in legislation and contracts that require investors to contribute to decommissioning at the end of the project and that require them to put up performance guarantees to ensure that funds are available when the time comes.

Questions for further discussion

• Does the reliance on a goals-based system have any implications for the liability regime in the event of an accident?

• In the absence of clearly defined rules, would it be difficult to hold a company liable for damages?

³ Refer to the International Finance Corporation’s Performance Standards, which define the investor’s responsibility for managing social and environmental risks; or to IPIECA’s 19 good practice documents on oil spill preparedness and response, known as the Oil spill report series.
Objective 2: Maximize Economic Returns to the State Through Licensing

Challenge: Designing appropriate tax structures

The fiscal terms of licensing agreements can serve as important tools for emerging producer governments. Producers must choose whether to prioritize up-front payments or longer-term cash flows. They must also strike a balance between direct tax revenues and indirect economic benefits, which can be generated via local content requirements.

Recommendations

• Government should clearly articulate the fiscal terms governing upstream petroleum activity. These should be as simple as possible, as complex tax structures are more difficult to administer.

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

• Before licensing, government should make provisions in the tax code for taxing capital gains by early entrants that later sell out.4

• Government should include progressive, flexible fiscal elements, such as profit-based production-sharing formulas or resource rent taxes. This approach is typically recommended for most petroleum producers, but it bears particular relevance for new producers. Including flexible fiscal elements makes such countries more attractive to risk-averse investors, since the higher rates are triggered only if a project becomes very profitable. At the same time, such policies can allow the government to capture a substantial share of any eventual windfalls.

• Government should include royalties in production-sharing contracts. The royalty represents the most assured source of fiscal receipts for the resource owner. Production-sharing contracts can be designed so that the effective tax take eliminates the need

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4 The Columbia Center on Sustainable Investment has developed a brief that reviews options: 'Capturing the benefits of a transfer of mineral rights – scenarios to capture by contract/legislation/regulation and issues to consider', http://ccsi.columbia.edu/files/2013/11/CGT__note_-_May_18.pdf.
for imposing a royalty. However, this would then require a degree of regulatory capacity to ensure that costs were kept down. For new producers, the required capacity levels may not be high enough.

Royalties are also an appropriate fiscal tool for new producers because they bring revenues from the first day of production. This helps to reassure the population about the benefits of resource development (see Objective 3).

**Challenge: Dealing with knowledge and information asymmetries in negotiations with foreign oil companies**

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

**Recommendations**

- When in direct negotiations, government should work with consultants or technical advisers to evaluate the baseline conditions for the award of acreage; such external advisers should also support the state in the negotiations. Government should ensure that it has access to adequate financial modelling, which is a key negotiating tool.

- Government should move as many fiscal elements as possible into standardized laws and regulations that apply across licences. Although this can reduce flexibility, it simplifies administrative functions and minimizes the number of fiscal matters that need to be negotiated with each company. Countries should define the fiscal obligations in the law (i.e. the requirement to pay royalties, taxes, rents, etc.), and then further specify those obligations in the regulations.

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

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

**Question for further discussion**

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

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5 A future workshop could discuss whether to, and if so how to build on efforts such as http://www.resourcecontracts.org, a nascent initiative being organized by the World Bank, the Natural Resource Governance Institute and the Columbia Center on Sustainable Investment. The site is meant to serve as a ‘one-stop shop’ for publicly available oil and mining contracts.
AFTER DISCOVERIES

Challenge: Changing investment terms without scaring off investors

New geological information can increase a country’s attractiveness to investors. New discoveries in-country or even nearby can lead to a surge of exploration interest from oil companies. These new data may prompt governments to seek to revise the terms of investment to their advantage. However, as Flavio Rodrigues, government relations and regulatory affairs director for Shell Brazil, points out, it is good practice to modify the terms of future licensing rounds rather than change the terms of existing agreements:

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

Nevertheless, over the course of 25–30 years circumstances may change beyond the scope of pre-existing contracts and broader legislation, and governments may want to amend the investment terms, just as companies do. Our group debated the legitimacy of renegotiating an existing agreement. A near consensus emerged that renegotiation was sometimes necessary in order to maintain a long-term partnership between oil companies and governments because the refusal to review terms could be destabilizing and unfair to some countries. It is also in the long-term interest of companies engaged in the country to ensure that the deal is viable.

Discussions focused on one avenue for renegotiation, which is to include renegotiation, economic balancing and adaptation clauses in contracts from the outset, allowing renegotiation when specific triggers are activated. Such clauses can add significantly to the perception of investment risk for companies and require careful design. But they have proved to be more efficient and fair mechanisms in comparison with classic freezing or stabilization clauses.

If the oil company has not met its obligations under the applicable deal (or the laws/regulations), then the country may be within its rights to terminate the contract.

Recommendations

- Government should design progressive fiscal terms at the outset, in order to capture maximum windfalls as the geological and price contexts evolve. It should request external support where necessary to achieve this effectively.

- Government should respect existing contracts. If changes are necessary (e.g. to reflect a more attractive geology or as a result of changes in other legislation), the first remedy should be to modify the terms of future contracts.

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6 For the sake of simplicity, we may use the term ‘stabilization clause’ when referring to ‘freezing clauses’, and ‘renegotiation clause’ when referring also to adaptation and economic balance (or rebalancing) clauses. Stabilization clauses are aimed at protecting the private investor by restricting the power of the state to amend the contract regulations and/or the laws that are applicable to petroleum operations. Renegotiation clauses may offer both parties protection against the hardship caused to either of them by a change of original circumstances. The clause will aim to maintain the economic equilibrium of the contract during its lifetime.

7 The following groups can support governments in contract negotiations: the World Bank’s EI-TAF; the African Development Bank’s African Legal Support Facility; the International Senior Lawyers Project; and the Commonwealth Secretariat’s Ocean Governance and Natural Resources Management Section.
• When designing contracts with a renegotiation clause – which would allow renegotiation when specific triggers are activated – governments should ensure that:
  • The clause is phrased in very clear language.
  • It specifies which terms are subject to renegotiation (local content, fiscal, environmental, financial terms).
  • It specifies what triggers would lead to renegotiation (political, cost, commodity price, and legal or tax changes).
  • It specifies clearly what is the baseline of the renegotiation/rebalance ex ante.
  • It specifies the process of the renegotiation/rebalance ex ante.

Questions for further discussion

• What threshold (e.g. economic unfairness or inappropriate environmental provisions) needs to be met to justify renegotiation?

• What good practice mechanisms can governments follow for renegotiation of existing contracts? Which should be avoided? How can governments manage renegotiation to minimize conflict and arrive at a win-win outcome?

The following recommendations will be considered:

• Before opting to encourage (or compel) companies to come to the table to renegotiate an existing contract, a government should:
  • Carefully analyse the prospective economic gains from renegotiation, in line with current and anticipated market conditions.
  • Analyse the trade-offs or risks involved in an aggressive attempt to renegotiate.
  • Communicate carefully and clearly with companies currently present in-country, prospective new investors, and citizens about the goals and possible mechanisms of a renegotiation process. Listen to their views, and take them into account when finalizing a strategy.
  • Negotiate first. Wherever possible, government efforts to revise contracts should be approached via a process of mutual negotiation to arrive at a new deal that works for both parties, rather than by unilateral action on the part of the state, which can significantly damage the perceptions of the business community.

One emerging producer expressed relief:

Renegotiation has been such a taboo topic. It’s good to have a forum where we can actually discuss this … and in which there is enough trust between us to tackle this.
Objective 3: Earn and Retain Public Trust and Manage Public Expectations

Challenge: Arriving at meaningful community engagement

Misunderstandings between affected communities and government or industry are common. When communities don’t see their views reflected in documents and final decisions after consultations, they feel that they were not really consulted. For some, not having a veto on projects means they are not really involved in decision-making about the sector. While it will never be possible for government decisions to meet the desires of all interest groups, governments have the challenge of having to mediate between competing interests of communities surrounding the project site and other interest groups elsewhere in the country.

Recommendations

• Government and industry should avoid symbolic engagement and facade consultations. Community engagement should be about really listening, in order to understand the core values of communities and how these shape their interests.

• Enhanced communication should not be seen as a substitute for the actual delivery of windfalls or other sector-related benefits.

• Government needs a strategy for community engagement, clarifying which stakeholders will be heard, how their views will be taken into account, and how competing interests will be balanced.

• Government should communicate its community engagement plan to all stakeholders. Government should aim to begin communicating before exploration begins and continue to communicate regularly. This will help to manage public expectations.

• Government and oil companies can draw on trusted messengers to support their engagement efforts and communication strategy – e.g. community leaders and cultural or religious leaders, as well as academics, advisers and members of professional associations who can provide information.

• Oil companies should employ specialized staff for community engagement.

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

Bashir Hangi, communications officer for Uganda’s Ministry of Energy and Mineral Development, warned another participant from a country with good hopes of commercial discoveries:

Don’t wait. Before discoveries you need a clear, proactive plan about how to engage. Send an advance team to the ground before the seismic studies are carried out, to explain to the communities who these people are and exactly what they will be doing.
Challenge: Overcoming lack of trust

Trust is a key ingredient in community engagement. But it is lacking in post-conflict situations and where corruption has been endemic. Communities with low education levels, and that are economically and politically marginalized, or geographically isolated, also may not trust the messages that are being conveyed. In our discussions, the resistance to petroleum industry operations among the Turkana community in Kenya illustrated the issues at stake.8

Ernest Rubondo, commissioner of Uganda’s Ministry of Energy and Mineral Development, made the following comment:

It is a difficult task to meet someone who doesn’t trust you. But you can’t escape this responsibility. And besides, it will improve, and trust will be built as you meet.

Recommendations

• Government should travel to the concerned communities, to meet in person.
   Speaking exclusively to interest groups from the capital deprives the government of opportunities to understand the interests and values of the community, and also to identify and mitigate misunderstandings about the project.
   As one participant from a country with recent discoveries explained:

   We issued press releases from the capital. Meanwhile there was local gossip. People read into our decisions, seeing special interests. We should have been on the ground, managing that message.

• Government and industry should be mindful of the tone of their conversations with communities. They should be aware of potential (mis)perceptions by communities about their interests and intentions as regards the project and the future of the community.

• Government and oil companies should understand community dynamics so that they can work well with communities and avoid offending them.

• Government should help communities to access information about the project.

• Pieces of information that should consistently be disclosed include details on revenues generated by the project and key steps in the project implementation timeline.

• Government and oil companies should deal with communities in a fair and sincere manner. They should communicate to them not only the project’s benefits, but also its potential negative impacts and the mitigation measures put in place to guard against them.

• Government should also increase the public disclosure of information related to the licensing and tendering processes. Similarly, government should publish the criteria for assessing bids and hold open bidding rounds for both exploration licensing and tendering.9

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8 A case study will be made available via the project web page.
9 As discussed under Objective 1, a country with low exploration interest may need to follow the open-door policy and engage in direct negotiations as companies present themselves. Open bids for tendering are preferable in both situations.
Increased disclosure will raise public confidence in the system and improve the financial benefit for the producing country. The following comment from Charlie Scheiner (La’o Hamutuk in Timor-Leste) illustrates this point:

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

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

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

One participant made the following comment:

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

Abdlatif Y. Al-Hamad, director-general and chairman of the Arab Fund for Economic and Social Development, and former finance and planning minister in Kuwait, warned:

In Kuwait, we have been producing for over 40 years … and we still haven’t managed public expectations!

Moderating public expectations is a critical issue. Our discussions pointed to the damage done when politicians deliver inflated messages about the transformational potential of the industry. As one participant noted:

People wonder: Where is the impact? Where are the results?

Promising transformational impacts in the short or medium term that cannot possibly be delivered creates public mistrust of government policies for the sector, and of the industry more broadly.

**Recommendations**

- Government should seek to manage expectations before and after discoveries are made.
- Where significant discoveries have been made, both government and opposition parties need to be realistic in statements about the scale and speed of monetizing the new discoveries. Politicians should coordinate their message with civil servants (and industry), who can ground it in technical assessments of the resource base. They must also manage the public’s expectations regarding job creation and profit windfalls. Leaders should resist the temptation to tell citizens
that natural resources will transform their communities or their economies when significant uncertainty remains. Such promises may deliver fleeting political benefits but often exacerbate long-term distrust.

- Government should use the NOC or ministry of energy website to communicate with citizens about the scale and nature of discoveries, as well as the time frame for production. It should also provide details of dry wells, to help moderate expectations.

- Government and oil companies should educate citizens about project cycles – for example, the difference between a discovery of petroleum and a commercially proven discovery, the steps that must be taken before production can begin, and the types of skills required at various stages of the project.

- Government should use various other means of communication to target populations that do not have access to the internet. This can take the form of mainstream media, town hall meetings, road shows, etc. Government should encourage oil companies investing in the country to participate in these communication efforts and to share their knowledge about the resource.

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

- The question of the redistribution of wealth and opportunities to producing and non-producing regions is salient in both emerging and established producer countries. At stake are issues of fairness, a sense of ownership, and compensation for local negative impacts from the development of the resource.

**Questions for further discussion**

- Can investments in social infrastructure projects support inclusion and eliminate the capital cost for low-income earners to ‘get on the grid’ – i.e. transportation networks, power generation, education and health?

- What is the relative effectiveness of the different means of revenue distribution – e.g. decentralization, cash transfers, national allocations and local funds?
Objective 4: Increase Local Content and Benefits to the Broader Economy

Challenge: Laying out policies that maximize national development

It is a challenge to develop a macroeconomic policy that maximizes linkages between the capital-intensive, high-tech petroleum sector and other sectors of the economy. The difficulty is greater for emerging producers because – given the newness of the national petroleum sector – the government and local industry will not have had time to prepare education programmes, vocational training and SME development programmes directed at the needs of the petroleum sector.

Recommendations

• Government must have clear objectives when it comes to national development. It should identify which parties are involved in achieving those objectives (government, oil companies, service companies and EPC contractors) and what each will do. Priority sectors for local development should be chosen strategically, and government should implement an integrated strategy that includes market analysis and skills enhancement.

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

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

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

Questions for further discussion

It is important to understand the timing required for skills ramp-up in a petroleum project. Procurement begins once the final investment decision (FID) is taken. At this stage it is already too late to engage potential local companies, in terms of helping them access finance and build the required capacity. These matters should be incorporated well before FID is reached.

• How can the lead time required for local suppliers to prepare themselves be built into the process?

Can a government ask investors to prepare a forward needs assessment for projects, with a view to enabling it to map out a skills development plan that is aligned with industry requirements? Building skills takes time – when is the right point to implement such a plan?

Industry players increasingly point to the value of collaboration between oil companies, service companies and EPC contractors in sharing costs for developing local content and in exchanging information about their expected demand for specific skills, goods and services. What is needed to make this happen? Should government require EPC contractors, service companies and operators to coordinate ahead of bidding and include a joint proposal for local content development?

It is challenging for governments with no past experience of petroleum sector projects to anticipate the ramp-up of skills involved. Most hires will be during the construction phase, with a peak four to six years into project. The greatest demand will be for non-skilled workers and technicians. Local suppliers that are called on to provide services and manufacturing should have transferable skills so they can deal with the off-peak period of project development and the swings in business inherent to the oil and gas sector.

Which skills are most likely to offer ‘dual use’?

How best to involve local schools and universities in developing the required skills?

Some investments by Asian NOCs, while developing much-needed national or local infrastructure, have missed opportunities to create jobs for nationals.

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

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

In the view of Tony Paul, managing director, Association of Caribbean Energy Specialists Ltd (ACES), Trinidad and Tobago:

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

Experts disagree about how much companies should take over roles typically played by governments. Some say that allowing oil companies to take on responsibilities that usually reside with the state or the local private sector could ultimately undermine their capacity. Such a scenario may also lead oil companies to undertake activities that fall outside their core competence. That said, each oil company is different. Government can expect more in terms of broad packages of activities from NOCs from Asia and less from small exploration companies.

**Recommendations**

- Government should first develop a thorough understanding of the local context (demand-side requirements, supply-side capabilities, etc.), in order to define which local content targets would be realistic and achievable.\(^\text{11}\)

\(^\text{11}\) Refer to IPIECA’s ‘Local content strategy’ for further recommendations on setting realistic local content objectives.
• Government should focus next on capacity-building by requiring investors to develop the workforce and the supply base. For many emerging producers, the starting point in terms of demands on foreign oil companies should be local sourcing of simple on-site services – construction and consumables for workers, for instance.

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

• Government must facilitate foreign oil companies’ efforts to develop the local supply industry and workforce. Specifically, government should link local content policy in the oil sector to its broader education strategy and build the kind of workforce that is able to respond to the country’s future needs.

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.

Questions for further discussion

• What can governments do to remedy this?

• Should local content regulations shift from a focus on whether companies are domestically based/owned/registered to a requirement of creation of value addition in-country irrespective of the ownership of the supplier companies?12

Analysing the impact of local content efforts can help to devise appropriate policies:

• Would there be a benefit in releasing regular data on progress against local content targets?

• What are useful measures of long-term economic benefit?

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

Local content can be more expensive than content that is sourced outside a producer country in cases where oil operators, service companies or EPC contractors are required to build the capacity of the local hires or local suppliers. However, local content becomes cheaper once local suppliers and staff reach the capacity levels required by the industry. A government’s own capacity-building costs can always be recovered indirectly when the capacity that has been built becomes available to other sectors of the local economy.

12 This is the recommendation of Uganda’s National Content Study.
If the reserve base is small or under-explored, companies do not know whether there will be substantial production over a long period. Thus they do not know whether they will be in a country long enough to both invest in local capacity development and recoup the investment through repeat use. If companies cannot recoup the additional investment or the geology is not attractive enough for the company to justify this expenditure as the costs of a ‘licence to operate’, they will expect to be compensated for the higher costs of hiring or sourcing locally.

An additional challenge for countries with low prospectivity is that they may attract small exploration companies that are not well capitalized. Such companies are not suited for substantial investments in national development.

A comment from Rolf Magne Larsen, vice-president at Statoil:

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

**Recommendations**

- Government should require foreign oil companies (and the NOC if applicable) to invest in developing local capacity in goods and services for which the petroleum sector has an immediate need or, preferably, in goods and services that have ‘dual use’ applications. To this end, governments should identify skills, trades, infrastructure, goods and services that can be used by other sectors of the economy in the long term.

- Government should collaborate with companies to develop training and hiring programmes. This can help to ensure that such programmes are well integrated into both the companies’ operations and the country’s local content strategy.
Objective 5: Build Capable National Organizations to Participate in and Oversee the Development of the Resources

Assigning appropriate institutional roles and responsibilities for maintaining this important sector is a critical factor for emerging producers. Without capacity, those institutions will be unable to carry out the roles assigned to them.

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

In this spirit of ‘getting governance right’ from the outset, there is a rush to assist governments with recent discoveries. Foreign donors and technical advisers offer guidance and capacity-building support to help prepare the country for the next stages of petroleum sector development. This assistance can be invaluable in enabling emerging producers to establish appropriate rules and institutions to oversee the development of resources and build capacity to be successful. But for optimum effect, these services must be coordinated and directed by governments themselves.

A key message that came out of our discussions was that some governments – especially post-discovery – received too much unsolicited advice. This results in ‘advice fatigue’ and confusion. The following problems were highlighted:

• Each assistance provider wants individual attention from senior civil servants, which puts a heavy time and administrative burden on these individuals. They must field repeat questions from multiple providers.

• Assistance providers advise officials in multiple institutions – and each is focused on different issues, e.g. the ministry of finance will be concerned with the fiscal regime, the ministry of energy with technical questions, and the central bank with macroeconomic issues. As a result, the advice is not coordinated or coherent. This prompted the following comment from Amb. Ombeni Sefue, chief secretary of the Office of the President (Tanzania):

  "We in government need time to caucus internally, to think through what we want to do and what we need."

• This problem of lack of coordination is compounded by the fact that multiple assistance providers are offering their services simultaneously, or in succession, without building on the assistance already offered.

• While there is a need for assistance providers to improve in-country coordination, especially in cases where the government has not managed its own assistance requirements, incentives are lacking.
• The assistance offered may not be what is most needed in-country. One participant noted: ‘Governments can write laws, contracts, policies … they don’t need that help. They need comparative data and deep analytical thinking’ that help them choose the right type of contracts or legal disposition. To meet this need, the advisers should be experts in the subject matter. Producers also expressed a real need for mentoring.

Recommendations

• Government and advisers need to move from supply-led advice to demand-led advice. Advisers should allow a government space and time to reflect on its national strategy and to formulate what its needs are.

• When circumstances change dramatically, government should take the time necessary to think through its vision for the petroleum sector, the policies that follow from that, and its needs in terms of technical information, capacity-building and advice.

• To ensure that assistance is demand-driven, government should draft a ‘Terms of Reference’ document that defines exact needs, and it should require assistance providers to submit bids outlining their ability to meet these needs.

• Each government should aim to speak with one voice. One option is to establish a secretariat that houses all relevant government competences, and which receives high-level political support and has responsibility for coordinating assistance, in line with a coherent vision for the sector.

• Advisers should listen to government needs, and ask which other organizations are providing (or have provided) assistance and what activities they are carrying out, with a view to avoiding duplication of efforts and contradictory advice.

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

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

• Emerging producers can seek technical advice from and share experience with more established producers.

Challenge: Speeding up the capacity-building process to obtain capable oversight institutions

The most effective way for an NOC to gain competence is to learn on the job. For instance, an NOC might fill the shoes of a departing international oil company (IOC) or enter into partnerships that allow it to act as an operator. Similarly, government institutions that are given responsibilities can build capacity quickly.
Once an organization secures a role, it requires financial resources, information, human capacity (skills, knowledge, experience) and supporting processes to carry out the role assigned to it. Emerging producing countries often have urgent development needs, and governments in such countries may have limited funds to allocate to capacity-building. Thus governments must determine which tasks and which actor(s) they wish to prioritize in their capacity-building efforts, and how they plan to minimize the associated costs.

It is considered best practice to separate the functions of policy-making, regulation and operations into three distinct bodies, as this maximizes the clarity of roles and allows for better accountability for the delivery of each function. However, where state capacity is low, technical skilled personnel are in short supply, and the reserve base is either small or uncertain, such a separation may be not feasible or advisable. Indeed, building up the skills and processes across three distinct bodies requires significant investments of time and money. 13

Some emerging producers have opted to concentrate responsibilities for the sector among the smallest possible group of actors in order to minimize expense and concentrate capacity-building. Eddy Belle, CEO of PetroSeychelles, commented:

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

Similarly, in the case of Suriname, Vandana Gangaram Panday at Staatsolie offered the following lesson learned:

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

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

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

Recommendations

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

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

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

AFTER DISCOVERIES

• When discoveries are made, government must allocate more resources to building capacity in auditing and monitoring operations. If the responsibility for monitoring operations lies with the NOC, then the NOC must develop this capacity, and the government should begin evaluating the NOC’s performance in achieving that.

If public funds are limited, technical advisory groups (such as the Norwegian Oil for Development programme, the Natural Resource Governance Institute, the Commonwealth Secretariat, the World Bank, the IMF and many others) can support capacity-building in the civil service.

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

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

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

• When discoveries are sufficient to justify the NOC developing an operational role (to assess this see below – Challenge: Can the state afford an NOC that is an operator?), the NOC should transfer its regulatory role to government to avoid the conflict of interest that results from the NOC regulating its own operations. (For further discussion of how to transfer these responsibilities, see Objective 6: Increase Accountability – Overcoming entrenched interests in a reform – also below.)

One workshop participant commented:

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

PRODUCTION PHASE

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**Policy option: Entrust the NOC with a regulatory role**

NOCs with a regulatory or state agency role, i.e. which represent the state in overseeing the petroleum sector, have more opportunities to build technical skills than emerging NOCs without this role.

Potential state agency roles include:

• Data management and promotion

• Licensing and negotiation (or an advisory role in respect of the state institution responsible for licensing)
Guidelines for Good Governance in Emerging Oil and Gas Producers

• Reviewing work programmes and making recommendations to the state on the approval of the programmes

• Monitoring operations

Ensuring effective national participation in the upstream through the NOC as a state agent requires clear roles and sufficient capabilities. In practice, many NOCs operate without a clearly defined mandate or financial model. Their regulatory responsibilities may be informal only (for instance where the ministry holds formal responsibility for the sector but in practice depends on the NOC for guidance). This situation leads to gaps in accountability because it is unclear which institution will hold the NOC to account for its performance of a role it does not formally have. The second challenge relates to the NOC’s access to finance. Many NOCs lack a clear financial model, which leads them to become creative with their revenue sources.

Recommendations

• Government must define the scope and limits of the NOC’s state agency role.

• It should clarify when the state will take back regulatory responsibilities. (Refer to Objective 6: Increase Accountability – Policy Option: Take regulatory responsibilities away from the NOC for recommendations on when such a transfer of responsibilities is recommended.)

• The NOC must build its capacity to take on the concessionaire or regulator role effectively. An NOC with a concessionaire role needs a more skilled workforce than does an NOC that is simply a minority partner in licences. The financial and personnel requirements for a concessionaire or regulatory role vary widely depending on the size of the resource base, the stage of development of the resources (whether promotion, exploration or production) and the type of geology (whether complex fields, offshore or onshore, or in environmentally sensitive areas). In most emerging producer cases studied in this project, a concessionaire or regulator role entailed a threefold increase in staff.\textsuperscript{14}

• Government must approve an explicit financial model for the NOC.

• Government must invest it in its audit capabilities and introduce strong reporting and accounting standards.

Policy option: Establish a regulatory agency

Establishing a strong new regulatory agency in a context of low state capacity is challenging, as the following comment made by Charlie Scheiner (La’o Hamutuk) illustrates:

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?

\textsuperscript{14} A forthcoming paper on financing operator NOCs will be made available via the project web page.
Some regulatory agencies in emerging producers do not have the capacity to hold operators fully to account for their performance. In some places, agencies have not been allocated sufficient autonomy and thus have not been able to establish their independence from the political leadership. This raises the possibility that licences will be awarded to companies that are under-qualified but well-connected politically. Establishing an independent and capable regulator in a low-capacity context is a significant challenge.

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

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

In established producers, multiple entities would normally carry out the various regulatory functions (e.g. drafting and enforcing regulations, data management, technical reviews of work programmes). However, in a context of low administrative capacity, it is difficult to establish multiple regulatory agencies. In such cases, the establishment of these agencies can be an incremental process that takes into account the specific needs of the industry.

**Recommendations**

- In countries with low state capacity, external technical assistance is critical to the successful establishment of an independent regulatory agency.15

- Government officials and other stakeholders should work to ensure that there is strong political will to back the governance system.

- Government should initially create one regulatory agency to take on all of the above regulatory functions. This concentration of responsibilities is especially warranted where state administrative capacity is low and the size of the reserves base is uncertain.

- If the civil service has established a sufficient degree of capacity, a specialized unit at the ministry of environment or natural resources can be put in charge of environmental monitoring. Similarly, a specialized unit at the ministry of finance can handle tax collection.

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

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

In emerging oil hotspots, governments and NOCs have in recent years demonstrated much ambition in respect of the technical role of the NOC. Some have set their sights on developing operator capabilities. But this strategy takes time and is expensive.

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A lesson learned by Statoil, in Norway:

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

A lesson learned in Ghana, from Sam Addo Nortey of Ghana National Petroleum Corporation (GNPC):

Like other NOCs in Africa, the GNPC has to compete with other government priorities to obtain funding. More radical funding is required to execute the mandate effectively and exhaustively.

A comment from Roger Avinaga, manager of commercial and strategic planning at Petromin PNG Holdings Ltd, in Papua New Guinea:

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

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

The first step is usually for the NOC to take on a minority stake, which is likely to be financially carried by foreign oil partners, unless the NOC is established with a strong capitalization or means of generating profits from other activities. If its stake is carried, the next step is often for the NOC to become a contributing equity partner. Once this has happened, NOCs frequently seek to take on a minor operatorship first, and then a major one.

The financial and time investments needed to achieve such milestones will depend on a country's capacity levels in, for example, the civil service, national education and the petroleum sector.

The case of GNPC illustrates what it can cost to become a stand-alone operator in a medium-high state capacity context, with petroleum experience accruing especially over 10 years of active exploration, three years of project development planning and four years of production, and with the NOC benefiting from collaboration with foreign oil companies. In 2014 the company estimated total expenditure for the first eight years of the strategy at $4.5 billion–$11.4 billion, depending on how aggressively it pursues growth. GNPC presented a case study on ‘The Cost and Challenges of an NOC Developing Operator Capabilities’, which outlines this company's strategy for becoming an operator and the capacity and financial challenges that face it. The forthcoming paper on financing operator NOCs will provide comparative information on the costs of various NOC roles, the human capital, and time needed to move from one stage of technical responsibility to another.
Recommendations

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

• Government must understand what different NOC roles cost in their own specific national contexts.

• Government and NOCs should review the state of the resource base, assess what financial and technical resources are available, and task the NOC with a role that it has the capacity to execute and which the state can afford.

• Government should wait to make significant investments in developing an NOC’s operational capabilities until discoveries have been made that establish a reserves lifespan of at least 15 years.

• Until this reserve base is established, government should train nationals to raise general human capacity and state administrative capacity. At the same time, governments should focus skills-building on the most relevant ministry, and should provide the NOC with only a limited budget for building operational skills.

• When a significant reserve base warrants the development of operational capabilities, it is critical that governments approve an explicit financing model for the NOC and introduce strong accounting and reporting standards, in order to improve the governance of the NOC.

Challenge: Ensuring a non-operating NOC participates meaningfully in the development of the resources

A government can choose to give the NOC a guaranteed minority stake through the petroleum law, or it can leave it to the NOC to negotiate its stake with foreign oil companies. In many cases, NOCs with minority stakes and no state agency role for overseeing the national petroleum sector struggle to establish themselves technically. To some extent these NOCs play a symbolic role, representing the state in the upstream, but are not technical or commercial equals to the operators and do not have regulatory responsibilities. Moreover, they often struggle financially and cannot access sufficient funding to increase their minority stakes in licences.

Recommendation

• Until the NOC is able to generate revenues from production, the government should grant the NOC a revenue stream that covers the operating costs expected to be necessary to fulfil its mandate.

Most NOCs in countries without significant discoveries and without a state agency role (e.g. with concessionaire responsibilities) typically have a workforce of 20–40 employees and an annual expenditure upwards of $1 million.
The following are typical revenue streams for minority stake NOCs:

- Government budgetary allocation (until the NOC can generate revenues from production).
- Financial markets are available when there is a proved resource base. (Government support is required.)
- Government can design the licensing regime to require a share of operator payments to be made to the NOC (e.g. signature bonuses, bidding-round payments, other operator payments).
- Government can legislate a downstream levy or import mandate for the NOC.
- Financial markets and oil company partners can provide capital to enable the NOC to take on equity stakes in licences. (Access is improved post-discovery.)

A number of non-operating NOCs pursue growth strategies, increasing their stakes in exploration and development licences and investing in technical capacity development. Some of this ambition is driven by the company, and some by government. Either way, NOCs in countries without production usually struggle to secure sufficient and reliable finance for this growth. NOCs developing technical skills will require finance in the area of $2–4 million, with a staff of 60–90, to achieve moderate growth. (An NOC that is developing operator capabilities will require a larger staff and budget; refer to the above challenge: Can the state afford an NOC that is an operator?) NOCs expanding their equity stakes will require larger capital inlays – the range of situations makes generalizations difficult.

Recommendations

- The NOC should only pursue a growth strategy under the direction of the government, which is responsible for defining its mandate.
- The NOC’s growth strategy should in line with available resources, both geological and financial.
Objective 6: Increase Accountability

**Policy option: Take regulatory responsibilities away from the NOC**

Sometimes the NOC plays a critical role in promotion and oversight of the petroleum sector on behalf of the state. Over time, government may want to introduce more checks and balances in the system. This may involve taking back the NOC's regulatory responsibilities and assigning them to a state agency.

Various factors can trigger such a reform and the creation of an independent regulatory agency:

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

**Challenge: Overcoming entrenched interests in a reform**

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

Who initiates the reform, what triggers the need for reform, and how the reform is carried out are all factors that determine the level of resistance and ultimately the success of the reform process. Reform that is driven by the NOC's desire to focus on its business typically provokes the least resistance from government officials. Reform that is government-led tends to provoke more resistance from the NOC. That said, NOCs tend to be less resistant to reform when it is driven by a larger representative or legitimate constituency (e.g. parliament), or when there is consultation with civil society. These differences are illustrated in the contrasting experiences with institutional reform in Brazil and Algeria.
Emerging producers do not need to set a ‘final’ institutional structure from day one. Instead, they can follow a phased approach and engage in incremental changes. Producers can think a step or two ahead and anticipate future needs. Reform does not always need to be introduced rapidly; it can be considered as being a process of continual evolution.

Recommendations

- Producers at an early stage of the development of their resource base should start with one credible body that is responsible for all administrative and regulatory functions. Over time, governments should build up capacity elsewhere and introduce checks and balance into the system.
  The introduction of checks and balances is particularly important in small countries that have few qualified personnel to oversee the sector. In such cases, a handful of people may dominate the governance system by accumulating multiple roles.

- Governments should immediately introduce key mechanisms for public accountability, including audits of agencies and state-owned companies, and regular disclosure of information to the public.

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

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

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

Challenge: Weeding out corruption

Corruption creates popular mistrust of government and industry (see Challenge: Overcoming lack of trust in Objective 3). It is a challenge to weed out corruption where it has thrived, but our future discussions will review what avenues exist to pursue this.

Questions for further discussion

- What enables corruption to take root?

- What steps can governments take to strengthen accountability processes? (One example might be to increase the capability of parliament, the media, civil society and the general public to ask the right questions of those with responsibilities in the sector.)

- What processes can governments introduce to minimize corruption?

- What incentives can be introduced to maximize professionalism in state institutions?
Annex 1: Further Reading and Useful Governance Tools

Norway’s Oil for Development programme has developed a practical checklist for assessing the state of petroleum-related governance in a given country. This draws on the principles and indicators developed by Chatham House’s Good Governance of the National Petroleum Sector Project. It is available at: http://www.institutenorth.org/assets/images/uploads/files/Petroleum_sector_governance_checklist_revised_04_11.pdf.


Building on the five principles of good governance identified in the Chatham House project on Good Governance of the National Petroleum Sector, this report provides examples from country case studies and offers context-specific guidance for the petroleum sector policy- or strategy-maker.


The Charter comprises a set of principles aimed at guiding governments and societies in how best to harness the opportunities created by extractive resources for development. It does not offer a blueprint for the policies and institutions countries must build; instead, it lists the ingredients that experienced producer countries have used successfully. It offers 12 precepts that run through the stages of development of the petroleum sector.


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


The Resource Governance Index measures the quality of the oil, gas and mining sectors of 58 countries, representing 85 per cent of the world’s petroleum. It scores and ranks the countries, relying on a detailed questionnaire completed by researchers with expertise in the extractive industries. The index assesses the quality of four key governance components: institutional and legal setting; reporting practices; safeguards and quality controls; and enabling environment. It also includes information on three special mechanisms commonly used to govern oil, gas and minerals: state-owned companies, natural resource funds and subnational revenue transfers.
Annex 2: Participant Countries of the New Petroleum Producers Discussion Group

- Belize
- Democratic Republic of the Congo
- Ghana
- Guyana
- Kenya
- Lebanon
- Liberia
- Mexico
- Mozambique
- Namibia
- Norway
- Papua New Guinea
- São Tomé and Príncipe
- Seychelles
- Sierra Leone
- South Sudan
- Suriname
- Tanzania
- Timor-Leste
- Trinidad and Tobago
- Uganda
- Uruguay
Acronyms

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<th>Acronym</th>
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<tr>
<td>EI</td>
<td>extractive industries</td>
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<tr>
<td>EI-TAF</td>
<td>Extractive Industries Technical Advisory Facility</td>
</tr>
<tr>
<td>EPC</td>
<td>engineering, procurement and construction</td>
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<tr>
<td>FID</td>
<td>final investment decision</td>
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<tr>
<td>GNPC</td>
<td>Ghana National Petroleum Corporation</td>
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<td>INP</td>
<td>National Institute of Petroleum (Mozambique)</td>
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<tr>
<td>IPIECA*</td>
<td></td>
</tr>
<tr>
<td>IOC</td>
<td>international oil company</td>
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<tr>
<td>NGO</td>
<td>non-governmental organization</td>
</tr>
<tr>
<td>NOC</td>
<td>national oil company</td>
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<tr>
<td>SME(s)</td>
<td>small and medium-sized enterprise(s)</td>
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* Stand-alone acronym. IPIECA is the global oil and gas industry association for environmental and social issues.
About the Editor

**Dr Valérie Marcel** is an associate fellow at Chatham House, and leads the New Petroleum Producers Discussion Group. She is an expert on national oil companies and petroleum sector governance. She has carried out extensive fieldwork in order to gain an understanding of the perspectives of producer countries. She is the author (with John V. Mitchell) of *Oil Titans: National Oil Companies in the Middle East* (Chatham House/Brookings, 2006). Dr Marcel’s current research focuses on governance issues in emerging producers in sub-Saharan Africa, as well as in other regions. She is a member of KPMG’s advisory team for energy sector governance. She also provides thought leadership for the Global Agenda Council on the Future of Oil & Gas at the World Economic Forum. Dr Marcel previously led energy research at Chatham House; and taught international relations at the Institut d’études politiques (Sciences Po), Paris, and at Cairo University.
Acknowledgments

The Guidelines for Good Governance in Emerging Oil and Gas Producers presented here are drawn from a Chatham House project that gathers together petroleum producers and governance experts in annual workshops. Recommendations focus on issues discussed at these workshops, and firm prescriptions are only offered where broad consensus has emerged. As such, the Guidelines do not cover all issues relevant to the situation of new producers, but focus specifically on the topics that were covered at the workshops held at Chatham House on 5–6 November 2012 and 12–13 May 2014. Other topics to be considered in future workshops are outlined in this document in order to frame ongoing and future discussions. These are flagged as ‘questions for further discussion’. The Guidelines are a living document.

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