Research Paper

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Guidelines for Good Governance in Emerging Oil and Gas Producers 2016

CHATHAM HOUSE
The Royal Institute of International Affairs

Contents

Foreign & Commonwealth Office

The Commonwealth

Natural Resource Governance Institute

Summary

The *Guidelines for Good Governance in Emerging Oil and Gas Producers 2016*, 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.
- Government policy should be guided by a clear vision for the development of the country and a strategic view of how the petroleum sector will deliver that vision.
- 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, and be robust through declining oil and gas prices.
- 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.[1] 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, in Tanzania, in July 2015, and in Kenya, in March 2016.

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.

Governments in producer countries must have a clear vision of their objectives in the petroleum sector. This will allow them to focus their energies and scarce resources on the country's top priorities.

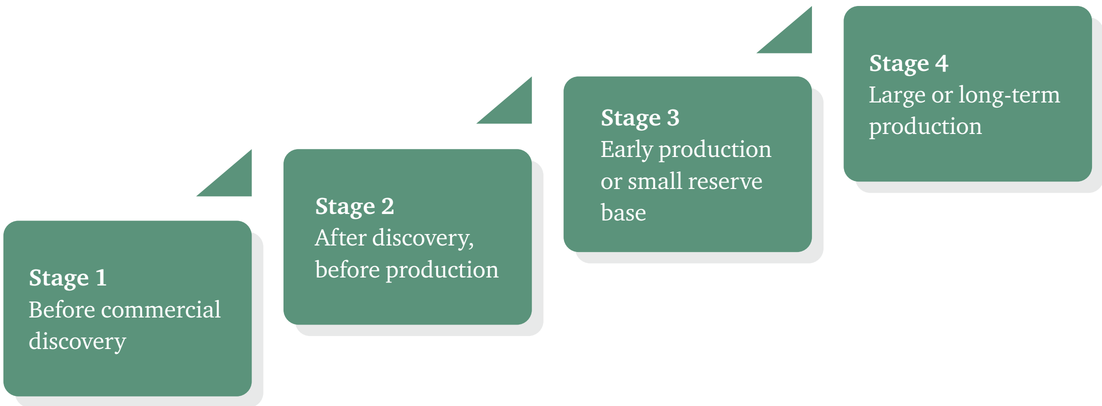
[1] Refer to Annex 2 for more holistic guides to good governance in the extractive sector.

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**.

Each stage of resource development from exploration to production brings a particular set of opportunities and challenges. The Guidelines serve as a checklist for assessing whether policies are adapted to the evolving national context. 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 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.

They must also undertake an honest appraisal of the state's available resources and capacity. This supports the creation of realistic policies and offers a baseline against which capacity development can be measured.

Four key stages in resource development



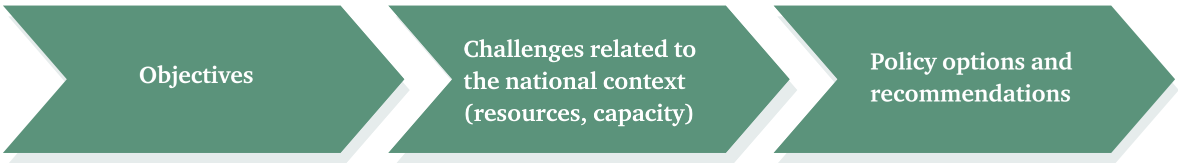
Focus on objectives

The Guidelines are structured around the objectives listed below. Governments should understand the relative importance of each objective. Objective 1, which is concerned with the national vision, should underpin the other objectives.

Key objectives for the petroleum sector

Objective 1: Elaborate a strategic vision for the sector
Objective 2: Attract the most qualified investor for the long run
Objective 3: Maximize economic returns to the state through licensing
Objective 4: Earn and retain public trust and manage public expectations
Objective 5: Increase local content and benefits to the broader economy
Objective 6: Build capable national organizations to participate in and oversee the development of the resources
Objective 7: Increase accountability
Objective 8: Safeguard the environment

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 limited knowledge of the petroleum sector, in addition to facing 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 eight 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 discussion group meetings held at Chatham House, in November 2012 and May 2014, in Tanzania, in July 2015,[2] and in Kenya, in March 2016.

Objective 1: Elaborate a strategic vision for the sector

It is critically important for government policy to be guided by a clear vision for the development of the country and for the role of the petroleum sector therein. Governments should base this vision on an analysis of available resources and capacity, as well as opportunity costs and risks associated with the chosen development model. They should be strategic about choosing priority sectors. Governments should clarify the role of each institution in delivering that vision. Leadership, consistency of purpose and dedication to implementation are crucial to success.

The strategic vision for the sector should underpin the following objectives.

Objective 2: 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. The challenges facing 'frontier' countries are exacerbated in a low-price environment. As fewer companies are able to take on exploration risk.

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

[2] The third meeting of the New Petroleum Producers Discussion Group was hosted by the Tanzania Petroleum Development Corporation in Dar es Salaam.

of richer data about their own acreage. Better data reduces risk, which is particularly warranted in a low-price environment. A better understanding of the market and potential investors will enable emerging producers to target their marketing at appropriate companies. Consultations with reputable firms can improve the design and marketing of a licensing round, thus making it more attractive to investors.

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. Rules to govern this trade of licences (or farming out) should take care not to discourage new investors by putting financial or regulatory burdens on the practice, while preserving state interests. 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, government may have no alternative but to use a first-come-first-served licensing process. To achieve good results, producers must apply transparent selection criteria and ensure that agreements reached do not preclude future licensing through auction. They may also consider whether to delay new awards when market conditions are depressed.

Objective 3: Maximize economic returns to the state through licensing

Emerging producers should design fiscal terms that are aligned with the national vision and ensure clear fiscal priorities. They must also clearly articulate the fiscal terms that govern upstream petroleum activity. Emerging producers must also develop simple tax structures. 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 producers seeking capital for exploration should focus on requiring viable work programmes in order to encourage drilling activity. To attract and retain investors, the use of progressive, flexible fiscal formulas and royalties that respond to changes in profitability is particularly recommended.

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.

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. Similarly, low prices may prompt companies to ask governments for revisions of terms. 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, periodic review clauses and adaptation clauses from the outset, which would allow renegotiation when specific triggers are activated.

Objective 4: Earn and retain public trust and manage public expectations

To avoid misunderstandings and overcome mistrust, governments and industry should engage meaningfully with communities, particularly those surrounding onshore fields. 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 have a responsibility to communicate with communities at each stage of resource development. They 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 the 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. Similarly, low oil prices can have significant impacts on projects and government revenues. Governments should communicate up-to-date information about these impacts. 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.

The distribution of wealth among producing and non-producing regions is salient for both emerging and established producers. There is no uniform or generally optimal mechanism for revenue distribution. Governments should be careful to manage expectations and communicate about revenue-sharing systems, in particular with regards to communities close to project sites. In deciding on any decentralization mechanisms, governments should have clear goals. They should also assess the capacity of sub-national governments to spend the revenues and the processes to hold them to account for that expenditure.

Objective 5: 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 local content objectives, which are set within a broader national vision. For instance, they should strategically target which skills and supply chains to develop. Governments should identify the sector's expected needs and assess the potential of the resource base. Foreign oil companies can assist with providing data from their forward plans. Governments should assess national capabilities in order to identify strategic targets for national development. 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. For maximum impact on the economy, these efforts should be strategic and grounded in a thorough understanding of the local context. Preference should be given to skills that can benefit other sectors of the economy. Governments should then adopt a simple monitoring and reporting system to ensure progress is made in achieving national development goals.

Abiding by 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 the local suppliers. In a context of geological uncertainty or low commodity prices it is a challenge to get foreign oil companies to invest in local content. Carefully designed local content policies that address the sector's needs and are adapted to national capabilities will be mutually beneficial. 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 6: 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 the 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 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 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 during the oil price boom.[3]

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 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.

[3] 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.

Governments and NOCs should be strategic about building skills and target those that are needed to fulfil the mandate given. 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. 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 7: Increase accountability

Various drivers 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.

Governments and oil companies should view corruption as a costly problem, one that grows only more costly with time. Professionalism and transparency can change incentive structures and serve as critical antidotes to corruption. External forces, such as civil society groups and international legislation, play an important role in driving change.

Objective 8: Safeguard the environment

Governments want to ensure that oil companies manage operational risk effectively and are accountable 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 that should be included in regulations.

Objectives, Challenges and Policy Recommendations

Since its establishment in 2012, the New Producers Group has journeyed through a significantly evolving oil and gas market. The high oil price, which spurred exploration and the opening of new frontier acreage, increased producer ambitions. These are reflected in our Guidelines, notably in the selection of policy objectives. These plan for success, as one should, to avoid being taken off guard by developments and to reap the benefits that fortune brings.

The discussions held in Tanzania in 2015 also served a critical role in balancing ambition with a reminder that circumstances change, sometimes for the worse. The steep fall in global oil and gas prices from mid-2014 dampened the exploration boom in frontier areas and caused delays, too, resulting in the shelving of development projects in many areas. In this context, emerging producers are competing for scarce foreign oil company investment and new producers face much lower revenue projections. Regulatory and institutional flexibility is needed to be resilient in this new environment. Governments and NOCs must have a strong focus on activities that add value, to capture the maximum benefit from any investments made.

Some countries will also have to come to terms with the likelihood that projects that were expected to produce revenues or generate investment may not materialize in the near term. Furthermore, they will need to work to recalibrate citizen expectations and avoid risky populist measures that may have consequences for the long-term development of the sector.

Objective 1: Elaborate a Strategic Vision for the Sector

EARLY ISSUE

Our discussions have stressed the importance of having a clear vision for the development of a new producer country – one that clarifies the role that the petroleum sector should play in realizing that vision. The absence of a broad national vision can lead the petroleum industry to become an 'enclave' industry very early in the process, which increases the risk of Dutch disease.

Recommendations

- Governments must have clear objectives when it comes to national development.
- The country's vision for the petroleum sector should flow from these national development priorities. This vision ought to be reassessed in view of changes in the global and domestic markets and the evolution of the resource base.
- Governments should identify which parties are involved in achieving those objectives for national development and for the petroleum sector, and what each will do.
- Governments should choose priority sectors for local development strategically. This should be underpinned by a careful and honest analysis of existing capabilities, the resource base and the market, to measure expected demand from petroleum projects.
- Policies for the petroleum sector should be clearly tied to objectives in the national vision, with governments regularly monitoring and following up on implementation.

Challenge: Political leadership is lacking

Leadership is needed to drive a countrywide dialogue on the national vision and to coordinate its implementation.

'We have the necessary policies and regulations in place, but we have no leadership, no vision. Should we proceed to develop our sector without it?' asked Wissam Zahabi, chairman of the board of the Lebanese Petroleum Administration.

Recommendations

- In the absence of political direction and leadership, officials with technical knowledge of the sector, petroleum and non-petroleum professional associations and civil society can all take the initiative to raise these issues in the public arena and apply political pressure for key decisions to be made.

Politicians and government may become engaged in the debate and embark on a process of elaborating a long-term agenda for the petroleum sector and national development. However, grassroots initiatives and public debate are unlikely to bring about a long-term agenda where there are fundamental leadership limitations.

Challenge: Balance competing objectives

Countries must evaluate what resources are worth to their economies and how best to leverage them. There are trade-offs involved in pursuing any one vision for the petroleum sector. For instance, Trinidad and Tobago chose to make the petroleum sector a catalyst for industrial development. It sold its natural gas to domestic industry below international market prices to stimulate industrial activity. The identification of industrial activity as an area requiring a boost was a strategic choice made by that country, informed by its assessment of capabilities and demand as well as by its national vision. The outcome could be characterized as fossil fuel-driven economic development through which, over time, a range of sophisticated goods and services have been produced locally.

Emerging producer governments should consider whether their country's oil and/or gas are of sufficient scale and low cost to allow them to follow a 'value addition' model. For instance, in Trinidad and Tobago, the annual oil and gas resource flows (barrels of oil equivalent) per person in 2014 amounted to 239 barrels, while that figure stood at only three barrels in Ghana, over the same period, and is projected to be two barrels in Uganda.[4] Governments should also consider the costs involved in growing dependence on the sector, as this development model encourages the economy to rely on fossil fuels rather than broad-based economic growth, which can lead to a number of well-known negative impacts on the political economy. Cheap factor inputs also discourage energy efficiency and encourage consumption.

Countries planning to use natural gas resources for power and national industrial development will need to carefully consider pricing and business models that will provide the commercial incentive for companies to invest in infrastructure, and develop realistic assessments regarding demand and sequencing of infrastructure.

The alternative 'revenue maximization' model would involve a country focusing on maximizing export revenues and reinvesting them in priority sectors. Again, the key question is which sectors should the revenues support? The answer should be guided by the broader vision for the development of the country.

Emerging producers should consider the potential risks involved with pursuing the revenue maximization model too. These revolve around possible mismanagement of revenues generated, which reduces the development impact. Also, governments may not choose the right industrial champions to support and nurture, leading to economic inefficiencies.

Another way to frame the discussion around the national vision is around values. A national vision for the country and for the petroleum sector may be driven by the following values, for instance: setting higher standards of transparency, aiming to have a high performing and professional oil and gas industry, protecting the environment and natural resources, and an inclusive and fair redistribution of wealth. Colombia's reform of the petroleum sector, for example, was guided by

[4] Keith Myers, presentation, Kenya National Seminar – New Petroleum Producers Discussion Group, 3 March 2016.

the principle of establishing itself as a country that managed its resources efficiently, transparently and to a high professional and technical standard.

As a Nigerian participant commented, the big framing questions have changed so that ‘new producers have to think about what is going to drive them’.

Recommendations

- In elaborating a national vision, governments should undertake an honest appraisal of the country’s petroleum resources, possible scenarios for production and export price over time – relative to population – and available resources and capacity.
- Governments and societies should reflect on the fundamental question of what kind of producer should we be? and which values will drive their development.
- Governments should complete a thorough analysis of the risks associated with different approaches and how these might impact the wider national vision for development.

  This includes the question of how petroleum sector development and revenues can be channelled towards sustainable activities in the rest of the economy.
- Recognizing that it is likely not possible to achieve all goals at once, governments should prioritize their objectives.

  A sequenced approach to the national vision may help to address these evolving priorities, as circumstances and capabilities change. In practice, too, the vision for the petroleum sector may be a hybrid of the models discussed above.
- Domestic energy use should be considered strategically at an early stage so that a country does not become locked into unsustainable consumption patterns.

  Our discussions stressed that holding fuel prices below cost of supply through some form of subsidy, and ignoring the cost of impacts of use, is a risky policy. Blanket subsidies (those applied across the market) encourage the undervaluation of a resource in society and, thus, encourage excessive consumption (and greenhouse gas emissions), benefit the rich more than the poor, and can lead to increasing dependence on imports of refined products at international prices (entailing a rising subsidy burden for the state). It is also politically difficult to remove energy subsidies once introduced. At the discussion, preference was given to targeted subsidies or cash transfers to enable increasing energy access in poorer and geographically isolated communities. For example, where gas is being produced this might include LPG distribution schemes to displace wood as a cooking fuel and the use of upstream revenues to fund the capital cost of off-grid (potentially renewable) electrification programmes. Assessing the full costs of fuel and energy production (including water use and environmental consequences) and the impacts of use (externalities including public health costs) will help to choose the right regulation and energy pricing schemes over time.

Challenge: Focusing on implementation

While strategic-level plans are very important, there is no benefit if they are not implemented. Consistency of purpose and dedication of implementation are crucial to success and to an enduring long-term vision for the sector. This long-term vision helps foreign oil companies and investors commit to long-term investments – in particular, in the gas sector and LNG. But it is also what the national industry requires to ramp up skills and expand infrastructure to meet the needs of the sector and the broader economy.

Carefully elaborated national development plans have been derailed in the past by short-term political demands. Corruption can also be an obstacle to implementation. These problems can impede the steadfast dedication required to execute plans according to a national vision.

'How do we delink the long-term vision from the electoral cycle?' one participant asked.

Recommendations

- By tying the strategy for the development of the oil sector to a broader long-term economic plan or national vision, formed through cross-party consensus, governments can ensure the strategy is grounded in country-wide economic plans and increase the political currency attached to the vision.
- Governments can involve civil-society groups as a means of increasing accountability and sharpening the focus on long-term issues.
- Governments can create an institution to oversee the implementation of the national vision. Legislation can clarify how various government bodies should coordinate for delivery of the national vision. Legislation can also require periodic consultation, review and update of the national vision.

Objective 2: Attract the Most Qualified Investor for the Long Run

EARLY ISSUE

Challenge: Attracting well-established companies to 'frontier' areas

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

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.

The challenges for 'frontier' countries have been exacerbated in the current low-price environment. Oil and gas companies worldwide are slashing budgets for exploration and development, and areas without a history of production are often the first to be cut. This reduces the options that governments have in choosing partners, and increases the calls by potential investors to provide generous terms to increase investment incentives.

Prospectivity and information about the geological basin are the most important drivers of 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 more willing to take on exploration risk, but some are poorly capitalized and unable to finance promised work commitments or execute operations safely on their own. Those smaller exploration companies willing and able to carry out promised work commitments, and to do so to a high standard, are the backbone of the development of new resources in emerging producer countries. However, in a low-price environment, these junior companies are few and far between, as they struggle to find equity partners.

Governments also have to concern themselves with keeping out the 'bad' companies. As Charlie Scheiner, from the NGO La'o Hamutuk in Timor-Leste, points out:

> 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

- Governments should consider investing in collecting geological data *before* licensing, to better understand the value of what they intend to license and to reduce the risk for investing companies. In a low-price environment the strategy of fleshing out and adding value to the data is particularly warranted as it decreases risk for the investor.[5]
- The entity in charge of licensing should educate itself about the industry, its different types of companies, and specific companies, too, in order to better target data marketing.
- Governments 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.
- In designing a licensing round, governments can increase the attractiveness of their basin by consulting with inter-governmental organizations and reputable firms that oversee awards, for the design, marketing and evaluation of their bid round programme. Consultations with oil companies can also help to ensure that terms are adapted to the market environment.

Box 1: Liberia case study

Liberia illustrates the benefits of drawing on external expertise to improve the design and marketability of a bid round. An international auditing and consulting firm was hired, after a competitive process, to provide independent oversight and to ensure the process conformed to international industry standards in providing the following services to the National Oil Company of Liberia (NOCAL): (i) advice on the structuring of the bid round; (ii) assistance with the development of the fiscal model used to create competitive production sharing contract (PSC) fiscal terms; (iii) received, reviewed and made recommendations to NOCAL with respect to pre-qualification submissions from prospective bidders; (iv) received the bids, opened the bids in the presence of the elected geophysical company and NOCAL; (v) undertook evaluation of the quantitative and qualitative elements of the bids received, and made recommendations.

In addition to this firm, the International Monetary Fund (IMF) was asked to review the financial model and fiscal terms. International legal and commercial experts developed the bid invitation letter, pre-qualification submission forms and the PSC (with instructions to emphasize Liberian-citizen participation, local content and state benefits). A geophysical company assisted NOCAL with marketing and promotion of the bid round to prospective bidders, conducted the technical road shows and managed Liberia's seismic catalogue.

The inclusion of an accounting and advisory firm and the IMF in a petroleum sector bid round were new in Liberia. Companies participating in the bid round made bonus bids that were unprecedented for a frontier jurisdiction without a commercial discovery and in the midst of very challenging global oil market conditions.

- Government will benefit from publicizing the model PSC, prior to its final publication, with an invitation for stakeholder comments, concerns and recommendations (e.g. from oil companies, civil society groups).

  Consensus based edits ensure the long-term resilience of the contract to changing market and political contexts.

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[5] The NOC Staatsolie, for example, invested in improving the quality of company data and making it available free of charge. This is remarkable given that data sales can make a significant contribution to the NOC operating cash flow.

- 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. Prequalification terms should include criteria related to financial, technical and organizational capabilities.

  The prequalification criteria can help weed out companies that do not have the capacity to carry out the work programme. Companies that are not publicly listed present significant risks and require greater due diligence efforts to ascertain that they are honest and capable.

  A pre-qualification process that is transparent (publishing the criteria, candidates and winners) or is conducted by an independent entity is more likely to result in the more qualified bidder being selected.

- Several measures can discourage ‘sitting on acreage’, such as an aggressive relinquishment policy and shorter renewal periods for licences. That said, governments should offer some flexibility in a low-price period.

- Governments should set rules to govern the trade of licences (or farm out) that protect the state interests, without putting such financial or regulatory burdens on the practice that they discourage new investors.

  Governments should recognize that individual companies are likely to trade their interests in a licence as it progresses from exploration to development and production. This is how junior companies work, in particular, as they tend to be designed to carry out exploration and not development.

- The government should establish provisions on capital gains taxation, to discourage ‘flipping’ and to benefit if one company transfers its interests to another at a premium. However, this tax should be adapted to the market environment, as a (higher level of) tax on capital gains will be a disincentive for junior companies and explorers.

- 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. As a result, the incoming company would be made to meet the same (or stricter) conditions for the issuance of a licence/right as those to which the existing holder is subject.

- Government should disclose bidding information to the public to discourage corrupt bidders and ensure that successful bidders are selected according to clear criteria.

  Government may also require beneficial ownership disclosure, as that is one way to discourage underqualified companies relying on political connections to win licences.

EARLY ISSUE

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 first-come-first-served licensing, transparent selection criteria should apply.
- For governments unfamiliar with the petroleum sector, it is vital to engage the necessary expertise – whether it is a private firm, a non-governmental organization or an international governmental organization – to balance the knowledge equation during negotiations.
- Under depressed market conditions, countries with frontier acreage should consider whether to delay new awards.

  When market conditions are unfavourable to investment, few companies are interested and the government would need to make bigger concessions in order to obtain contracts. Even then the reality is that companies probably would not invest significantly. This creates the risk that a government locks itself into an agreement with a partner that is sub-optimal.
- Governments 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.

Objective 3: Maximize Economic Returns to the State Through Licensing

EARLY ISSUE

Challenge: Designing appropriate tax structures

Trying to reconcile government and investor interests is a delicate balancing act, especially as commodity prices fluctuate. A government is eager to capture possible windfall profits and to reap the social and economic benefits of projects, while companies worry about avoiding cost overruns and blowouts, as well as pleasing shareholders who expect reasonable returns on their investment.

In designing the fiscal terms of licensing agreements, government 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.

In the current low-price environment, many new producers face demands from current and prospective investors to ease the fiscal burden, to provide an incentive to invest. The governments of these new producers are in the challenging position of having to assess these demands and remain attractive for investors without making unnecessary fiscal concessions that will substantially impair long-term revenue prospects.

Recommendations

- Governments should ensure that the fiscal terms are aligned with the national vision and the role the petroleum sector will play in this vision (refer to Objective 1). They should be clear about fiscal priorities, such as generating short- or long-term cash flows and direct tax revenues or indirect economic benefits.
- Governments should clearly articulate the fiscal terms governing upstream petroleum activity. These should be as simple as possible, as complex tax structures can be more difficult to administer.
- Governments should ensure the tax code and the petroleum law are in harmony.
- Before licensing, governments should make provisions for the fair taxing of net gains from the transfer or assignment of petroleum rights.[6]
- New producers seeking capital for exploration should focus on requiring sound work programmes rather than high signature bonuses (a onetime fee for securing a licence). If both can be achieved, all the better.

[6] 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.

This is an important policy decision for government. New producers typically want to encourage drilling of wells to acquire strong data on their geological resources. The risk of no discoveries in the frontier regimes could cause a state to seek signature bonuses but this would come at the expense of enriching the quality of geological data, as a result of drilling programmes potentially foregone. It is therefore suitable for new producers to attach more importance to work programmes than signature bonuses in the evaluation of bids or licence applications. However, fiscal regimes can be designed to cater for both work programmes and bonus payments without necessarily sacrificing additional drilling commitments.

- To attract and retain investors, government should adopt progressive fiscal systems, which respond to price or cost-driven changes in profitability, and flexible licensing systems to accommodate alterations to investor work commitments during price slumps.

  This approach is recommended for most petroleum producers, but it bears particular relevance for new producers. Including flexible fiscal elements makes such countries more attractive to the more 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. For the same reason, this approach can confer important benefits on a country in times of low prices.

- Cost recovery terms also play a significant role in attracting foreign investment. Governments should align the fiscal regime to take account of different cost profiles, for example, as a result of water depths.

- Governments should include royalties in the legislation as well as their contracts. The royalty represents the most assured source of fiscal receipts for the resource owner.

  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 4).

  In a production-sharing contract, a royalty can operate alongside a progressive profit-oil split, as a way to provide some assurances of early revenue (cost-oil limits within production-sharing can play a similar economic role). Royalties can vary depending on different kinds of fields of projects, requiring for example lower royalties for frontier acreage and higher cost gas fields.

EARLY ISSUE

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. Marny Daal-Vogelland, from the Surinamese NOC, Staatsolie, noted that in the absence of capacity or experience in licensing design, it was important to rely on external help:

> There is no shame in saying I don't know how to do this. Can you help me?

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.
- Significant external capacity is available, some of it at little or no cost, to producers. Governments should ensure such external support is tailored to the national context in order to avoid 'cookie cutter' solutions.
- Governments can benefit from the use of model production-sharing contracts with minimal biddable items.
- Governments 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. It also has the benefit of transparency and security for foreign investors. Governments 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 profit taxes could be negotiable, while the corresponding tax rates for such thresholds could be fixed.)
- Governments should include capacity-building requirements in licensing agreements.
- Governments 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. Today, over 900 oil, gas and mining contracts are publically available to view.[7]

AFTER DISCOVERIES

Challenge: Fairness in changing investment terms

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. Similarly, companies sometimes come to governments to ask for a revision of terms to reduce the taxation or operational obligations they face during periods of economic difficulty. This is happening today in many countries.

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 changing the terms of existing agreements.

[7] Refer to: www.resourcecontracts.org.

> 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. Against the backdrop of a high oil price in May 2014, 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 periodic review, renegotiation, economic balancing and adaptation clauses in contracts from the outset, allowing renegotiation when specific triggers are activated. Such clauses can add significantly to perception of investment risk for companies and require careful design. But they have proven to be more efficient and fair mechanisms in comparison with classic freezing or stabilization clauses.[8]

In case an 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.[9]
- Government should be wary of the risks associated with pressing for renegotiation of 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.
- When designing contracts with a renegotiation or periodic review 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).

[8] For the sake of simplicity we may use the term 'stabilization clause' when referring to 'freezing clauses', and 'periodic review clause' when referring to adaptation and economic balance (or rebalancing or renegotiation) 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. Periodic review clauses allow the government to change those laws, but require the investor to be compensated if the equilibrium changes. It 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. For further reading on this, see http://ccsi.columbia.edu/files/2014/08/Periodic-review-in-natural-resource-contracts-Briefing-Note-FINAL-8.11.pdf.

[9] 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.

- It specifies clearly what is the baseline of the renegotiation/rebalance *ex ante*.
- It specifies the process of the renegotiation/rebalance *ex ante*.

FUTURE WORKSHOP

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.

An 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 4: Earn and Retain Public Trust and Manage Public Expectations

EARLY ISSUE

Challenge: Arriving at meaningful community engagement

The need for community engagement varies with the types of projects. Onshore exploration is substantially different from offshore exploration, in terms of visibility and impact on the lives of neighbouring communities. For onshore fields, development and production impacts are also different from those of the exploration phase. Communities surrounding the fields commonly expect jobs and economic opportunities, though they may also question the need for development and want to preserve their way of life. Communities and subnational governments will often be concerned with the institutional arrangements for distributing revenues.

In consultations with communities surrounding onshore projects, misunderstandings are common between them and government or industry. Some governments and oil companies view one-way communication (informing the communities/public) as engagement. But communities and the public may expect more. 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 do need to engage meaningfully with these stakeholders and mediate between competing interests of communities surrounding the project site.

Recommendations

- Government should have a clear sense of what role the petroleum sector will play in supporting the implementation of the national vision, when engaging in consultations with communities (see Objective 1). Government will need to align both local and national concerns.
- 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 industry should avoid symbolic engagement and façade consultations. Community engagement should be about really listening, to understand the core values of communities and how these shape their interests.
- Once open dialogue is established between government and communities concerning oil activities, it should be maintained.

Jackie Khoury, former strategic and technical director on the board of NOCAL, current adviser to the board, explained:

> Liberia had well over 150 public engagements prior to creating its petroleum policy and law but stopped engaging and informing the public shortly after – the abrupt halt in basic communication created an atmosphere of suspicion and fostered gossip mongering.

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

Bashir Hangi, former communication officer for Uganda's Ministry of Energy, 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.

FUTURE WORKSHOP

Questions for further discussion

- Higher standards of community engagement would have the industry moving on from the minimum level of participation, which entails informing the public/communities (one-way communication), and beyond community consultations to a higher standard requiring free, prior and informed consent (FPIC). FPIC is the principle that indigenous peoples and local communities must be adequately informed about projects that affect their lands in a timely manner, free of coercion and manipulation, and should be given the opportunity to approve or reject a project prior to the commencement of all activities.

  FPIC is emerging more broadly as a principle of best practice for sustainable development and a risk management tool, used to reduce social conflict as well as increase the legitimacy of the project in the eyes of all stakeholders and rights holders.[10]
- What are the benefits and challenges of higher standards of community consultation? Which communities would need to give FPIC? Is this applicable only to onshore projects?

[10] Oxfam Community Consent Index 2015.

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.

Ernest Rubondo, director of the Uganda Petroleum Directorate, 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 with respect to the project and to the future of the community.
- Government and oil companies should understand community dynamics so that they can work well with communities.
- Government should help communities to access information about the project.

  Information that should consistently be disclosed includes details on revenues generated by the project and key steps in the project implementation timeline.

- Governments 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.
- Governments should also increase the public disclosure of information related to the licensing and tendering processes. Similarly, they should publish the criteria for assessing bids and hold open bidding rounds for both exploration licensing and tendering.[11]

The issue of contract transparency is not clear-cut in our group. 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

[11] As discussed under Objective 2, 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.

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.

AFTER DISCOVERIES

Challenge: Moderating public expectations about the sector after discoveries are made

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 not 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 and politicians should ground communication about discoveries in the strategic national vision for the role of the petroleum sector (see Objective 1), to clarify what role the new petroleum sector will have in broader development plans.
- 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 timeframe for production. They should also provide details of dry wells, to help moderate expectations.

  Low oil prices can significantly affect the pace of investment in discoveries or can even lead to shelving of projects. Government and NOC budgets are impacted, too, as a result of reduced upstream payments, and spending on capacity-building and social projects will be reduced.
- In a low-price environment, it is important that the government communicates up-to-date information and assumptions about project development and potential revenue generation.
- Changes to IOC and NOC plans and government expenditure such as those described above must be explained to the public. An emerging producer participant suggested that taking a proactive approach to managing expectations was important: 'Don't wait for people to ask what happened.'

- Government and oil companies should educate citizens about project cycles – for example, the difference between an oil or gas discovery 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, radio talk shows, 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.

AFTER DISCOVERIES

Challenge: Fair distribution of wealth to producing and non-producing regions

The question of how revenues and other economic benefits from petroleum are distributed between central and subnational governments, and between 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. In many new producers, people who live near the location of an oil or gas project make a claim to some kind of direct authority over the management of the project or the revenues that flow from it. These claims can derive from many different sources:

- Traditional systems or beliefs about rights to land or ancestral heritage.
- A belief that local governments are more accountable to communities than national governments, and therefore more likely to make effective and responsible decisions about how to spend natural resource revenues. This perspective is particularly common in communities that were underserved by national-government provided services before the onset of petroleum activities.
- The reality that the risks associated with petroleum activities – including environmental damage, disruption of existing economic livelihoods, migration and other social impacts – are disproportionately borne by those living close to the project site.
- Political opportunism that can be used to stir up passions in the service of narrow personal or interest-group agendas.

Addressing these claims has both a policy and a political dimension for governments in new producer countries. Addressing the policy dimension requires analysing how any decentralization of responsibilities and revenues is likely to impact the quality of service provision and the access that citizens – both inside and outside of producing communities – have to economic benefits deriving from the industry. Addressing the political dimension requires managing expectations, negotiating among competing interests and being transparent about rules and the flows of revenues.

Different new producer countries have made various choices about redistribution of revenue streams to subnational governments or other stakeholders. International experience makes it clear that there is no uniform approach for all new producers to follow. Some countries eschew any special mechanism altogether, leaving all revenue collection and spending responsibilities in the hands of the central government. Others have given subnational governments the responsibility to collect some revenue streams themselves – typically these are relatively small streams such as property taxes, though a few countries allow subnational governments to collect income taxes or royalties. Others centralize revenue collection in the national government, but manage some system whereby a portion of petroleum revenues is transferred back to subnational governments.

In some countries, the factors on the ground make a decentralized system economically optimal or politically necessary. But it is important to note that simply instituting a revenue-sharing system is no guarantee of effective or accountable management of natural resources. Notably, some countries that have implemented revenue sharing in order to mitigate conflict have seen the system become a flash point for additional clashes. In many cases, devolution of expenditure responsibilities to local governments has made public financial management *worse*, via white elephant projects, localized corruption, or local wage inflation and disruption of other sectors.

Recommendations

- Government should give careful attention to the management of public expectations – especially within communities close to project sites. Early and regular communication with a diverse range of stakeholders within these communities is key. This should cover the functioning of revenue-sharing systems, what levels of revenue are possible, and risks surrounding whether and when expected revenues will actually materialize.

- In making decisions on possible decentralization mechanisms, government should clearly identify the goals that a system should promote and be able to prioritize conflicting goals.

  There are several different rationales that can justify a decision to decentralize responsibility or revenues – including compensation for environmental damage, mitigation of the risk of conflict or promotion of equal development across all the regions of a country.

- Government should assess the capacity for expenditure of each region or level of government when making decisions about how much revenue to allocate to them.

  It has been shown that countries that have allocated revenue flows to subnational governments in excess of their actual expenditure responsibilities have increased the chances that these revenues will be spent on projects that provide little economic benefit, or on political patronage. On the other hand, where a subnational government is not accorded sufficient revenues to carry out ambitious public expenditure responsibilities, service delivery will suffer and social dissatisfaction will rise.

- National and subnational governments should ensure accountability mechanisms are in place at all levels of government.

  In many countries local governments are just as prone to corruption and mismanagement as central governments. As such, the same kinds of mechanisms to link public expenditure to the public good are necessary (e.g. transparency of revenue flows, citizen input into public expenditure decisions, monitoring of implementation of spending).

Extra-governmental redistribution mechanisms

Other tools to address the needs and concerns of citizens and interest groups in close proximity with project sites, include promotion of local content (see Objective 5), the promotion of community development agreements directly between extractive companies and communities and, in a few cases, cash transfers directly to citizens or communities.

Objective 5: Increase Local Content and Benefits to the Broader Economy

Challenge: Designing high-impact local content policies

> 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.
>
> *Tony Paul, chairman of the Permanent Local Content Committee, Trinidad and Tobago.*

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 small-medium enterprise development programmes directed at the needs of the petroleum sector. They will also not have the same scale of petroleum sector activity as established producers, one that creates a higher level of demand for skills, goods and services, which could over time be produced domestically.

In addition, against a backdrop of low oil prices, foreign oil companies are focused on cost reductions and will thus be reticent to make significant commitments to local content development. It is particularly important in such situations to make all investments count.

Recommendations[12]

- Governments should develop local content objectives that are consistent with the national vision (refer to Objective 1). This vision will determine priority sectors for development. They should also identify which parties are involved in achieving those objectives (government, oil companies, service companies and EPC contractors) and what each will do.

- Governments should identify the sector's expected needs, beginning with a careful analysis of the resource base (e.g. stage of development – whether at the exploration, development or production phase – and the number and location of discoveries).

- Governments should enlist foreign oil company operators to provide early data on their needs throughout the project development lifecycle and share this data with learning institutions and local suppliers.

  At the licensing stage, oil companies can be asked to provide details on their procurement strategy and to provide annual updates to local suppliers. At the pre-FEED (front-end engineering design) stage, operators can produce estimates of demand and costs, as they

[12] Refer to the New Producers Group's forthcoming paper 'Local content decision tree for emerging producers' for guidance on the steps involved in designing a context appropriate local content policy; Available at: https://www.chathamhouse.org/about/structure/eer-department/new-petroleum-producers-discussion-group-project. Refer to the following resources for good general advice on local content policies: IPIECA's 'Local content: a guidance document for the oil and gas industry' (2nd Edition, 2016), http://www.ipieca.org/publication/local-content; ICMM (2011) Mining: Partnerships for Development Toolkit. Available at: http://www.icmm.com/mpdtoolkit. CCSI conducted a survey of local content frameworks in a number of countries, including legislation, regulations, contracts and non-binding policies dealing with local content issues in the mining and petroleum sectors. Available at: http://ccsi.columbia.edu/work/projects/local-content-laws-contractual-provisions/.

will have received these from suppliers and engineering companies. During the FEED stage, companies elaborate their procurement plan and can provide forward looking plans outlining their needs over the stages of the project. At the point of final investment decision (FID), companies should have detailed estimates of costs and timelines and they will give suppliers only a few weeks to bid for the work.

- Government should assess what capabilities, supplies, infrastructure and financial services are available locally to meet petroleum sector needs. Rather than set a general local content target for the petroleum sector, governments should designate specific targets for each element that can be supplied locally. Government should be strategic about which local goods and services to include in the oil industry's procurement plans.
- To maximize impact of petroleum projects on the economy, government should focus on creating value beyond a specific project. Preference should be given to skills that can be transferred to other economic activities.
- Government should map out a skills development plan, based on the forward needs assessment described earlier. This will enable the country to meet the industry's demand for skills, goods and services when they are needed.

  Timely industrial and skills development is especially important in a country with only one or two fields. It is also difficult for governments in new petroleum provinces to anticipate the demand for skills, goods and services that will emerge at each stage of a project. At the stage of final investment decision (FID) it is already too late to engage potential local suppliers, in terms of helping them access finance and build the required capacity. These matters should be incorporated well before FID is reached.
- 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.
- Government should adopt a simple measurement and reporting system, to minimize the burden for investors and also to support ease of implementation. Government should define activities and targets that are measurable, in order to enable a monitoring, reporting and enhancement loop. There should be regular reviews with the partner companies, and policy should be amended where necessary.

EARLY ISSUE

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

Too often local content policies are designed without sufficient consideration of the resources available nationally and the changing nature of these resources, or without sufficient co-operation with partner companies.

Recommendations

- Government should avoid simply mimicking other countries' local content policies. They should first develop a thorough understanding of the local context (e.g. scale of discoveries, availability of skills and infrastructure, availability of gas in country). They should then assess what skills will be needed through the lifecycle of the project(s). This can be done in collaboration with foreign oil companies (as described in the previous section). This assessment should be the basis for defining local content targets that would be realistic and achievable.[13]
- 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. They should avoid the delivery of turnkey projects run by foreign staff.
- Governments 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.

FUTURE WORKSHOP

Questions for further discussion

Some governments require foreign companies to partner with or contract to companies that are domestically based. In countries where local capacity is low, such rules can facilitate the creation of shell companies that benefit financially without actually contributing to or learning from the project operations. What can governments do to remedy this?

EARLY ISSUE

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.

[13] Refer to the New Producers Group's forthcoming paper, 'Local content decision tree for emerging producers', https://www.chathamhouse.org/about/structure/eer-department/new-petroleum-producers-discussion-group-project; and IPIECA's 'Local content: a guidance document for the oil and gas industry' for further recommendations on setting realistic local content objectives.

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 both to invest in local capacity development and to 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. Such companies are not suited for substantial investments in national development.

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, government 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. These programmes should be developed at the licensing phase, as early coordination can help to ensure that such programmes are well integrated into both the companies' operations and the country's local content strategy.

  Ideally local capacity development commitments should be part of the companies' development plan submitted to government, which requires companies to commit to it.

Objective 6: 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.

AFTER DISCOVERIES

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, former 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

- 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 (see Objective 1).
- 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 their needs in terms of technical information, capacity-building and advice.
- To ensure that assistance is demand driven, government should draft a ‘Terms of Reference’ or roadmap strategy document that defines exact needs. 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 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.[14]

14 The New Petroleum Producers Group organizes mentoring relationships between peers of member countries of the group, focused on sharing of practice on technical policy issues.

EARLY ISSUE

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

The most effective way for an NOC or a ministry 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 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.[15]

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. Eddie 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 commented:

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

[15] For an assessment of the consequences of concentration in specific countries, see Patrick R. P. Heller and Valérie Marcel, 'Institutional Design in Low-Capacity Oil Hotspots', Revenue Watch Institute, 31 August 2012, http://www.revenuewatch.org/publications/institutional-design-low-capacity-oil-hotspots.

Recommendations

EARLY ISSUE

- 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.
- All institutions involved in the regulation and monitoring of the petroleum sector should be aligned and speak to foreign oil companies with one voice.
- It is critical that governments establish 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, the NOC or the regulator. 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.

PRODUCTION PHASE

- 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: Is the NOC's mandate clear and affordable?*), 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 *Challenge: Overcoming entrenched interests in a reform*, also below.)

One discussion group 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.

EARLY ISSUE

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);
- Reviewing work programmes and making recommendations to the state on the approval of the programmes; and
- 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 7 – 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 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 three-fold increase in staff.[16]

- Government must approve an explicit financial model for the NOC.
- Government must invest 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, at the Timorese NGO 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 billion. How can a balance be achieved between such unequal entities?

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, former 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.[17]
- Government officials and other stakeholders should work to ensure that there is strong political will to back the governance system.

[16] Refer to Marcel, V. (2016), 'The Cost of an Emerging National Oil Company', Available at: www.chathamhouse.org/about/structure/eer-department/new-petroleum-producers-discussion-group-project.
[17] Heller and Marcel (2012), http://www.revenuewatch.org/publications/institutional-design-low-capacity-oil-hotspots.

- Governments 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, government 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.

In Ghana, the Environmental Protection Agency (EPA) collects penalties from oil and gas companies for any environmental infractions, as well as fees for permits and certifications required for operations. These revenues allow the EPA to finance its capacity-building. In a low-price environment where companies focus on cost cutting, governments should be cautious not to overburden the industry with permit and certification fees.

Challenge: Is the NOC's mandate clear and affordable?

In emerging oil hotspots, governments and NOCs had in recent years demonstrated much ambition in respect of the technical role of the NOC. Some have set their sights on developing operator capabilities.[18] But this strategy takes time and is expensive. Without a clear mandate and finance streams, NOCs will struggle to establish themselves.

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, 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 further lesson learned in Liberia by Jackie Khoury, former strategic and technical director on the board of NOCAL, current adviser to the board:

> Drastic austerity measures were required at NOCAL when oil prices plummeted. The company's unrealistically high operational expenditures quickly over shadowed its traditional revenue streams, prompting immediate intervention.

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.

[18] An operator has legal authority to explore and produce petroleum resources in a given field. In practice, this requires the company to have the capability to propose a development plan, raise money and manage a large project, including supervising international partners and contractors.

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 project's research paper, 'The Cost of an Emerging National Oil Company', describes typical NOC roles at different stages of development of the resource base, the human resources required for each role and the finance streams available as the geological situation evolves.[19]

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:

- Governments must understand what different NOC roles cost in their own specific national contexts.

- Governments 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 it can realistically carry out and which the state can afford.

  The NOC role should be an important element of the country's national vision for the development of its petroleum resources (see Objective 1).

- Too often, in response to opportunities, NOCs define their role in a haphazard way and without clear instructions from government.The NOC's strategy should set the long-term aims of the company. It should be robust in a low-price environment, appropriate to the company's strengths and weaknesses, and reviewed annually. The company's strategy department and/or a member of the board of directors should be tasked with considering potential opportunities, anticipating possible events and challenging project decisions by asking, 'What can go wrong?'[20]

  With an appropriate strategy, a company will be more able to plan for the shorter term. Thus, the company will be more likely to fare well through commodity cycles.

- 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 be in line with available geological and financial resources.

- 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.

[19] Available at http://www.chathamhouse.org/about/structure/eer-department/new-petroleum-producers-discussion-group-project.
[20] Elizabeth Mitchell, 'NOC Strategy Clinic', New Producers Group training session, March 2016.

- 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.
- Government and NOCs should be strategic about their capacity-building. They should identify the skills available and those required to effectively fulfil the mandate given. Looking forward, they should map out the skills that will be called on at each stage of resource development. To fill any skills gap, they should target the appropriate training, after which they should test the acquisition of skills, and ensure these are applied in the workplace.
- Government must approve an explicit financing model for the NOC. It should be clear about the activities the NOC can pursue and the revenues it can generate from those activities.
- Government should introduce strong accounting and reporting standards, as well as strong codes of conduct for NOC employees and leadership.

  These standards will improve the performance of the NOC, forcing it to match spending to company strategy. Rigorous accounting and reporting also increases the ability of the company to access external finance from oil company partners and financial markets.

Objective 7: Increase Accountability

PRODUCTION PHASE

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 drivers 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 data management, 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.

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 balances 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.
- Government should elaborate a transition plan. This should clarify the roles of existing and new entities, to avoid any overlaps in responsibilities.

Challenge: Weeding out corruption

Corruption creates popular mistrust of government and industry (see *Challenge: Overcoming lack of trust* in Objective 4). It is a challenge to weed out corruption where it has thrived.

The perception of corruption increases above ground risks for investors and pressure on government, civil servants and NOC executives to stop corrupt practices will increase as a result. Regulations, such as the OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions, the US Foreign Corrupt Practices Act (FCPA) and the upcoming regulations requiring US, European and Canadian oil-company disclosure of tax payments on a project-by-project basis, along with international scrutiny of financial transactions, all play a positive role in preventing companies active in these jurisdictions paying bribes. However, as was pointed out in our discussions, some companies are not subject to sufficient pressure from such regulations: foreign and local private companies, NOCs operating abroad and companies only listed in non-OECD jurisdictions.

Recommendations

- Government and oil companies should view corruption as a costly problem, one that creates inefficiencies, undermines the rule of law, prevents competition that could allow the selection of high quality services, can result in fines, criminal liabilities and reputational damage, and distorts the distribution of wealth in society.[21]
- Professionalism and transparency are important antidotes to corruption. Government should increase transparency in transactions and procurement in particular.
- Government should build the independence and competence of the judiciary and other state institutions, to ensure key checks and balances are in place.

  Corruption thrives when the public is apathetic and expects less from industry and government. Education is an important tool in creating an engaged civil society. Some countries in the New Producers Group were suspicious about foreign involvement in or influence over the agenda of civil society groups (in particular, hidden political agendas) and their lack of broader accountability, but they acknowledged they were nonetheless trusted messengers for the public.
- Governments should engage with civil society groups to better inform them and enable them to hold government and oil companies to a higher standard of performance and ethical behaviour.
- Companies in the oil and gas sector (including NOCs) need to address their corruption risks proactively by implementing an effective anti-corruption compliance programme. Companies should be familiar with applicable anti-corruption laws and the related guidance issued by the enforcement bodies. Individuals responsible for anti-corruption programs should also be familiar with the key guidance documents that exist, including the OECD Good Practice Guidance on Internal Controls, Ethics and Compliance.

  An anti-corruption programme cannot guarantee that a company will eliminate all risk of corruption occurring, but it can mitigate these risks through their timely identification and treatment.

[21] The World Economic Forum's Council on the Future of Oil and Gas has written a memo outlining the Trust Challenge of Corruption in the oil and gas sector (April 2016); http://www3.weforum.org/docs/Trust_Challenges_Facing_Global_OilandGas_Industry.pdf.

Objective 8: Safeguard the Environment

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 limited 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', one participant, said.

Risks are high. Government needs 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.[22]

  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, to increase the regulators' ability to understand the technical risks involved in operations.
- Until regulatory capacity is sufficiently established, government 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 the discussion group:
  - Government can create a network of regulators for greater exchange of ideas and information among emerging producers.
  - Government can map out the available technical expertise across their continent (or region) and set up a system to share available technical experts.

[22] One point to consider, in future discussion, is whether the reliance on a goals-based system has 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?

  - Government can ask oil companies for their advice on regulations, while safeguarding their independence (to avoid regulatory capture). They can request opportunities for secondment of staff to the companies to build capacity.
  - Government can seek support from consultants to oversee the regulatory regime. However, this support should not be a substitute for developing national capacity.
- Government and regulators should draw on international standards to write their regulations.[23]
- Government 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.

EARLY ISSUE

Challenge: Prevent flaring

Flaring occurs when the associated gas found in oil (or sometimes condensate) reservoirs is not used by the operator. It is costly in terms of the environmental damage it causes and the missed opportunity to use the gas productively. This may seem to be an issue to be tackled at the production phase, but it is difficult to avoid flaring once production begins without the right legal framework in place. For emerging producers, with only small fields in production, it is particularly challenging to convince companies to invest in developing the infrastructure to capture, transport and transform what are only small amounts of gas. Anticipating and preventing flaring at an early stage of development is key.

A stipulation can be included in production sharing or concession agreements that bans flaring, with penalties for unauthorized flaring (sometimes operators flare for security purposes and exceptional permits are given). Agreements can also require gas reinjection into the reservoir.

FUTURE WORKSHOP

Questions for further discussion

- When is the right time to start planning around the necessary infrastructure to use associated gas?
- How stringent should the regulations be on flaring and associated gas use when an emerging producer tries to attract investors?

Possible productive uses of the gas:

- The associated gas not used by the operator can be sold to the NOC for free.
- If the project sources power from the grid, the operator could be required to assess whether the associated gas could be used to meet its own power needs.
- Make terms of investment in infrastructure attractive to investors (e.g. a gas gathering and processing facility, a gas pipeline, a power plant or an LPG facility).
- Support economies of scale by grouping infrastructure for several fields.

[23] Refer to the International Finance Corporation's Performance Standards, which define the investor's responsibility for managing their social and environmental risks, or IPIECA's 19 good practice documents on oil spill preparedness and response, known as the Oil spill report series.

Annex 1: Further Reading and Useful Governance Tools

Chatham House's first producer-led governance initiative, between 2005–07, led to the elaboration of five principles of good governance. These, too, are salient in an emerging producer context. **Good Governance of the National Petroleum Sector: The Chatham House Document**, edited by G. Lahn, V. Marcel, J. Mitchell, K. Myers and P. Stevens, 2007 and 2009, is available at: https://www.chathamhouse.org/sites/files/chathamhouse/public/Research/Energy,%20Environment%20and%20Development/ggdoc0407.pdf.

The full text report provides examples from country case studies and offers context-specific guidance for the petroleum sector policy- or strategy-maker. **Report on Good Governance of the National Petroleum Sector**, edited by G. Lahn, V. Marcel, J. Mitchell, K. Myers and P. Stevens, 2007, available at: https://www.chathamhouse.org/publications/papers/view/108468.

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: https://www.norad.no/globalassets/import-2162015-80434-am/www.norad.no-ny/filarkiv/ofd/petroleum-sector-governance-check-list.pdf.

The Natural Resource Charter, available at: http://www.resourcegovernance.org/publications/natural-resource-charter-second-edition.

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 World Bank's **Extractive Industries (EI) Source Book**, available at: http://www.eisourcebook.org.

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 with 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.

Natural Resource Governance Institute's **Resource Governance Index**, available at: http://www.resourcegovernance.org/rgi.

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

- Afghanistan
- Angola*
- Barbados
- Belize
- Côte d'Ivoire
- Democratic Republic of the Congo
- Ghana
- Guinea
- Guyana
- Jamaica
- Kenya
- Lebanon
- Liberia
- Madagascar
- Mauritius
- Mexico*
- Mozambique
- Namibia
- Nigeria*
- Norway*
- Papua New Guinea
- São Tomé and Príncipe
- Seychelles
- Sierra Leone
- South Sudan
- Suriname
- Tanzania
- Timor-Leste
- Trinidad and Tobago*
- Uganda
- Uruguay

* Indicates established producers

Acronyms

EI-TAF	Extractive Industries Technical Advisory Facility
EPC	engineering, procurement and construction
FID	final investment decision
GNPC	Ghana National Petroleum Corporation
INP	National Institute of Petroleum (Mozambique)
IOC	international oil company
NGO	non-governmental organization
NOC	national oil company
NOCAL	National Oil Company of Liberia

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.

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The *Guidelines for 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, in Dar es Salaam, on 30 June – 2 July 2015, and in Naivasha, Kenya, on 2–4 March 2016. Other topics to be considered in future workshops are outlined in this document in order to frame discussions going forward. These are flagged as 'questions for further discussion'. The Guidelines are a living document.

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