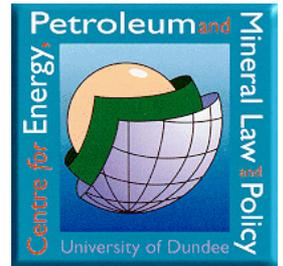




**CHATHAM HOUSE**



# **REPORT ON GOOD GOVERNANCE OF THE NATIONAL PETROLEUM SECTOR**

**April 2007**

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### **Editorial note**

*The authors worked as members of an editorial group led by Valérie Marcel, including Pedro Gómez, Willy Olsen, and Prof. Isabelle Rousseau, who reviewed texts and made valuable contributions to both this Report and the related Document. All participants in the project's workshops were invited to comment on the final draft of the Report: many did so, some at length, and all to good effect. The authors thank those who responded, and especially Prof. Imad Al-Atiqi, Alejandro Litovsky, Dr Bright Okogu and Abdullatif Al-Othman, for their valuable comments and advice throughout the drafting process. In a subject of this breadth it is impossible that everyone is satisfied with every word, and this was not sought. The authors are solely responsible for any opinions expressed in the present text, and for any errors or omissions.*

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## INTRODUCTION

### **About the Good Governance of the National Petroleum Sector project**

Beginning in February 2005, Chatham House, London and the Centre for Energy, Petroleum and Mineral Law Policy (CEPMLP) at Dundee University facilitated a dialogue between participants from government, national and international oil companies, NGOs and financial institutions from 23 developing and developed oil- and gas-producing countries.<sup>1</sup> The conclusions of this dialogue have been supplemented with in-house research on international governance practices. The main conclusions of the project to March 2007, and the 40 general governance benchmarks for the petroleum sector comprised within this *Report*, are set out in *Good Governance of the National Petroleum Sector: The Chatham House Document* (available at [www.chathamhouse.org.uk/goodgovernance](http://www.chathamhouse.org.uk/goodgovernance)).

This *Report* sets out the analysis and discussions on which these conclusions are based, and provides examples from country case studies and offers checklists and guidance for the petroleum sector policy- or strategy-maker.<sup>2</sup> It is a 'living text' for 'good governance' debates around the world, and will be revised to reflect future discussions and comments from petroleum sector stakeholders.

Participants in the project were clear that, though principles might be universal, practice depends on the national context and the state of development of the sector. We hope that the project will promote a greater awareness of the rich breadth of experience upon which producing countries can draw and provide a starting point for making practical improvements to governance systems.

### **Background**

In developing countries with substantial oil and gas resources, the petroleum sector is the key to generating wealth and creating a sustainable economy and positive long-term human development. Producer governments and citizens are concerned with dependence on volatile oil revenues, and current high oil prices have both raised the stakes and increased public expectations. The difficulties of managing oil revenues efficiently and fairly, the requirements of economic liberalization and pressure from evolving international standards have all contributed to an increasing focus on the governance of the petroleum sector and how it performs its role in the economy.

The *Document* and *Report* are not management textbooks. Their purpose is to help policy advisers, officials, industry executives, and civil society advocates in producing countries to identify possible improvements in their petroleum sector governance.

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<sup>1</sup> The project was led by Dr Valérie Marcel with Professor Paul Stevens, and a team comprising Pedro Gómez, Glada Lahn, John Mitchell, Dr Keith Myers, Willy Olsen and Professor Isabelle Rousseau.

The project has focused on the relationship between NOCs and their governments. Getting this relationship right was considered the key to successful management of petroleum resources for the majority of our participants. However, we should note that not all producing countries have an NOC and we hope that the *Document* and the *Report* will also be useful to new producers whose governments are tasked with designing a governance system for the sector from scratch. It should also be made clear that we have tried to troubleshoot for potential problems in petroleum sector governance in order to help producers identify and address these. This does not imply that there is any intrinsic problem with the NOC model itself, but rather, that, given the parameters of its national mission (see Part 2, [Section 2](#)), the NOC requires the development of a specific set of governance guidelines and benchmarks not always covered by those relating to private corporate entities. For wider civil society also, the relationship between government and NOC is critical to how wider civil society focuses its attention on the petroleum sector.

There is a wide range of producer experience and thus a great interest displayed from producers in learning from one another and in sharing best practice. Participants were particularly interested in exploring the principles, guidelines and benchmarks to be applied in relations between the national oil company management, the executive governments, and public regulatory agencies in a variety of national contexts. This is a broader view of governance than is addressed in separate initiatives— such as the Extractive Industries Transparency Initiative (EITI) and Publish What You Pay (PWYP), which have focused on resource revenues, and the International Monetary Fund's *Code of Good Practices on Fiscal Transparency*, which focuses on fiscal processes in the government sector. These obviously form part of the orchestra of good governance and engage several producer NOCs and governments as well as international companies and civil society generally.

## **The process**

So far there is no international standard or measure of good governance for the petroleum sector. It is not obvious what international organization would provide a formal institutional base for the development of benchmarks and indicators of good governance practice. The Chatham House-CEPMLP project provides an informal forum in which officials, and executives from the producing countries can share their knowledge and shape common principles and guidelines in discussion with experts and representatives from national and international civil society and institutions. The project has:

- Brought producers together through a series of three workshops in constructive dialogue about the governance of their national petroleum sectors.
- Established as broad a consensus as possible on what constitutes good governance.
- Surveyed current governance practice worldwide, identifying key governance arrangements and identifying the criteria for their effective implementation.

In future, the project aims to communicate the key findings more widely among those involved in, or concerned by the governance of the petroleum sector, and to involve a wider range of countries and organizations.

## **Structure of this Report**

This *Report* has two parts.

**Part one** answers the question *what are the requirements of good governance of the national petroleum sector?* It presents five principles of good governance that should guide sector organization and practice, and identifies the key governance functions required in the national oil and gas sector.

**Part two** focuses on *the practice of petroleum sector policy-making and implementation of policy in particular national contexts*. It offers suggestions on how to address challenges and improve governance. This section is structured via five key governance tasks facing oil and gas sector policy makers:

1. Defining authority and responsibility for setting and meeting objectives
2. Choosing objectives
3. Meeting objectives
4. Ensuring objectives are being met by others
5. Enabling good decisions.

## PART ONE: WHAT ARE THE REQUIREMENTS OF GOOD GOVERNANCE IN THE NATIONAL PETROLEUM SECTOR?

The project's ongoing producer dialogue has helped establish a common understanding of five **universal principles** of good governance which transcend national boundaries: clarity of goals, roles and responsibilities; sustainable development for future generations; enablement to carry out the role assigned; accountability of decision-making and performance and transparency and accuracy of information. There was also agreement on identifying four key governance functions: **policy-making, strategy-making, operational decision-making and monitoring and regulation**, and on who the key **actors** in the governance of the oil and gas sector are: namely the **State/Government, people and society and operators and investors**.<sup>3</sup>

There was general agreement on the importance of the **national context** on how governance functions are implemented and organized. Case studies contributed by participants demonstrated how much countries differed in their governance processes. These may involve, in different ways and with different weight, the executive government, the national central bank, a petroleum advisory council, official regulators, local authorities and the legal institutions. Parliament, trade unions, the media, civil society groupings etc. may represent people and different elements in society. The investor/operator grouping includes the national oil company, local private-sector companies, international oil companies and financial institutions. An NOC can be more of a government agency than an operating company. In some countries trade unions may exercise a strong role in the state legislature and have representation on the Board of the NOC. Identifying and understanding the national context is therefore a first step in developing strategies for improvement of governance in the petroleum sector.

### NATIONAL CONTEXT

All those involved in this project agreed that the national context is important in defining how the principles of good governance are applied, and how the national context may change over time.

In working with the *Document* and the *Report*, it may be helpful for readers from the producing countries to evaluate which national context they are dealing with. They can estimate where their country is located in the worksheet below, which characterizes in simple terms these key categories of national context that affect governance of the petroleum sector. These national context categories will be fleshed out in Part Two of the Report.

NATIONAL CONTEXT	HIGH				LOW
Centralization of institutional power					
Public trust in state institutions					
Level of economic development					
National prosperity					
Dependence on petroleum					
Pressure of population					

<sup>3</sup> For further discussion of the principles, functions and actors, please see K. Myers and G. Lahn (2005), 'Interim Report: Good Governance of the National Petroleum Sector'. Available at [http://www.chathamhouse.org.uk/pdf/research/sdp/GGInterim\\_report.pdf](http://www.chathamhouse.org.uk/pdf/research/sdp/GGInterim_report.pdf)

Competence of NOC					
Dominance of ministry of petroleum					
State control of resources					
International obligations (OPEC, WTO)					
Clear & detailed legal framework					
Weight of history					

## THE PRINCIPLES OF GOOD GOVERNANCE

The principles of good governance are high-level principles which will be used to develop criteria, measures, and expectations that form the basis of the good governance guidelines.

### 1. Clarity of goals, roles and responsibility

Whatever the organizational model for governing the petroleum sector, there is consensus among producers that *clarity of goals, roles and responsibilities between agencies* is crucial. Lack of clarity can lead to conflicting agendas, duplication of effort and policy paralysis. For each policy, strategy or operational decision there has to be clarity on the intended outcome of the decision, who will be involved in making it and how. Those involved in the decision-making process should know who is responsible for providing input, recommending a course of action, approving the decision, implementing the decision and monitoring the implementation.

**Figure 1: A generic demarcation of governance functions and accountabilities**

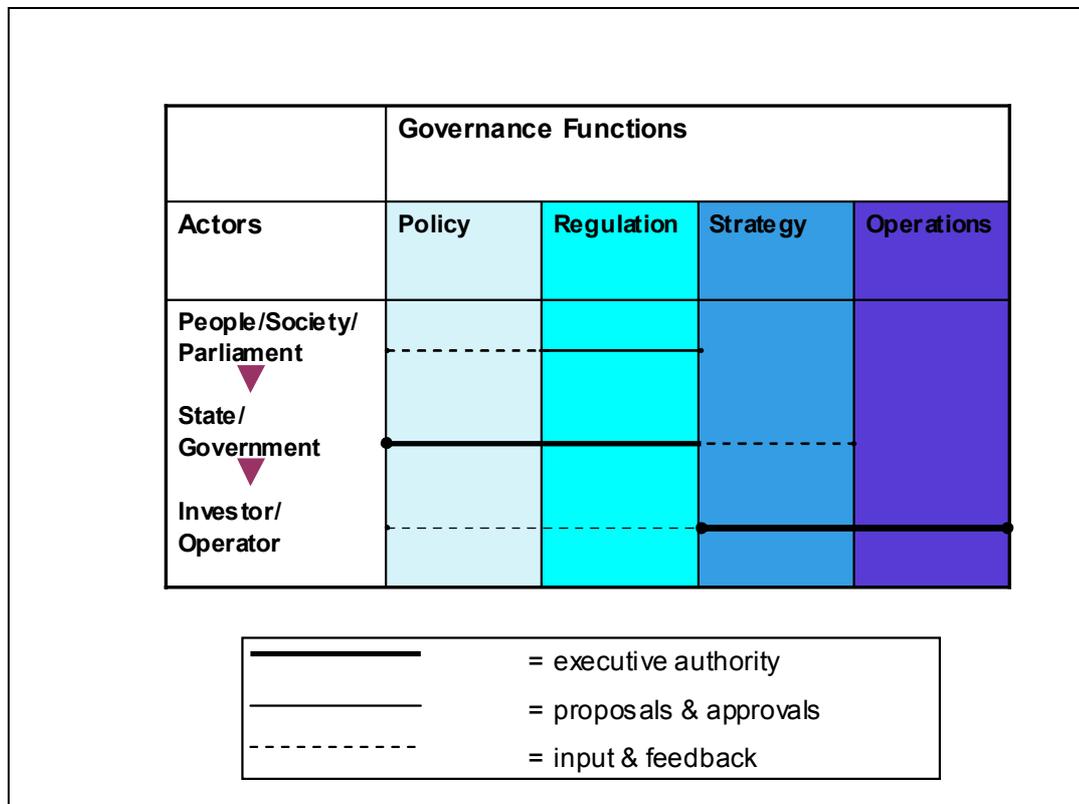


Figure 1 shows a generic model for a clear demarcation of roles between the principal actors in oil and gas sector governance. Society delegates responsibility for policy-making to government which, in turn, delegates responsibility to operating companies to carry out oil and gas operations. The people/society hold government accountable for the policies. Government holds the operators accountable for implementation of those policies.

Several actors may be involved in the same function, each with a specific role within the decision-making process. Government has executive authority for sector policy and regulation. The investors/operators provide the information and feedback to enable appropriate regulatory standards and policies but are chiefly responsible for strategy-making and operations. People/society contribute to policy-making debate and are ultimately responsible for the approval of the chosen policy and can assist in the monitoring and regulation of operations in the sector through media investigation, industry analysis and direct communication with the sector.

Key issues are:

- The assignment of goals, roles and responsibilities
- The boundaries between policy and strategy-making
- The location of responsibility for regulation
- The purpose of a NOC
- The relationship between NOC and state
- The IOC role (where applicable)

There is often confusion between the ministry of petroleum and the NOC over responsibility for policy and strategy making and what the difference is between the two. For instance, if the Minister sits on the NOC board of directors, s/he must distinguish between the role of *sovereign owner* (on behalf of the people) when setting energy policy and the role of *company shareholder* (profit and value-creation) when engaged in commercial decision-making.

Where to situate industry regulators and what powers to assign them are crucial questions for many producers, especially those undergoing a change such as opening up the sector to competition. It was agreed that the optimal arrangement would allow the operator to concentrate on operating and the regulator to be objective about compliance. However, the degree to which the *regulator must be separate from the NOC or from the ministry of petroleum* is controversial.

The effectiveness of the regulatory function depends on the capacity and authority of the regulator and the willingness of other actors to defer to its authority. There is always a balance to be drawn between the need for control through regulation and the need for operational efficiency. There are a number of organizational models available and the Norwegian and Malaysian models can be seen as different ends of a spectrum. Norway separates *policy* (ministry), *regulation* (government-appointed and statutory bodies: National Petroleum Directorate, Petroleum Safety Authority, State Pollution Authority) and *operations* (NOC) into different entities. In contrast, the Malaysian model has no ministry. Policy, regulation and operations are housed in separate departments of a single national oil company whose head reports directly to the Prime Minister.

Achieving national development goals is feasible without an NOC but many producing countries choose to have one. The issue then becomes how much

autonomy to give it, how commercially orientated it should be and how it can evolve with changing national needs.<sup>4</sup>

The IOC role in a host country's governance is clearly limited - it seeks to achieve an economic result and operate in accordance with its contractual obligations and with national and international law. What IOCs choose to do in the country beyond their contractual and legal obligations falls in the arena of corporate social responsibility (see [Section 2](#) on Sustainability).

## **2. Sustainable development for the benefit of future generations**

As a capital- rather than people- intensive industry, dependent on finite resources, sustainability should be at the heart of petroleum sector policy-making. Sustainable development policies address meeting the needs of the present without compromising the well-being of future generations.

The key issues include

- Sustainable resource management
- Revenue management
- Commitment to education within and outside the sector
- Support for the non-oil economy
- Corporate Social Responsibility and its role

For the NOCs, the careful management of petroleum production and minimizing environmental impacts are considered part of their principal contribution to the sustainable development of their country. IOCs can assist by sharing good environmental practice and technology. The impact of international agreements, such as the Kyoto Protocol, on national-level decision-making is at present unclear for many producers and has yet to be discussed.

It is widely accepted that prudent management of petroleum revenues is vital in order to neutralize the effects of windfalls during times of high oil prices and ensure long-term prosperity.<sup>5</sup> Intergenerational investment funds are considered useful, provided they would be protected from short-term political exploitation. By providing guarantees that future governments will be constrained in their expenditure decisions, present governments can choose better, more far-sighted policy options. For these effects to work, withdrawal procedures should provide for high levels of transparency.

Education, training, experience and business opportunities at operating level can feed into the development of the nation as a whole, growing human capital, promoting the local private sector and helping to diversify the economy away from petroleum. NOC linkages with IOCs for knowledge, skills share and technology transfer can be designed in a mutually beneficial way.

On the issue of how the industry can create such opportunities, producers agree that policy-makers can be expected to set the operator *fair and realistic local content targets* adapted to the local skills base and supported by an implementation plan. Enforcing a quota or offering too large a subsidy on local services could discourage competition and lead to inefficiency. Thus policy-

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<sup>4</sup> See Valérie Marcel (2005) 'Good Governance of the National Oil Company', Chatham House. Available at <http://www.chathamhouse.org.uk/pdf/research/sdp/GGjmc.doc>

<sup>5</sup> See P. Stevens. (2005) 'The Management of Revenues', Chatham House. Available at <http://www.chathamhouse.org.uk/pdf/research/sdp/GGps.doc>

makers should begin with a thorough assessment of current capabilities and consultation with the operators.

For the NOC, outsourcing for services and privatizing non-core activities may help to diversify the country's economy, making it more resilient. It may also lead to more efficient acquisition of services, provided that there is a degree of competition and that the outsourced or privatized enterprises have access to the best technology and supply standards.

The voluntary role that the IOC plays in the national development agenda is usually termed corporate social responsibility (CSR). At its most basic, CSR is the operator's delivery of goods beyond tax for the host country and the mitigation of risk and legitimacy to operate for the company. Requirements for constructive CSR strategies include finding a common interest between commercial and national development needs and coordinating projects with the relevant levels of government and community recipients. The IOC will need to take into account the political and development environment of the host country and make a careful assessment of the potential impact of a CSR project. Further work will look at how best to coordinate local government, national government and companies' core business interests.

### **3. Enablement to carry out the role assigned**

Enablement is a major issue for producers because there is often a mismatch between where skilled people are concentrated (in the operating companies) and where they are also needed (in the ministry, regulator or broader government). Likewise, the remit of authority and financial capacity of an actor may not be sufficient to meet the objectives and responsibilities assigned to it. For optimum performance, each actor must have access to the necessary means in terms of authority, financial resources, information, human capacity (skills, knowledge, experience etc.) and supporting processes.

Key issues are:

- Delegation of decision-making authority
- Institutional capacity
- Rationalizing national and commercial goals for the NOC
- Fiscal and budgetary relationship of NOC to State
- How is NOC performance incentivized
- Making the regulator effective
- The requirements for governance reform

Delegating decision-making authority and reinforcing capacity are the first steps in the process of enablement. Particular caution is needed to specify the boundaries of fiscal systems, decision-making, approvals and regulation. These in turn require a high level of transparency and inter-agency communication ([Section 5](#) on Transparency).

For an NOC, national social obligations and commercial objectives can be in conflict. Producers agree that, as the government's capacity grows, it should normally take over most social functions of the NOC so that the NOC can focus on optimizing resource development. The NOC/operator, for its part, needs to provide reliable information and transfer knowledge to government to enable government to choose best policies for the petroleum sector.

NOCs are sometimes exposed to policy volatility that disrupts the implementation of long-term strategic plans. A degree of financial and decision-making autonomy can shield the NOC from policy volatility but needs to be balanced against the need for accountability (see below). If money is allocated year by year within the government budget, NOC investment and long-term planning is difficult. The clear preference for many NOC managements would be a *corporatized NOC* with its own balance sheet and the right to retain revenue for reinvestment. Likewise, operational decisions are likely to achieve the best results when made by competent technical and commercial management within a clear regulatory framework and a minimum of day-to-day political interference or bureaucratic procedures.

To enable the regulators to regulate the industry, they need authority, a strong regulatory/legal framework and have the knowledge, experience and skill to do the job. However, this must be balanced by the danger of 'over regulation', inhibiting the operator's competitiveness. How to reform systems of governance towards greater enablement is perhaps the greatest challenge.

#### **4. Accountability of decision-making & performance**

Accountability of decision-making and performance provides assurance to society that decision-makers (individuals and institutions) are identified, that they explain their decisions to a higher authority, and that their performance is assessed objectively. Without accountability, corruption and malpractice can flourish and good practice can go unrecognized. Accountability requires clear delegation, capable institutions and mechanisms of enforcement. In the petroleum sector, the operators are accountable to their shareholders (in the case of an NOC, this is the government, to which society entrusts natural resources). The government is accountable to society.

Key issues are:

- Mechanisms for holding decision-makers to account
- Benchmarking NOC performance
- Incentives for greater accountability
- The role of parliament and civil society
- Evaluating CSR/national mission spending
- The impact of stock exchange listing on corporate accountability
- National versus regional/international accountability

Mechanisms for ensuring accountability include regulation, performance contracts, disciplinary processes, industry audits and channels of communication with society and the law. A performance contract between government and operator may foster accountability by making performance targets and standards explicit. A system of benchmarking to compare performance between NOCs is recognized as potentially helpful in encouraging improved performance. However, this would be challenging to implement owing to the wide variety of geological and political contexts in which NOCs operate and the lack of transparent data.

Encouraging more accountability within a system, while likely to gain support from the general public, will draw resistance from some within the sector. To reform a system towards greater accountability, compliance incentives may be required. External benchmarking, anti-corruption initiatives that publicize results, competition and market mechanisms (e.g. external borrowing, selling debt, stock exchange listing) are some of the measures we have discussed.

Where a parliament and/or civil society groups exist, they can play an important role in accountability. Their involvement can increase people's understanding of how the oil and gas sector can benefit them and provide valuable checks and balances on practice. The media is considered an important monitoring and investigative instrument in many countries. Specialist parliamentary committees can be part of the auditing process and special interest NGOs can help to communicate society's expectations to the sector. Parliamentary powers to hold the sector to account and the relationship between concerned NGOs and agencies within the sector will differ from country to country and require further exploration.

In addition to their core business, operators usually invest in some kind of social or infrastructure building projects. For the NOC, this can be understood as 'national mission' spending; for IOCs, it comes under corporate social responsibility. It was agreed that this investment should address the country's development priorities. Therefore, measuring its effectiveness in terms of those priorities is essential (see also [Sustainability](#) above).

## **5. Transparency and accuracy of information**

Whatever the precise mechanisms of governance and accountability in a particular national context, their effectiveness depends on reliable, relevant and timely information. Those charged with defining roles and objectives for the sector must be aware of the capabilities and interests of each responsible authority; in turn, actors must be aware of the authority they are permitted and their limitations. Transparency not only removes the cover for possible corruption, but enables good decisions, allows rapid intervention to correct problems in the system, and builds trust. In our discussions, a distinction was drawn between internal transparency (amongst institutions directly involved in petroleum governance) and external (sector to public) transparency.

Key issues are:

- Transparency of data between government and operator
- Transparency beyond the petroleum sector
- Justifiable confidentiality
- Transparency in licensing
- Transparency in procurement
- Incentives to make transparency initiatives work

There has been broad consensus over the necessity of internal financial transparency between ministry, treasury and NOC (including petroleum revenue, the NOC budget and expenditure). Where IOCs are spending money from joint ventures on community projects, this information also needs to be made available to the government to ensure that there is value for money and coordination with other policies.

Questions remain over what other information should be divulged externally. Are there reasons why some information should be shared only between government and company? What should be made available to a parliament/general public? Two big incentives for government in disclosing data are a) conferring a sense of public ownership, and therefore increasing social stability and security; and b) earning international credit and credibility. It is accepted that corporatization of the NOC, stock exchange listing and international competition can all lead to greater transparency.

Publishing the criteria for assessing bids, holding open bidding rounds for both exploration licensing and tendering, and publishing petroleum agreements can both raise public confidence in the system and improve the financial benefit for the producing country. Nevertheless, transparency of licensing alone does not guarantee the most beneficial contracts. This will depend on how well-devised the bidding criteria are.

More transparency tends to be accepted by producers as positive on condition that publication is accompanied by explanation and education to minimize the potential for misunderstanding and the manipulation of data statistics.

## **KEY GOVERNANCE FUNCTIONS**

In this section we provide definitions for the four governance functions required in the national oil and gas sector. Development of a common language is important, as there is often confusion as to what these functions mean. In each case we are referring to the function at a national, sector level rather than at a corporate level.

### **1. Policy-making**

Public policy typically comprises a set of objectives, laws, plans, political actions and standards of behaviour that aim to achieve goals in the national interest. As petroleum is a national resource, its exploitation requires policy to ensure maximum benefit to the country and its society. The petroleum sector also has to operate within a national policy agenda which sets out national goals, priorities and direction. In addition to policy specific to the petroleum industry, broader public policy may impact on the oil and gas sector. This could include, for example, measures to encourage private-sector involvement or increase the employment of nationals.

### **2. Strategy-making**

The strategy function concerns how the oil and gas sector will deliver national policy objectives (e.g. the pace and means of oil and gas development, the programmes to build local capacity, priorities for the use of scarce resources, responses to uncertainty etc.). The distinction between policy and strategy functions is important, but is often unclear.

### **3. Operational decision-making**

Operational decision-making involves managing the more short-term on-the-ground industry operations within the strategic framework. The organizational model for the operations function will reflect the role and degree of autonomy of the national oil company, the role assigned to international oil companies and the organization and effectiveness of the regulatory function. There is sometimes confusion as to which decisions are operational and which strategic when responsibilities are unclear.

### **4. Monitoring and regulation**

The monitoring and regulation function provides assurance that policies are being adhered to and national goals are being achieved. It compensates for the inevitable gap between the knowledge of the policy-makers and that of the operators. Monitoring and regulation includes financial and technical oversight,

the auditing of data and the holding of agencies to account. It may also include the setting of industry standards and performance measures.

## PART TWO: SETTING AND ACHIEVING OBJECTIVES FOR THE PETROLEUM SECTOR

This section focuses on objectives for the oil and gas sector, as they lie at the centre of the project's discussions on good governance. Five sets of questions allow us to examine the practical challenges related to the implementation of the principles of good governance.

	<b>Governance tasks</b>	<b>Governance principle</b>	<b>Related questions</b>
1	Defining authority and responsibility for setting and meeting objectives	Clarity of goals, roles and responsibilities	Who sets objectives, targets and regulations for the sector? How are functions distributed and roles defined? How is authority delegated and how are responsibilities defined?
2	Choosing objectives	Sustainable development for the benefit of future generations	What objectives are chosen for the sector and why? How do objectives and regulations contribute to sustainable development?
3	Meeting objectives	Enablement to carry out the role assigned	What does each actor need to perform his or her role effectively? What can each actor do to help enable other actors?
4	Ensuring objectives are being met	Accountability of decision-making and performance	How does the government/shareholder know objectives are being met? How can decision-makers be held to account for compliance and performance?
5	Enabling good decisions	Transparency and accuracy of information	What information do those involved in the decision-making process need to make good decisions?

For each of the above tasks, each section of Part Two:

- Explains the applicability of the relevant governance principle to the task
- Gives a set of generally applicable benchmarks to help assess governance practice in this area and adhere to the appropriate principle
- Describes governance practice within different national contexts and explains the challenges related to certain practices

- Where possible, suggests in a box '**key questions**' to consider when seeking to improve governance within the parameters of existing national context
- Where possible, suggests in a '**tool box**' measures which might improve governance, if required. Some tools are alternatives, some are complementary, while some may work better in one national context than another.

In this *Report*, **objectives** refer to the goals that are designed to drive and guide companies active in the petroleum sector. Objectives can be aspirational or binding. In the case of international oil companies, binding objectives (for drilling, development, etc.) are often laid out in the licensing terms or in the negotiation of the contract. For NOCs the objectives may be more flexible. Government should make the relative importance of these objectives clear to the operators – national or international-clarifying, for instance, which objectives override others. By contrast, **targets** are specific, operational goals for the oil and gas business. These include reservoir depletion rates, production volumes, as well as cost and productivity targets. **Regulations**, such as HSE regulations, labour laws and accounting laws are set by government (not necessarily by the ministry of Petroleum) and are compulsory. Companies can, in some instances, set their own targets, whereas setting objectives and determining regulations is a political responsibility.

As explained earlier, the **national context** is a critical factor in our analysis. There is no universal model of good governance which can be applied to all producing countries. The national contexts of producers affect governance structures and shape the options available to decision-makers for improving the governance arrangements in the country. *This report therefore suggests improvements to governance which can be adapted to various national contexts.* Appendix 1 lists important national context factors which underpin the analysis in Part 2 of this Report.

## 1. DEFINING AUTHORITY AND RESPONSIBILITY FOR SETTING AND MEETING OBJECTIVES

This section relates to the principle of clarity of goals, roles and responsibility in policy- and strategy-making. Those involved in the development of this Report agreed that a key factor to emerge from all three workshops was that clear assignment of responsibility for setting objectives, targets and regulations for the sector and the national petroleum company is crucial. This includes clarity on the distinction between responsibilities for the functions of policy- and strategy-making. Lack of such clarity can lead to conflicting agendas, duplication of effort, inefficient decision-making and policy paralysis. However, clarity is not enough: to be able to effectively carry out his or her role in setting objectives, targets and regulations each actor needs the appropriate capacity, authority, information and human resources (skills, knowledge, experience etc.).

**Chart 1: Setting objectives for the petroleum sector**

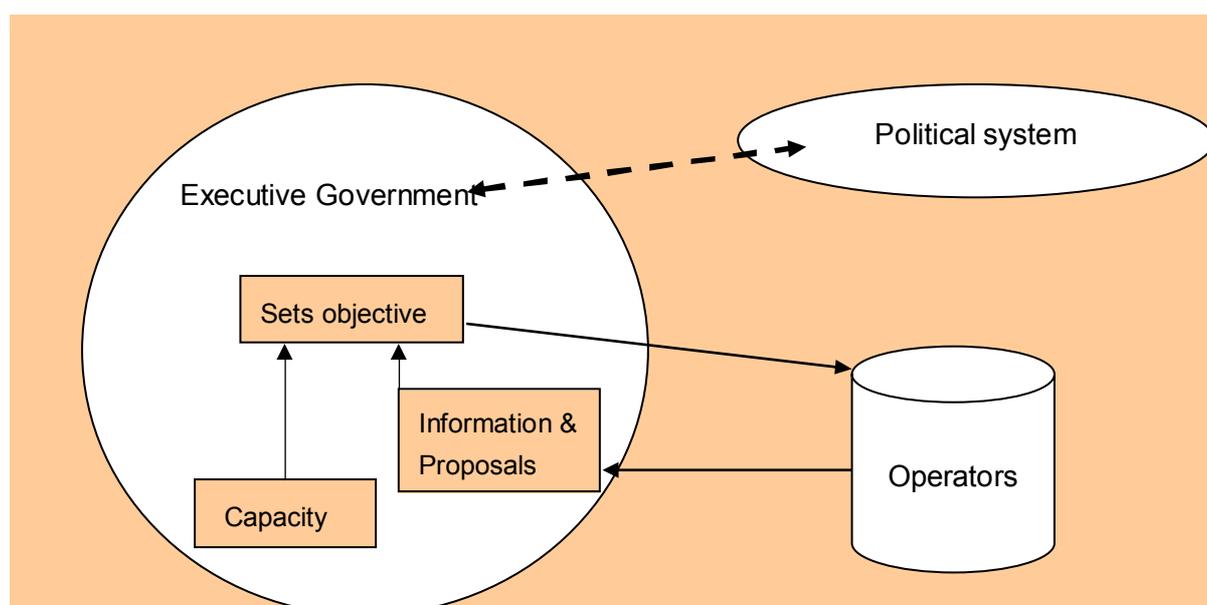


Chart 1 shows the basic relations between actors necessary for setting objectives for the petroleum sector: the operational expertise – whether through the NOC or private companies and the regulator where one exists – must provide government with industry information and policy-makers must have the capacity to understand oil sector information and evaluate how the sector can best contribute to national objectives. The NOC and regulator also have a role in contributing to policy proposals. The political system meanwhile, should guide the executive government on national priorities and provide some checks and balances on whether proposed objectives for the oil sector are being met in an acceptable manner.

## Benchmarks for clarity of goals, roles and responsibilities

- National development objectives and the role of the oil and gas sector in contributing to those objectives are clear and well communicated to all stakeholders.
- The roles of (a) policy-making, (b) strategy-making, (c) operational decision-making and (d) monitoring and regulating industry activity are clearly defined and assigned to individuals and/or agencies.
- Responsibility for the regulatory functions is assigned to allow for objective, fair and independent oversight, to avoid conflicts of interest and to minimize duplication of effort.
- Where there is an NOC, its purpose and mission are well defined and its objectives are transparent and aligned with national development goals.
- The NOC's operating role is defined in a way that allows commercial and non-commercial responsibilities to be distinguished, and prioritized if necessary.
- The legal framework for the NOC clearly defines the rights and responsibilities of shareholders and other stakeholders.
- The governance structure specifies the role of the NOC board, the limits of its authority, what it is accountable for, and to whom.
- The legal, fiscal and regulatory framework in which foreign and private operators/service companies will operate and any obligations to the country beyond their agreed work programme are clearly defined in their contracts.

The following national context categories play an important role in determining who is responsible for setting objectives, targets and regulations. These categories can also help explain why some countries suffer from a lack of clarity in this important governance function.

### 1.1 Relationship between government and NOC

Setting the objectives for the sector should, in principle, be a government responsibility. There are inherent asymmetries between government and NOC. The government has ultimate authority, but the NOC has technical and commercial information and evaluation capacity. Governments set the rules of the game through policy objectives and regulation. The power of NOCs comes from their knowledge of the industry and as businesses, their managers are usually inclined seek autonomy to pursue corporate as well as national goals. These power (and information) asymmetries are not static. They may be in the process of being redefined and the balance of power can change.<sup>6</sup> The balance may differ according to topic. Governments normally dominate decisions on depletion policy and production targets (e.g. through OPEC quotas), though the company may offer advice. On technical matters, such as project specification or day-to-day trading, the companies dominate. Formal delegation of capital project decisions to the company varies in practice from a high degree of delegation (e.g. to the Saudi Aramco Executive Committee) to a low degree, where relatively small projects require government approval (e.g. Kuwait).

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<sup>6</sup> Valerie Marcel (2006), *Oil Titans: National Oil Companies in the Middle East*, Washington, DC: Brookings & Chatham House, p. 4.

### **1.1.1 Government-dominated process (top-down):**

Where the ministry of petroleum is institutionally strong, it has often developed a good knowledge of the sector's capabilities and is able to set realistic objectives for the national oil company. In other cases, the leader of the country has become directly involved in setting (some) objectives for the national oil company.

#### **Key questions for locating weaknesses in top-down process**

- Are political objectives imposed in commercial and technical decisions (e.g. determining projects, wage settlements, foreign sales and investment contracts)?
- Does government intervene in management appointments below formal interface of board and senior executives?
- Does government have sufficient industry data to set detailed performance targets?
- Do changes of minister or senior ministry officials lead to policy uncertainty?

#### **Toolbox for improving top-down process**

- Clear specification of objectives to management
- Ex ante agreed processes for (e.g.) awards of contracts, management appointments
- Routine evaluation of results, using agreed definitions, with key data supported by independent auditing
- Evaluation of costs and benefits of government intervention in industry activities
- Good flows of communication between NOCs, IOCs (if present) and ministry.

### **1.1.2 Company dominated process (bottom-up):**

Where the company dominates the ministry in terms of knowledge and capacity, it may take the lead in determining broad objectives which affect national strategy for the sector (e.g. Venezuela in the 1990s, Suriname). While the operator/s may be better equipped to propose industry-specific policy – particularly in the early stages of petroleum sector development this system risks the company pursuing its own business objectives at the cost of the government's development policies. This is especially relevant where NOC operations overseas deepen the information asymmetries and allow ever-greater rent-seeking. It also reduces government capacity and therefore accountability over management of the industry.

Responsibility for setting company objectives and targets tends to be internalized when NOCs become partially privatized (e.g. Brazil and

Norway). In these cases, the company board has responsibilities towards private shareholders and must publish financial and operating information according to the relevant stock market rules. This limits the freedom of the government to intervene 'behind closed doors' beyond general issues of policy.

### Key questions for locating weaknesses in bottom-up process

- Does industry management serve its own company and employees' (and contractors) interests at the expense of state revenues ('rent-seeking')?
- Do company and government ethical standards differ?
- Do company plans and actions conflict with government policy (e.g., on regional development, foreign relationships, production rates)?

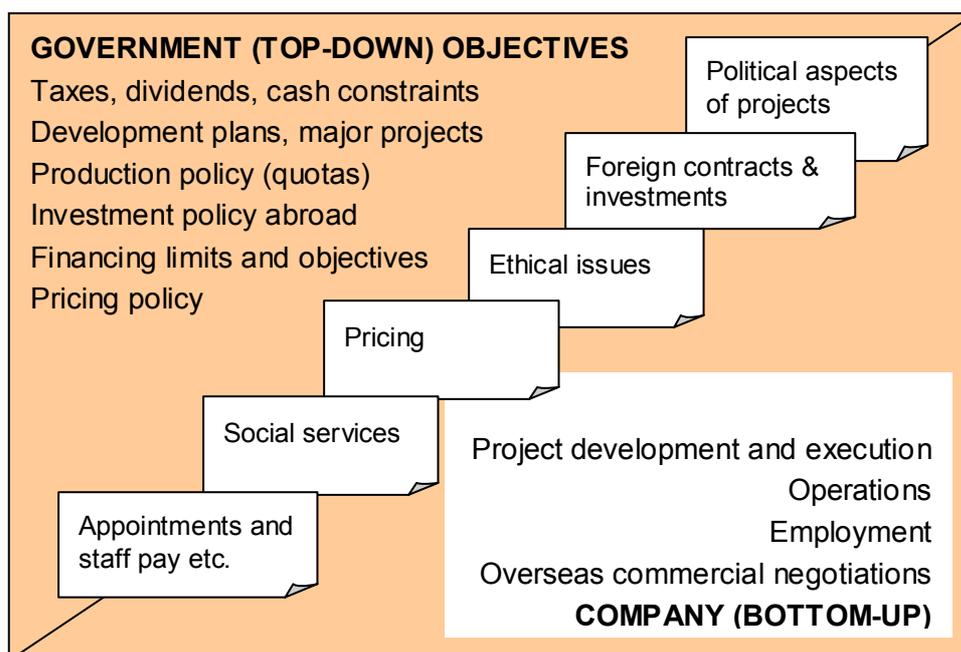
### Toolbox for bottom-up process

- Increase competence of relevant departments of government
- Independent auditing and reporting to government
- Clear statement of national policies affecting the company

#### 1.1.3 Shared responsibilities:

Responsibility for setting objectives and targets for the industry (whether IOC or NOC) is often *shared* between government and the NOC. This area of shared responsibility sometimes leads to confusion, particularly in the challenging topics shown in the boxes of the following chart.

**Chart 2: Shared responsibilities between government and operator**



In cases where there is confusion of responsibilities, the conflicting objectives and targets must be prioritized. Clarity can be achieved through clearly understood rules for establishing priorities in each area, with corresponding exchange of information and discussion of purpose. Normally, government should order the priorities of the objectives it gives to the sector (given information and discussion about operational realities). The priorities for technical and operational targets, meanwhile, can usually be set by the operator within the framework of higher-level government priorities).

**Key questions for shared responsibilities (for each of the topics in the boxes in Chart 2)**

- Where are conflicts debated? How are impasses resolved?
- Where are agreed objectives set out and communicated?
- How is performance measured?

**Toolbox for shared responsibilities**

- Regular joint reviews of objectives and achievements
- Process in place for resolving conflicts and impasses between government and operator
- Definition of what should be reported
- Agreement on measures of success in achieving objectives

## 1.2 Executive government and wider society

The relationship between the government executive and the political system will affect the way in which objectives and goals are set for the national petroleum company.

Broadly speaking, in parliamentary and congressional systems, the executive government is accountable to a legislature which will also have an objective-setting role and will require information. The capacity of this legislature to interpret the information and proposals it receives will affect the clarity of its decisions. In 'centralized' systems, information and capacity are concentrated within the executive government and the company. The way in which broader civil society influences petroleum sector activities will depend on the national context.

### 1.2.1 Parliamentary and congressional systems:

Many producers have parliaments or congresses, some of which play an active role in shaping objectives, targets and regulations or seek to influence the decision-making process in this regard. This is the case notably in Brazil, Canada, Colombia, Iran, Kuwait, Malaysia, Mexico, Norway, Russia, the US, Trinidad, the UK and Venezuela. In these systems, the government (through the ministry of petroleum) is responsible for setting the objectives and targets of the sector and these decisions are subject to parliamentary approval in some form or another, whether through general legislation, approval of government policy, approval of agreements with foreign oil companies, or approval of the budget of the state oil company (if any). In some countries (i.e. Mexico, Venezuela, Colombia) the oil workers' unions play a prominent role in sector policy-making. The Mexican Oil Union, Sindicato de Trabajadores del Petroleo de la Republica Mexicana (STPRM) played a dynamic role in nationalization of the petroleum sector and the construction of the Pemex. The union is involved with currently dominant Party, PRI and they favour strong links between the company and government. STPRM has unusually large participation in the NOC's management (see [Appendix 2](#)) and control of employment (except for senior categories of employees).

#### *Responding to multiple expectations in parliamentary and congressional systems:*

Where parliamentary approval is necessary, petroleum objectives may be entangled with other political issues: in Norway, Statoil's overseas investments were criticized in parliament. Elsewhere too, parliaments have opposed the commercialization of the NOC's goals (e.g., cutting social programmes or subsidies on gasoline, or removing restrictions regarding the source of crude for international refineries). Parliaments may also formally prescribe or expect that the national company carries out certain social obligations (e.g. supplies to remote areas, sub-marginal energy pricing, employment of local staff, and support of local industries). The interests of inhabitants of the oil-producing regions of the country may also have political impacts on the setting of objectives (Canada, Nigeria, Norway, UK, Iraq).

The involvement of parliament in such matters can attract public attention to important issues affecting the sector, bringing about dialogue between state institutions (and the public) regarding the most appropriate goals

and objectives for the sector, and thus increasing the legitimacy of the decision taken.<sup>7</sup> However, in areas where technical information and competence are critical to the decision, parliamentary and public debate alone may not lead to the best economic, environmental or commercial result. In some countries a “petroleum council” exists, including parliamentary as well as executive government and unofficial representatives, which may provide more informed and expert discussion.

In some countries, the involvement of multiple institutions in the decision-making process has had negative effects on the clarity of the industry’s objectives. Parliamentary involvement has sometimes led to lengthy approval processes for setting objectives and targets for the oil and gas sector. A good example of this has been the role of the Iranian parliament in developing the terms of the buyback contracts, the Kuwait parliament in debating the approval of project Kuwait, and the Russian Duma in approving early proposals for Production Sharing Contracts on a project-by-project basis. A strong oil workers’ union may also restrict company policy on employment, inhibiting company flexibility in this and other strategic areas, depending on its political strength.

A buffer exists for NOCs which are organized as corporations under normal company law, whose financial relations with the government are defined by taxes and dividends, and which have non-government shareholders (this is the case for Petrobras, Statoil, Gazprom and Rosneft). The government may remain accountable to parliament for general policy, objectives for the sector and key appointments. However, the company’s board is accountable to investors and creditors as well as to the government (which has a controlling interest), and is legally or contractually committed to publishing audited financial and operational information. Such companies may face more financial scrutiny, and less political scrutiny, than a company organized as a government agency or a corporation in which there are no non-government financial interests.

### **1.2.2 Centralized political systems:**

In a number of producing countries, the political system is centralized and there are fewer institutions involved in decision-making. Proposals regarding the oil and gas sector may be debated only on the NOC’s Board and in a higher governing council (often a ‘Supreme Petroleum Council’ or SPC). Political representation on these bodies may include relevant ministries, such as Finance and Planning, and some representatives from civil society (such as the chamber of commerce or a university dean). In some cases (such as Saudi Arabia), there is a corporate organization with an advisory board which includes non-government industry experts, including foreigners. However, decision-making is hierarchical and dominated by the involvement of a strong political actor (usually the minister of petroleum on the Board and the ruler of the country on the SPC). Centralized systems may be more consensual than is formally

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<sup>7</sup> Such a process of debate was initiated by the Algerian Ministry of Energy and Mines in 2003 when it sought to introduce a major reform of the energy sector. The ministry held numerous seminars and Q&As with the national assembly, as well as Sonatrach and labour unions. This reform involved significant changes to the objectives of Sonatrach, as well as to the legal and fiscal framework for the sector. This process is described in detail in Chapter 4, V. Marcel, *Oil Titans, op. cit.*

apparent. The centralized system of government allows the head of state or government clearly to define responsibilities, reducing the need for company management to be involved in public or inter-agency debate about policy choices outside its business remit.

Appendix 2 lists the membership of such Boards and Councils in a number of countries.

### *Openness in centralized systems*

Centralized systems carry two main risks. Information reaching the central decision-makers may be filtered and abstracted to the point where important details are lost. This is a problem for all corporate managements, whether nationalized or not. The centralized decision-makers may be insensitive to developments external to the company and to social needs and pressures. They therefore need to place particular emphasis on the make-up of their decision-making bodies so that the relevant interests are voiced. As in parliamentary systems, there may be expectations for the national company to carry out social missions relating to employment, pricing, and local purchasing. In developing countries, the national company, by reason of its organization and resources, may also be expected to provide health and education services and build infrastructure, especially during the early phases of development in a region.

#### **Key questions regarding the political system**

- Where is authority of each body defined? (laws, statutes, cabinet decisions, corporate articles, etc)
- Are there overlaps, gaps, ambiguities?
- How do the various authorities get information about the sector?
- Where are alternative objectives/policies debated?
- Does each body involved have sufficient technical capacity to fulfil its role?

#### **Toolbox for institutional questions**

- Simple, comprehensive guide to the authority structure
- Shared base of information
- Openness to a range of inputs from outside the petroleum sector

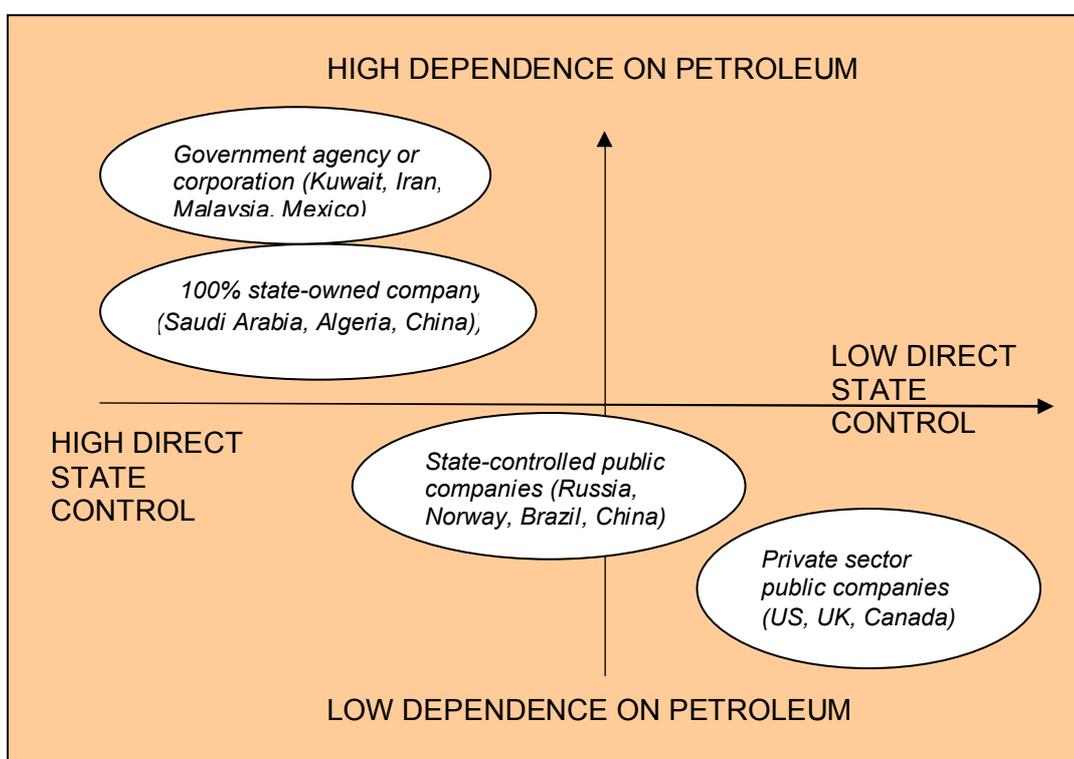
### **1.3 Degree of economy's dependence on oil**

The degree of government (and parliamentary) involvement in setting objectives for the petroleum sector is affected by the general role of the government in the economy and level of economic dependence on the sector. Broadly speaking, the more dependent the government is on petroleum revenues (and the economy on

foreign exchange earnings from petroleum revenues),<sup>8</sup> the more closely involved the government will be in setting financial objectives for the sector through the national company, while less dependent governments can rely on tax and general exchange regimes to capture the benefits of the sector for the state and general economy.

Existing national contexts show that a rough trade-off exists between the importance of oil in the economy and the autonomy of the NOC, though other factors are involved and there are some countries (such as India), where state control is high but the importance of the state oil company to the economy is low compared to highly oil-dependent economies. Chart 3 illustrates the possible trade-offs.

**Chart 3: Dependence on petroleum and state control**



**1.3.1 Low-medium economic dependence on sector:**

In diversified market economies, where dependence on petroleum production is low, and companies can access national and international financial markets, policies specific to petroleum may be mainly concerned with providing a fiscal setting and with appropriate environmental, health and safety regulations (US, UK, Canada), leaving private-sector companies to pursue strictly commercial objectives and set targets for themselves designed to enhance company performance in the financial markets.

<sup>8</sup> Technically, the higher the ratio of the non-petroleum fiscal deficit (financed by petroleum revenues) to government expenditure, and the higher the ratio of the non-petroleum current account deficit to current account payments of foreign exchange, the higher the dependence of the economy. This is approximately the methodology used by the IMF, and in the 'Economic Background' chapter of *Oil Titans, op cit*.

In some countries, dependence on national petroleum production may not be high, but there may be a legacy of state management in the economy which extends to the sector through state companies and planning processes (Russia, India, China). Economic reform and the development of the financial sector of these countries may lead to greater privatization of the sector which could enable companies (NOCs and/or IOCs) to set their own commercial objectives and leave policy-makers freer to choose privatization and open-market alternatives.

### **1.3.2 High dependence on the sector:**

Where petroleum revenues pay for the greater part of government expenditure and the country's imports, key government objectives are to ensure that the development of petroleum resources is efficient and that the distribution of economic benefits reflects national priorities. The government's petroleum revenues are the principal source of finance in the economy, with financial markets focused on the non-petroleum sectors. This often translates as pressure for the specific actors in government to be directly in control of the industry through an NOC. This model can help meet economic and social needs of producing countries in the early stages of development and promote a greater sense of national ownership over resources (see notes on 'national mission' below). It may also lead to more institutions being consulted in setting objectives for the sector – these may include the ministry of finance, the country's leader and parliament/congress.

## 2. CHOOSING OBJECTIVES

This section relates to the **principle of sustainable development** and determining policy objectives for the sector that can optimize the contribution of the resource to national wealth. Objectives must ensure that the development of resource is environmentally, socially and economically sustainable, as well as technically and commercially efficient. As regards the NOC, these objectives will be reflected in its *national mission*. The NOC and other operators, in turn, will need to set a strategic course that can achieve these objectives. To do this, decision-makers will need to assess how the oil and gas sector can best contribute to national development policy and establish realistic targets.

### Benchmarks for sustainable development

- The national petroleum revenue management system provides for fiscal stability, and gives assurance that petroleum resources contribute to sustainable benefits for future generations.
- Education and training are sufficient to meet the sector's needs, and the transfer of skills to the non-oil sectors is promoted.
- Fair and realistic local procurement and employment policies promote human capacity technology transfer and diversification of the economy.
- Corporate social responsibility (CSR) policies and programmes are aligned with a national development agenda.
- The 'opportunity cost' of giving social objectives to the sector is thoroughly assessed.
- The promotion of social welfare and/or economic development through selling petroleum products at below international prices to national consumers are pursued only as part of a fair, transparent and costed policy, for example, to smooth the effects of fluctuations in international prices or address questions of energy poverty;
- Effective processes are in place to ensure that the development of hydrocarbon infrastructure and its operations do not result in long-term damage to local and regional environmental assets.

### The national mission

The **national mission** is an integral part of most national oil companies' goals. It distinguishes them from private companies and guides their decision-making in specific ways. NOCs and their country are interdependent. Unless their operations are primarily international, NOCs depend on the long-term stability and welfare of their country as their principal operating environment and source of future reserves. Their country depends on the NOC to optimize the development of the finite oil and gas resources for maximum benefit to society.

This symbiotic relationship has led commercial and national missions to be intertwined. In other words, NOCs must maximize profits to increase the revenues transferred to the state in a manner that also optimizes the fulfilment of

other national objectives that promote stability and welfare. This differs from the mission of a private sector company, whose contribution to society will come primarily through its adherence to legal regulation and taxation systems and then through corporate responsibility initiatives developed to enhance its investments and public image.

The scope, content and hierarchy of national objectives are the responsibility of the state. They could include: ensuring national control of the country's resources, supporting the national economic development policy (promoting opportunities for the private-sector, for instance), providing energy to domestic consumers (at domestically set prices or at international market prices), promoting social welfare (to the population at large or in the area of the operations) and becoming a vehicle for foreign policy or simply national pride.

NOCs that are partly privatized and wholly private-sector companies may still be expected to fulfil a national mission, either as part of the normal corporate social responsibility expected of a leading company in the economy, or as a specific mandate from their government. Where such mandates impose commercial costs on a privatized (even government-controlled) company, the Board's fiduciary duty to the private shareholders requires that such costs should be identified and compensated either financially or in terms of commercial privileges.

Whether privatized or not, the company's management needs to take account of the national mission programmes on its commercial results and technical performance, and to bring this to the attention of the government. This can usefully be done by a social-cost-benefit analysis, through which the company will take into account various externalities, valuing intangible benefits to society. By costing the externalities, the NOC will be in a position to justify the investment or explain the price tag of non-commercial activities to the government. Assessing the 'opportunity cost' – i.e. the cost of not choosing alternative options – of such projects is among one of the most valuable contributions which an NOC can make since the NOC often houses a high level of expertise in such exercises. To guide these investment decisions, NOCs need a clear view from government of which objectives should be privileged, so that the government shares responsibility for the allocation of resources.

### Key questions for defining the national mission

- Do government and NOC share a clear mutual understanding of what the objectives of the national mission are?
- Do government and NOC have a mutual understanding of the potential contribution and the limitations of the NOC (i.e., what it can and cannot do more efficiently than other agencies)?
- Does the NOC have appropriate tools to assess costs, benefits, and local capacity?
- Where the NOC is taking a large role in national development, is there a clear definition of the responsibilities and remit of each party and *shared accountability* with government?
- Do the media play a role in publicizing the impact of petroleum policies?
- Does the NOC have an exit strategy through which ownership of the programme can eventually be transferred to government or the private sector? (*this may also apply to IOCs*)

### Toolbox for national mission

- Common methodology and experienced analysts for evaluating costs and benefits of social and similar programmes
- Clear view from government of which social objectives have priority
- Good flows of information between government, NOC, and stakeholders
- Use of media, forums, local consultation processes (in some cases focus groups or the cultural equivalent), to guide and evaluate execution of social and environmental programmes

## 2.1 NOC objectives

The extent to which the objectives of the NOC are wide-ranging and lead the NOC to carry out a development role will depend on the degree of development of the economy, the levels of prosperity and the capability of state institutions to undertake development and welfare roles. The greater the socioeconomic needs, and the lesser the state and private-sector capacity to provide for these needs, the wider the scope of the NOC's development role. The objectives listed below are not mutually exclusive.

### 2.1.1 Maximizing revenues for the state:

Maximizing government revenues is a priority objective given to the petroleum sector by most governments, within the constraints set by their policies on depletion, development, and production rates (for example under OPEC quotas). What matters most in setting revenue targets is of course net revenue after costs have been deducted. Efficient use of real factor inputs (by management and technology) is of central importance if net revenues are to be maximized.

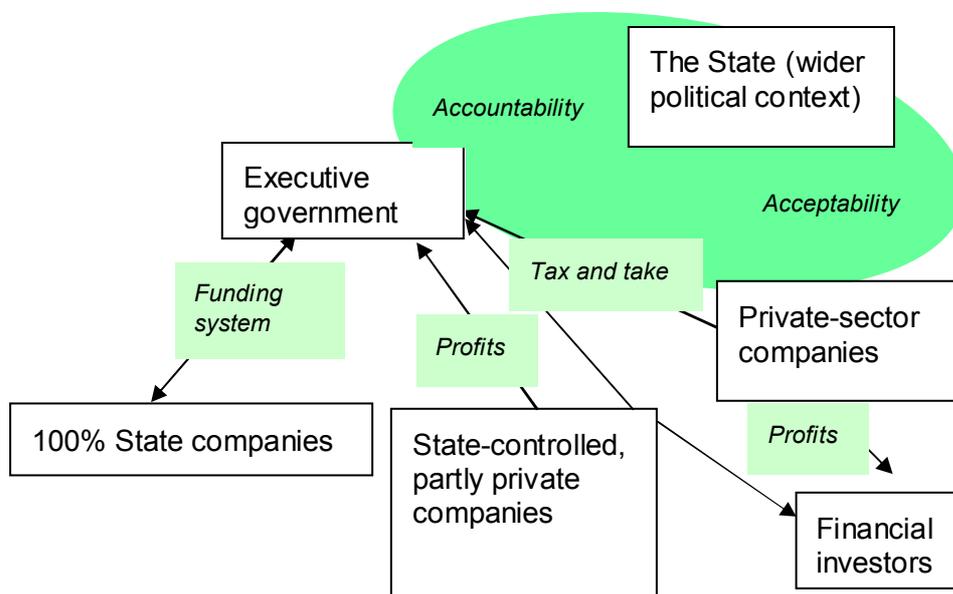
In setting targets, governments face a classic ‘owner-manager’ problem in which the manager (the company) has better information than the government and controls the operations and projects, while the government on behalf of the state, wants to be satisfied that the net revenues are the best available.

Where there are competing companies, their relative profitability is a measure of efficiency. In wholly state-owned companies, the mechanism for government take varies from surrender of all revenues (with funds allocated back to the NOC for costs and investment), to a quasi-corporate system with taxes, royalties and dividends paid to the government and profits retained by the company.

Whatever system is used, there is a possibility of distortion: management may be more willing than government to incur costs which reward the employees through benefits or promote the company through expensive head office buildings and services if these costs are mainly taken from potential government revenue.

How this problem of revenue flows is handled depends in part on the institutional structure and national context. Chart 4 indicates that the executive government has direct accountability in the country’s political system, whereas private-sector companies, while not being directly accountable, must behave in an acceptable way.

**Chart 4: Revenue flows and accountability**



Where the sector is wholly or partly privatized, the government ‘take’ is defined through leasing, taxation and royalty systems. In an ideal economy, these systems should not distort the company’s decisions: the same decisions should be made after taxes have been taken into account as if there had been no tax. Though this is an important principle, it can seldom be realised in practice. There is an extensive literature on the way that various forms of taxation increase a company’s willingness to incur costs – in some cases, solutions may involve reducing taxes paid.

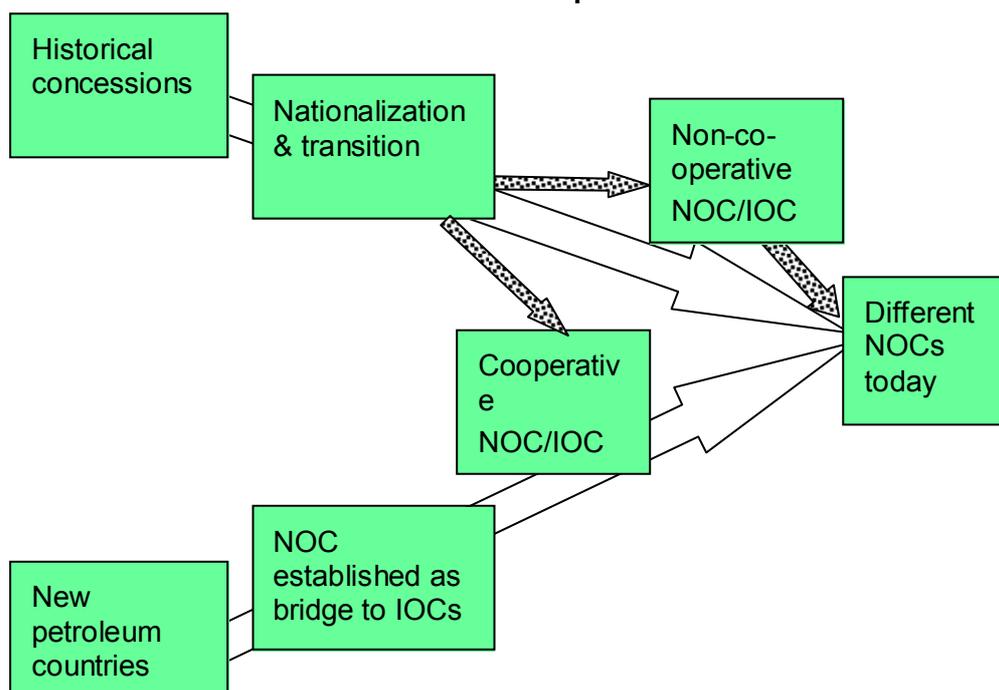
Governments may also define the commercial environment for the company, through conferring (and regulating) a monopoly or, alternatively, prohibiting monopolistic practices.

See [Section 4](#) for Toolboxes on Revenue Governance and Introducing a Public Transparency Initiative.

### 2.1.2 National control of the country's resources:

In this case, the NOC is charged with ensuring implementation of the government's resource policy, including the legitimate right for the state to appropriate as much rent as possible. This objective may also include ensuring greater national independence from foreign companies. The importance of this objective depends on national contexts and on the history of the sector in the country – see [Chart 5](#). In some countries the transition from historical concessions involved a breakdown of cooperation between the NOC and the IOCs. In others, including post-1970 producers, cooperation has provided a necessary bridge to the future. The objective for the NOC may change over time. Key factors are the maturity of the national industry and the changing role of foreign investors.

**Chart 5: The historical dimension of the petroleum sector**



Historically, the NOC has been a key instrument in many countries in achieving greater national independence from foreign companies. If the political objective of government is to free the petroleum sector from dependence of foreign investors, the NOC is a political vehicle for independence. This gives a new NOC a strong mandate and popular and political expectations can drive the NOC's performance. However, its operations and decision-making can also become politicized. Political expedience may entail direct government intervention in NOC

management and organization and critical review of its contracts and plans.<sup>9</sup>

In some countries with a well-established petroleum sector and in countries with more recently discovered resources, the objective of national control may be less about popular politics and more about ensuring a trusted partner to engage with foreign or private companies in the development of the resources. In other words, government may count on the NOC's knowledge of the industry to help it monitor and regulate IOCs operating in the country.

Many NOC professionals see their drivers as fundamentally different from those of IOCs, which they feel, are not thinking of the long-term prosperity of the country but of shareholder expectations of returns in the next quarter. Any difference in drivers between private and national oil companies is reinforced by the industry's common investment terms (notably PSAs, PSCs). These often involve international oil companies operating for a limited time in the country whereby the production sharing structure incentivizes them to develop fields as quickly as possible. If producers want foreign investors to develop their resources with a strong concern for ultimate recovery rates (and apply enhanced oil recovery techniques, for instance) they must build appropriate financial incentives into the contract terms.<sup>10</sup> There is often a trade-off which allows quick cost recovery for the foreign investor (to minimize its political risk) in exchange for a higher share of profits for the NOC or government in the long-term. The balance between short- and long-term may influence technical choices, and the NOC and government need to be aware of this.

Government agencies (whether the ministry of petroleum or an independent regulatory agency) also need the capacity to monitor the activities of foreign investors (and investor relations with the NOC). For this, the agencies require knowledge of best practice and new technologies.

It cannot be assumed that because the NOC is learning from its partners, this capacity will automatically will benefit other agencies within government. Monitoring activities also require the necessary access to operations and a willingness to make critical assessments.

A conflict of interests can arise where the NOC monitors and manages the performance of the IOCs while effectively competing with the IOCs (for new licences, for example). In some countries (Algeria, Mexico, Brazil, Norway) independent state agencies have been set up to regulate both state and foreign companies and in some cases to award licences where state and foreign companies are in competition. (Such regulatory agencies are also used in countries where there is no state oil company: US, Canada, UK).

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<sup>9</sup> This has been the recent experience in Venezuela and Bolivia.

<sup>10</sup> For a discussion of NOC perceptions of IOC drivers and improving investment terms, see Chapters 2 and 10 in V. Marcel, *Oil Titans*, *op. cit.*

### Key questions for control of resources

- What are the political priorities for the sector?
- What are the risks and benefits of these political priorities?
- Does the NOC have technical and managerial capacity?
- What are the risks and benefits of foreign involvement?
- Does the contractual structure encourage the desired type of investment and work commitment by foreign companies?

#### 2.1.3 Implementation of economic development policy:

This objective is an important aspect of NOC missions in many countries, especially where the level of economic development is low, poverty levels are high and state capacity to provide services is poor. There are two dimensions to the NOC's objective to promote development. In one, the NOC uses its role in the energy sector to maximize supply chains (forward and backward linkages) between the sector and the rest of the economy. The other is where the NOC takes on promoting development in areas quite unconnected to the sector. This often happens where the government itself lacks the capability to undertake development projects.

#### Conflicting missions

Objectives for non-petroleum development carry risks: pressure to absorb unemployment and buy local goods and services can burden the NOC and compromise efficiency; responsibility for building infrastructure can lead the NOC away from investment in its core business and may crowd out other companies from opportunities to develop. The petroleum industry can become a substitute for the capital market, creating jobs that are not competitive and not sustainable and driving out other economic activities. Much of the literature on this suggests such efforts have been less than successful.<sup>11</sup> See also [Section 5](#), on Enabling good decisions, for more on policies specifically relating to local content.

Another objective for the company is to promote education and training for nationals. This clearly represents a benefit to both the company and the society and is a common, and usually non-controversial, social objective. A problem may occur if the company invests heavily in schools, technical training colleges and universities, which are of a much higher standard than other government institutions, thus creating a two-tier education system.

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<sup>11</sup> For example see R. Auty, *Resource Based Industrialization: Sowing the oil in eight developing countries*, Oxford: Clarendon, 1990.

### Key questions regarding economic development objectives

- Has government delineated a strong vision/agenda for development within which the oil and gas sector's role is clear?
- Where the NOC is tackling development projects, what is the rationale behind this? Why has it been chosen rather than private sector or government agency?
- What is the impact of taking on development projects on the NOC core mission, financially and in terms of management effort?

### Toolbox for economic development objectives

- Promote education and diversification to building national capacity.
  - a. Training for nationals
  - b. Building centres of excellence
- Providing knowledge transfer to local companies
- Pre-contract training
- Partnership projects
- Outsourcing to local companies
- Privatizing non-core activities

#### 2.1.4 Promoting social welfare:

Promoting social welfare is a less central goal for most NOCs today, though they remain indirectly involved through the funding of state programmes. For example, Saudi Aramco built hospitals at a time when they were needed in Saudi Arabia's Eastern Province, but returned them to the state in the late 1990s. However, in countries where poverty levels are high and the state agencies have been unable to provide welfare services, the NOC may find it necessary to support the community in which it is working, beyond what might be expected in terms of normal employee and community relations. Sonangol, for example, initiated local agricultural projects to be run by local families. As a well-financed and capable institution, the NOC may also be expected to step in at a national level. In Venezuela, for example, PDVSA must now spend at least 10% of its annual investment budget on social programmes (valued at approximately \$1 billion per year).<sup>12</sup>

#### Who bears the cost?

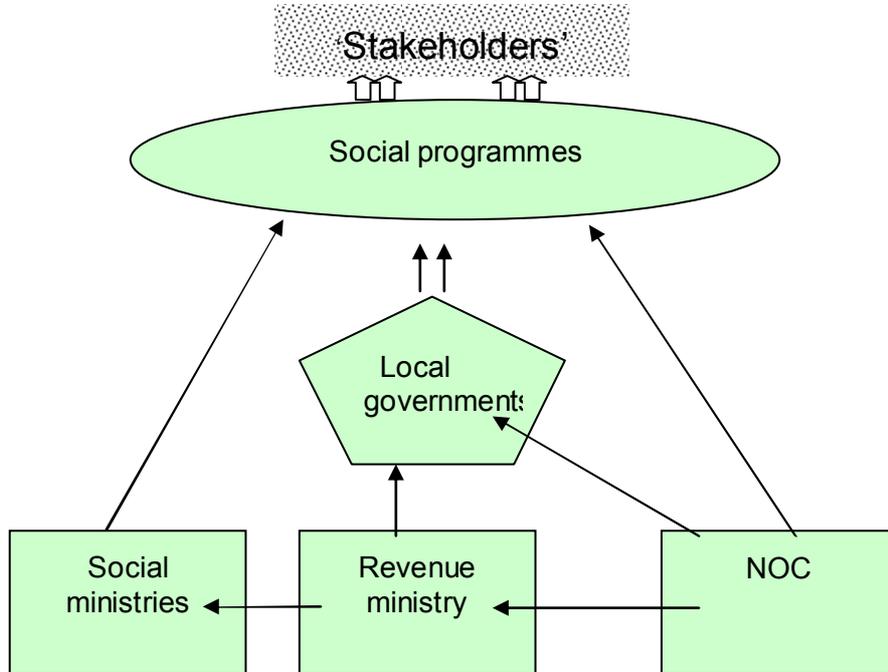
The flow of revenue directed from the NOC to social programmes is naturally at the expense of revenue yield to the central government. Such social objectives may in time lead the state revenues from oil and gas to decline. A balance must be found between the fiscal contributions that the NOC makes to the Treasury (which can fund social welfare) and its own capital requirements to pursue its commercial role.

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<sup>12</sup> Wall Street Journal, 2 August 2006.

In addition, there may not be a mechanism for aligning the priorities of the NOC social programmes with those of the social ministries or local governments.

**Chart 6: Revenue flows for social programmes**



Another issue related to the NOC's role in promoting social welfare is the lack of transparency and accountability for such spending. NOCs may become embroiled in local political controversy because of the way they choose to allocate social spending. The government, meanwhile, may escape accountability. In other cases, NOCs transfer revenues directly to regional or local governments who enjoy enhanced powers of patronage which may be used in ways which do not enhance the reputation of the NOC.

### Key questions for social welfare objectives

- Are defined budgets (at expense of petroleum revenue) agreed with central government?
- Is the NOC better able to execute programmes than central or local government?
- Are non-petroleum ministries and local governments involved in setting priorities and designing programmes?
- Is NOC involvement publicly explained?
- How publicly transparent are the social spending allocations?

### **Toolbox for social welfare objectives**

- 'Sunset' targets for NOC to exit welfare functions when government is ready/able to take over
- Social welfare plan to be supported by 'stakeholder' engagement
- Transparency for NOC extra-budgetary expenditure

#### **2.1.5 Providing domestic energy:**

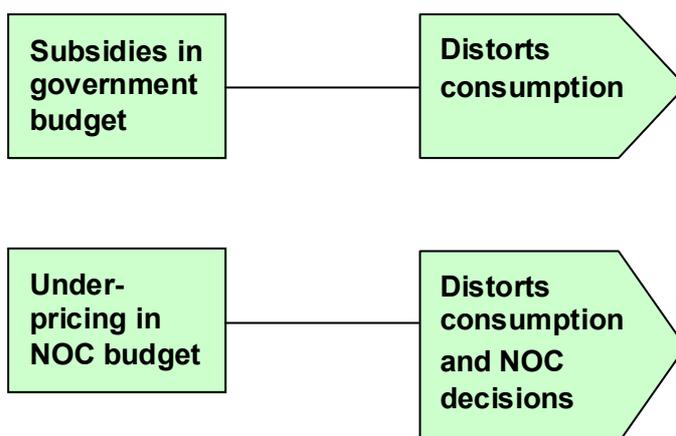
Most NOCs are uniquely responsible for the supply of fuel to domestic power stations, industry and commerce, and, in some cases, households (including vehicle owners). Moreover, in several cases, they provide subsidized or domestically priced energy to consumers. This is particularly true for countries with a large number of energy-poor and where the government's political legitimacy is based on providing essential services to the population.

What constitutes a 'cheap' or 'subsidized' price is a matter of contention. Normally, it is assumed that the export price acts as a proxy for the 'correct' price; however, some petroleum products are not exported, and some are imported. Domestically controlled energy prices may protect industries and the poor from international market price volatility and unsustainable price hikes. For some chemical feedstock there is no international market price. International commitments (such as the WTO, or the EU-Algeria and EU-GCC trade agreements) require that domestic prices be brought into line with international prices. However, some producers argue that the pricing of domestic energy based on long-run marginal costs leverages a producer's competitive advantage.

#### **Energy pricing**

In some countries, the cost of fuel subsidies is carried in the government budget: the NOC is compensated (from the revenue it pays the government) for the difference between domestic and international prices. In others, the NOCs must bear the costs of the subsidies within their own budgets. This can limit the availability of capital for investment to upgrade refineries and develop upstream assets, for instance. In addition, because government is not paying the cost of domestic energy directly (but passing it on to the NOC), there is less political incentive to change patterns of domestic consumption. This can lead to unsustainable growth in domestic energy consumption, with negative effects for the environment, as well as the treasury. A good example is Iran, where highly subsidized product prices are reducing Iran's ability to export oil. On the other hand, cheap fuel for households is a sure way of enabling the population to share in the oil wealth – although the share will be bigger for wealthier, larger consumers than for the poor. Any change leading to higher prices is likely to be politically difficult.

**Chart 7: The negative effects of subsidies**



In general, it will fall to the NOC to calculate the impact/cost of non-commercial activities so it can explain the price tag of non-commercial activities to the government. This is another example of the NOC's role in identifying the 'opportunity cost' of a particular policy.

### **Key questions regarding domestic energy objectives**

- What is the objective of subsidy/under-pricing?
- Does the cost fall on the government or NOC budget?
- Are the subsidies/price advantages open-ended or set to diminish?
- Will international commitments bring a change in policy?

### **Toolbox for domestic energy objectives**

- Identification of appropriate international price comparison
- Locate and identify subsidy in government budget
- Develop programmes to support consumer and industry in transition to market-oriented pricing

#### **2.1.6 Petroleum diplomacy:**

National oil companies are sometimes used to project a country's foreign policy in their dealings with foreign governments or foreign companies. For example, an NOC might adopt a favourable or unfavourable pricing regime towards purchasers or discriminate on national grounds in its choice of contractors or admission of foreign technical workers (which might infringe obligations under GATS if the countries concerned are

parties).<sup>13</sup> The NOC may favour particular importing countries through investments in particular pipeline routes. The NOC may also favour investors from particular countries. An NOC itself may act as a foreign investor, seeking to be a trusted partner for a newly emerging petroleum country in its development and its dealings with foreign partners. The NOC, as a large and well-financed organization in a strategic industry, may also be regarded as a “national flagship” for prestige purposes.

Conversely, the NOC may be affected by actions taken by foreign countries for political reasons against its government: sanctions on trade and investment, discriminatory treatment in access to finance and technology.

Private-sector companies, whether domestic or international, may be exposed to similar pressures as a result of their ‘home government’s’ diplomatic interests.

### Key questions for petroleum diplomacy objectives

- What government international commitments affect the NOC?
- Which government foreign policies affect the NOC?
- Does the NOC management have access to foreign ministry?
- Which areas of the NOC's business are vulnerable to international sanctions

### Toolbox for petroleum diplomacy

- Coordination between foreign and petroleum ministry
- Shared analysis of foreign policy implications of NOC actions and vice versa

## 2.2 Objectives for private oil companies

Through the national legal framework (hydrocarbons policy), tax and ‘take’ system or contractual obligations, the state may give objectives to international oil companies similar to those given to NOCs. These objectives may include the implementation of the nation’s economic development policy, providing energy to domestic consumers and promoting social welfare.

For example, NIOC’s buyback agreements with foreign partners require 51% of expenditure under the agreement to be placed with Iranian contractors, manufacturers and consulting firms (these may include Iranian companies with some foreign participation). ADNOC and its joint venture partners are required to obtain 51% of their goods and services from Emirati companies.<sup>14</sup> These objectives may also be required by the NOC. In Venezuela, for example, private

<sup>13</sup> Special pricing regimes might infringe WTO obligations if the importing country is a member of the WTO and national discrimination in selection of contractors might infringe obligations under General Agreement on Trade in Services (GATS) if the countries concerned are parties.

<sup>14</sup> John V. Mitchell, *op. cit.*

oil companies working in joint ventures will soon be required by PDVSA to spend 3.3% of their local investment budget on social programmes. PDVSA will also require their private oil company partners to source a majority of supplies and services in Venezuela.<sup>15</sup> Moreover, Norway in its early development promised 'better' treatment in licensing rounds to private companies that were willing and able to transfer knowledge and help state agencies build their technical capacity.

## Working with the private sector

In countries with a low level of economic development, the availability and quality of national supply chains may be insufficient and foreign investors may end up relying on shell companies that bring little competence to the project (but give an appearance of local content).

While in many situations the interests of the NOC and private-sector company are broadly in alignment, difficulties may arise if the NOC is unable to provide information or access to meet the obligations of the private-sector companies to account for its profits, to observe worldwide technical, human rights and environmental standards and not to support corruption. Private company may also be restricted by the foreign policy of their home governments. In some countries, situations may also arise where private-sector companies are expected to favour local groups with political influence.

### Key Questions regarding national objectives for private sector companies

- Are the requirements on local content, employment and pricing more or less onerous than for NOC?
- What are the processes for accounting and expensing costs of social programmes?
- What is the risk of corruption or public suspicions of corruption?

### Toolbox for national objectives for private companies

- Clear specification of commitments of company to social and economic programmes
- Transparent accounting and selection for social and economic programmes
- Shared initiatives to develop local capacity
- Anti-corruption laws and procedures

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<sup>15</sup> Wall Street Journal, 2 August 2006.

### 3. MEETING OBJECTIVES

What does each actor need to perform his or her role effectively? What can each actor do to help enable other actors?

This section relates to the **principle of enablement of each actor to carry out the role assigned** in accordance with the strategic and policy framework.

#### Benchmarks for enablement

- Policy-makers have sufficient knowledge, capacity and internal alignment to set effective policy and realistic and prioritized objectives for the sector.
- Checks and balances are in place at government level to enable consistency for long-term policy-making.
- Actors are delegated financial and managerial authority to carry out their role and/or function.
- The fiscal and budgetary relationship of NOC to state is structured to enable the NOC to achieve its objectives efficiently, i.e. there are checks and balances to ensure that NOC spending is in the national interest; the NOC is able to make purchases and investments promptly and have the stability to make long-term investment plans.
- There is an exit strategy to enable the NOC to transfer any non-commercial, social and/or national development functions to the government or other agencies when they are ready and able to take over.
- The selection criteria for appointments to the NOC board and executive management are transparent and the board has the appropriate knowledge, skills and resources to carry out its role.
- Operational and commercial decisions of the executive management and the Board are separated from political and other conflicting interventions.
- The industry regulating bodies have the necessary technical skills, financial resources, knowledge, access and legal authority to exercise their powers effectively.
- Audits of operators within the sector are coordinated to minimize duplication and avoid unnecessary bureaucracy.
- Staffing decisions are based on the principle of 'best person for the job'.
- NOC managers and employees see incentives to improve performance.

The degree of state control of the sector determines to a large extent which mechanisms are available to enable operators. The following section focuses on enablement issues for operators under the main legal structures for the petroleum sector (see also [chart 2](#) in [Section 1.2](#)):

### 3.1 Exclusively private sector

The petroleum industry in the US and Australia has always been organized entirely in the private sector.<sup>16</sup> In the UK and Canada, the private sector remains the dominant system, though in the late 1970s there were experiments with a state oil company. General laws for investor protection, company organization, health, safety and environmental protection and employment apply, together with regulations applied by financial organizations such as the stock exchanges and codes of practice for corporate governance in general.

These 'private sector' countries nevertheless have petroleum-specific legal frameworks for taxation of the petroleum sector and comprehensive hydrocarbons laws to set the parameters for companies in the sector. There are strong state regulatory agencies to supervise projects and to set technical, environmental and safety conditions.

Transparency of domestic listed companies' accounts should ensure that the government and public are provided with sufficient information. Tax, environmental, safety and employment laws will require information from non-listed companies and subsidiaries and branches of foreign companies.

#### *Control of volumes produced*

Operators active in these countries do not normally face restrictions on production or export volumes. However, governments can legislate to introduce mechanisms for state control over production and export volumes, for example in times of supply shortage. Such policies can be difficult to implement and would require consistency with WTO, IEA, NAFTA and EU obligations. An interesting example is the UK, where existing legislation allows the government to limit the production levels<sup>17</sup> of any company operating in the UK and to direct or limit exports. To date, the legislation has never been used but its presence gives the government considerable leverage over private company operations in times of crisis. In Norway (where the government has similar powers), it has also used licensing policy to delay the development of certain fields. In the Netherlands, the government has for a time limited production from the Groningen gas field to conserve resources and promote the development of smaller fields.

Private-sector organization may complicate government efforts to develop spare production capacity. Companies in these cases would require contractual or legal obligations to invest in spare capacity. Such obligations could deter investment, unless investment in spare capacity is financially incentivized.

#### *Strong legal framework:*

Reliance on foreign investors and domestic private-sector companies requires a coherent and systematic legal framework for taxation and regulation. These legislative arrangements must be made before opening up the sector to competition. Countries introducing competition should introduce a comprehensive hydrocarbons law to set the parameters for investors and build up a strong state regulatory agency to supervise investors

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<sup>16</sup> In the US and Canada, the petroleum resource is in principle in private ownership, except where it lies under federal or state land.

<sup>17</sup> Production is in any case carried out within the parameters of a government-approved development plan.

### **Key factors for opening up to private sector**

- Comprehensive hydrocarbons law in place before opening up the sector to competition
- Strong, well-equipped, regulatory institutions
- Coherent and systematic framework of taxation

## **3.2 Use of public sector**

Countries which rely on national oil and gas companies for all or most of their petroleum development use a variety of forms of organization: government agency (Iran, Mexico,) government corporation (Algeria, Kuwait, Malaysia Nigeria, Saudi Arabia, Venezuela), company in private sector with 100% government shareholding (ADNOC) or with controlling government interest (Brazil, Norway).

The following factors have an important impact on the enablement of the NOC to carry out its operations effectively:

### **3.2.1 Relationship between the ministry of petroleum and the NOC:**

An important distinction must be made between the state as sovereign and owner/shareholder, even where there is 100% ownership. Ideally, the government bodies in charge of the petroleum sector would understand the differences in their roles and objectives and behave according to the appropriate objectives in each. The role of the minister is particularly complex: s/he will mediate between the government and the sector and be responsible for policy (including production strategy and external negotiations such as those at OPEC) and some regulation while also being the 'Shareholder'.

There are examples where the executive management of the NOC deals directly with the Head of Government (Malaysia), there is no ministry specifically for petroleum, and the NOC deals directly with the finance ministry or ministry for public enterprises.

Where the NOC is organized as a corporation or like a private sector company, the ministry has a 'shareholder' role on the board. The NOC board differs from the private company board because the major or sole shareholder is the government. Ideally, the board's remit should ensure the shareholder's interest is adequately represented but allow the NOC executive management responsibility for day-to-day management and the development of plans and approval of certain levels of project expenditure.

#### *Balance of power between ministry and NOC:*

This arrangement involves mostly state actors and enterprises and the relationship between them is therefore crucial. The key actors involved (usually the ministry of petroleum and the national oil company) may compete for power. Where there is a high level of trust and clearly defined responsibilities, the management and the Supreme Petroleum Council may be separate (as in Saudi Aramco, where the President of Saudi

Aramco attends board meeting but is not a member), with a high degree of delegation of authority to the NOC Executive Committee.

NOCs can be less enabled when the ministry is dominant, and the Board, if it exists, does not limit itself to questions of policy, budgets and major appointments. The ministry and the NOC may become indistinguishable. Ministry interference in operational decisions is likely to result in efficiency losses. Also, the company will not be running like a business, but as an extension of the ministry. This can lead to a bureaucratic corporate culture and a lack of entrepreneurial drive for employees. With less autonomy the NOC may not have the space in which to develop its managerial competence.

### Key questions on NOC management

- Are the lines of reporting and accountability from executive management to the board or the government clearly defined?
- Is the role of the minister clearly defined and is the Minister able to make decisions without conflicts of interest?
- Are operational and commercial decisions of the executive management and the Board isolated from political interests?

### Toolbox on NOC management

- A clear definition of the responsibilities of the board - perhaps in the form of an explicit contract with the government.
- Clear reporting role for executives and board members.
- Separation of board (or government authority) and executive management
- A legislative framework (or decree) to institutionalize the definition of responsibilities of the board and its members.

### 3.2.2 Tax and finance structure:

There is a range of practice relating to the NOC's tax and finance structure, which give the companies more or less capability to self-finance from retained profits and to borrow from national banks or international financial markets against the security of their assets (usually assets held abroad, or export revenues accrued abroad, rather than petroleum reserves (which no NOC "owns") or assets in the country. Broadly speaking, the management of an NOC which retains profits and has some borrowing capacity is likely to have more discretion than the management of an NOC which is a government agency relying on allocations in the government expenditure budget.<sup>18</sup> This is a crucial element of enablement for NOCs.

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<sup>18</sup> In some countries (such as Iran and Venezuela) the arrangements are in the process of change.

### **3.2.2.1 Royalty, tax and dividend structure:**

This is the system in Algeria, Abu Dhabi, Brazil, Mexico, Nigeria, Norway, Russia, Saudi Arabia and the former system in Venezuela. It replicates (to varying degrees in different countries) the finance structure between an IOC and the state. NOCs pay royalties from upstream earnings, taxes and dividends to the state. Under this arrangement, the NOC can retain profits from its activities in the upstream. In the case of wholly state-owned companies, however, dividend policy may be used by the government to extract all revenue not required for approved plans. In the case of part-private companies, there is a stronger tendency to maintain stable sustainable dividends and allow the company to retain funds in the same way as a private-sector company. This system gives the NOC management an incentive to set up efficient operations because it can retain more revenues under its control.

All tax systems in a capital-intensive, high-margin industry incur a classic problem: generous allowances for capital expenditure, set against high tax rates, end up reducing government revenue and weakening the management's incentives to control costs.

### **3.2.2.2 Position in government budget:**

There are a variety of systems in which the NOC surrenders its operating revenues and is refunded or retains cash for its capital programme (Iran and Mexico under the former system). In some countries, both operating and capital expenditure must be presented in detail for approval to the government. In some of these cases, the main headings of NOC expenditure are then presented in the government budget to congress or parliament (Mexico, Iran, Algeria before the Hydrocarbon reform, Norway before partial privatization). Unless there is a high degree of delegation of authority by the government to the NOC directly, or through a Supreme Petroleum Council, these systems are likely to leave less autonomy for the NOC management and involve greater civil service or political intervention in the setting of NOC priorities and approval of projects, even to the extent of time-by-item negotiation of expenditure.

In some countries (Kuwait, Abu Dhabi, Malaysia) the NOC pays a specified percentage of gross petroleum revenues direct to a state investment or development authority so that these revenues are not available to the executive government for normal budgetary purposes. (In some countries, the government is obliged by legislation to contribute to a stabilization or heritage fund either a proportion of revenues, or those revenues which exceed some pre-budget target).

### **3.2.2.3 External finance;**

NOCs which are organized like private-sector companies (even with majority government control) have their own balance sheets and revenue streams defined only by taxes, royalties and dividends. They are competent to raise external long-term borrowing or issue new shares, though their debt may be taken into account in the government's own debt rating and any issuing

of new shares would need government (as well as other shareholder) approval. The ability to raise external finance is likely to reduce the competition for funds between the NOC and other government agencies and therefore increase the discretion of the NOC management in its investment choices and its stability for long-term planning. This can enhance its capacity to serve the main government objective of maximizing revenues by efficient operating, capital and financial management.

#### **3.2.2.4 Financing through other activities:**

Whatever the system for an NOC's upstream revenues and finance, it can often generate funds through other activities (typically through downstream, chemical or shipping and trading activities outside the country). The downstream and/ or foreign subsidiaries of KPC, NIOC and PDVSA engage in other activities from which the companies amasses revenues which they can reinvest independently.

Such foreign activities can contribute to the NOC's national mission through opportunities to gain commercial expertise and an international business awareness that can be transferred to the parent company. However, running independent, profit-making activities internationally has enabled some NOCs to escape auditing scrutiny from the Treasury. This arrangement also runs the risk that the NOC management becomes more interested in its profit centres (i.e. its revenue generating activities outside the upstream) than in the quality and performance of its upstream activities, and may favour the subsidiary activity by transfer pricing which reduces the revenue available for upstream tax and take.<sup>19</sup>

#### **Key questions for tax and finance**

- Does the NOC have access to sufficient funds for its capital investment plans?
- Is the NOC's expenditure subject to over-detailed government scrutiny?
- Do government allowances of expenditure against high tax rates lead the NOC to control costs?
- What is the position of the NOC in the government budget?
- Does it have access to external finance?
- How are the NOC's foreign or non-core activities justified in terms of its national mission? Is it favouring them at the expense of its capacity to pay tax and dividends to its national government?

<sup>19</sup> For further discussion of the financial structure of NOCs and performance incentives, see Chapter 6 in V. Marcel, *Oil Titans, op. cit.*

### **Toolbox for realizing tax and financial objectives**

- Transparent, independently audited accounts
- Profitability indices and benchmarks to discourage lax cost control at government expense
- Transparency of external financial arrangements
- Arms-length transfer pricing and profitability objectives for downstream and overseas subsidiaries.

### **3.3 Mixed use of public and private sectors**

There are various types of arrangements mixing private-and public-sector companies. First, there are countries with a 100% state-owned NOC working with private companies (usually foreign). They can partner in mixed enterprises (Venezuela, Malaysia) or in JVs (Abu Dhabi, Algeria, Nigeria). The private companies can also work as contractors (Iran, Venezuela (old system) or in PSCs (Azerbaijan, Angola). Second, there are countries with a partially privatized NOC, which works alongside local and foreign private sector (Norway, Russia, Brazil). Three main types of issue arise.

#### *Conflict of interest:*

The NOC may be required to compete with the private-sector companies (in new acreage or in the downstream sector) as well as to cooperate with them in joint ventures. For the private-sector companies, the NOC may stand between them and the ministry. In a contractor relationship, this may be simple for both the private-sector company and the NOC. However, in JVs and mixed enterprises, the private-sector company may seek direct access to the government in order to avoid dependence on the NOC in competitive situations. Moreover, if the NOC supervises the development of fields licensed to private companies, it must demonstrate a capacity to demarcate its roles as operator and regulator. A remedy is to provide an independent government agency with some regulatory or oversight functions (Algeria).

This problem of conflicts between regulatory functions and corporate interest in the NOC is more acute when there are private investors in the NOC (Brazil, Norway, Russia) who would benefit from advantages for the NOC over private-sector or foreign companies. In Norway the solution has been to divest Statoil of its former supervisory functions, the management of the state investment fund, and the management of the export pipelines.

#### *Cash-weak NOC:*

A different type of issue arises where the NOC is kept so short of money by the government that it is not able to meet the cash calls from its private-sector partners for capital expenditure in new projects. This may result in protracted negotiations to allow the foreign partners to be recompensed for carrying the NOC share of expenditure, delays to projects, and an unnecessarily unfavourable investment climate for the country.

#### *NOC/government agency competence:*

A third type of problem occurs when the national technical and managerial capacity of an NOC and/or government regulator does not match that of the

private-sector partner, with the risk that the private sector company will get 'too good a deal'.

Producers often face the dilemma of whether to build competence in both the ministry and the NOC or to concentrate national efforts in equipping either the ministry, which has ultimate political responsibility for the sector, or the NOC (giving the latter direct accountability to the highest political authority, as in Abu Dhabi and Malaysia).

### **Key questions for mixed public/private sector**

- Is the NOC's role vis-à-vis private investors in a JV or mixed enterprise clearly defined? Do the parties respect reporting and accountability lines?
- Does the NOC have regulatory functions?
- Do the IOCs have direct access to government? If so, which entities in government?
- Can the NOC meet its financial obligations in the partnership with IOCs?
- Where is the technical and managerial capacity strongest in country: in NOC or ministry or both?

### **Toolbox for mixed public/private sector**

- Clear and transparent procedures where NOC exercise quasi-government functions (contracting, regulation)
- Separate regulatory agencies applying equally to NOC/IOC
- Focus scarce national capacity on most essential functions, with direct political accountability

## 4. ENSURING OBJECTIVES ARE BEING MET

**Accountability** of performance is crucial at every level of a governance system. This principle is critical to the **functions of monitoring and regulation**.

### **Benchmarks for accountability**

- Mechanisms are in place to ensure that operators in the sector are in compliance with national and international regulations and contractual obligations.
- The NOC has internal audit functions (conducting financial, physical and process audits) which report to the board.
- The NOC is subject to regular, functionally independent audited reports and accounts prepared to international accounting standards, such as the IFRS (International Financial Reporting Standards).
- The national petroleum sector as a whole is subject to regular audit, accounting for revenues due to the government, revenues paid to the government and revenues received by the government.
- There is an effective mechanism for dialogue between local communities and operators to account for the impact of operational activities.
- NOC performance is benchmarked in a way that demonstrates relative as well as absolute performance, i.e. functional performance against comparable organizations.
- Corporate social responsibility/national mission spending in the petroleum sector is accounted for separately and evaluated against stated objectives.

#### *Monitoring performance:*

In wholly state-owned national companies, there is no competitive benchmark for performance in general. Comparisons with private-sector companies can sometimes be made of specific costs: cost per employee, cost per barrel, cost per unit of capital employed etc, which are revealed in private-sector accounts.

In partly privatized companies – organized under general company law but with government shareholders controlling – governments can look for revenue maximization through a combination of the tax system with the evidence of profitability in comparison with other private-sector companies.

In all cases governments and investors share an objective of minimizing fraud, corruption and waste as well as technical and resource costs. In countries with public accountability (e.g. from government to parliament), support for the government's tax policy and the company's role may depend on the public's belief in the trustworthiness of information about the company's revenue performance.

Some of our participants came from countries, companies, international financial institutions, civil society organizations and investment institutions that have expressed their support for the EITI Principles, and a pilot programme is under

way in Nigeria and Azerbaijan. The EITI aims to establish voluntary compacts between country governments and companies regarding natural resource revenue transparency. Using standardized reporting templates, companies would report what they pay governments and state agencies, including national oil companies and provincial governments. National oil companies would also report what they receive from companies and pay governments, while governments are to report revenues received from private-sector and state-owned natural resource companies. This architecture is intended to create a web of double-entry checks.

### **Key questions for revenue governance**

- What are incentives and distortions in tax and funding systems? (particularly as regards allowances against tax, and cost of capital)
- Can competitive comparisons be made? With whom?
- What are the risks of fraud and corruption?
- Is there public suspicion of what revenues are going where?
- What sort of transparency is needed to meet the expectations of:
  - a. The shareholder
  - b. The government
  - c. The public

### **Toolbox for introducing a public transparency initiative**

- Strong political support for the transparency initiative.
- Clear rules on who needs to know what and when.
- Common definitions.
- The body responsible for collecting and disseminating information monitoring (e.g. control, accounting and financial functions in a company, equivalents in governments and independent auditors) must be given the authority and means to carry out their work.
- Authorities in charge of auditing/monitoring/investigating should know what kind of numbers they are looking for, what numbers should look like, how they are generated and why.
- Mechanisms by which information can be shared in a neutral way, flows of information are maintained and any new agency does not become a data sink. Avoid recreating asymmetry of information.
- Fostering mutual trust between agencies in order to decrease the sense of vulnerability in agencies revealing numbers; Strong disincentives for obstruction.
- Checking processes to ensure data is accurate and to show up any discrepancies e.g. use of first principles to make sure revenue generated equates with oil produced.
- Need to develop way of turning data into information that people can understand.
- The same data should be good for both private and public use and be comparable from year to year so that agencies can be made accountable externally.

## **Regulation**

### *Definition of terms:*

The broad banner of **regulation** covers the setting of stable rules and standards for the industry, monitoring performance and ensuring compliance. This is a different activity from setting commercial or economic objectives and monitoring financial performance.<sup>20</sup> Rules and standards may be developed by government and regulators, or by the NOC and IOCs on the basis of international standards (such as the ISO standards) and best practice. However, government or regulators may decide to formalize these standards as obligatory targets for the industry.

There are potentially four bodies that can be entrusted to carry out the functions of monitoring and ensuring compliance: the NOC, the ministry of petroleum, one or more independent regulatory agency and parliament. The question of NOC regulation of foreign companies was discussed in the preceding section. Even where

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<sup>20</sup> Though in a monopoly domestic market, a regulator may be given economic mandates, as in the UK system of regulation for gas and electricity distribution to final consumers.

there are no foreign companies involved, the distribution of authority for regulatory functions is one of the most disputed themes of governance of the oil sector, with practice varying widely from country to country.

**Governance practice related to regulation:**

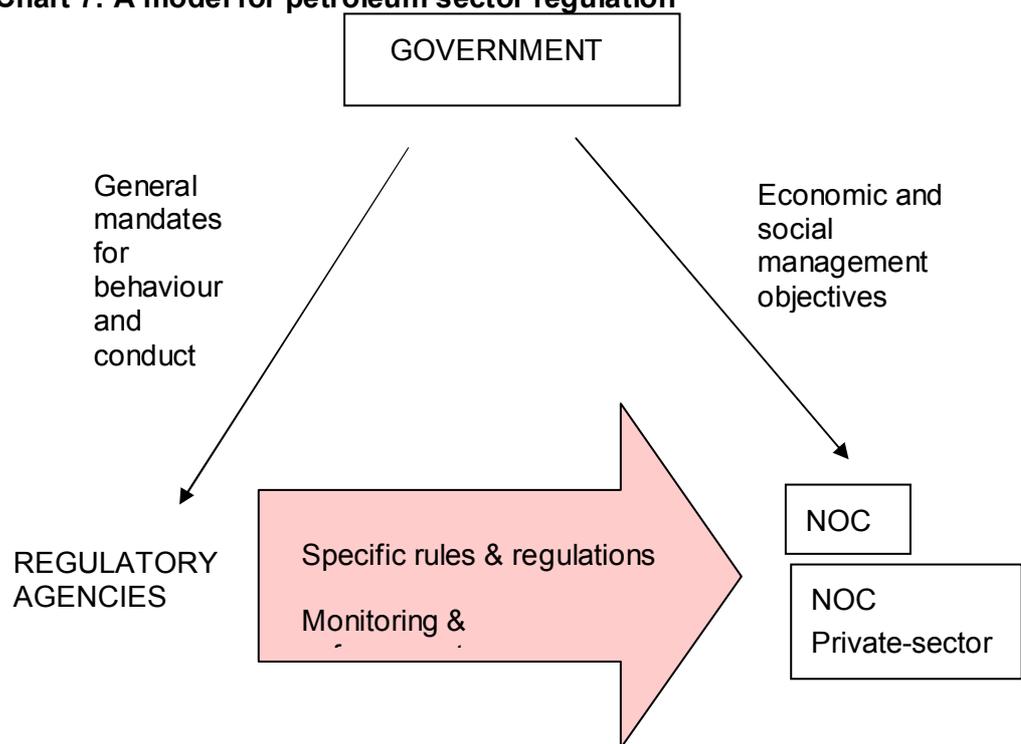
The capacity of the NOC to regulate its activities will depend on its knowledge and expertise, and the clarity of its mandate from the government, but also on its ability to demarcate its roles as operator and regulator. Though some NOCs have succeeded in this clear demarcation of roles, self-regulation is potentially risky. For example, if NOC performance is measured mainly on its revenue results and its contribution to national economic and social programmes, then NOC management may give less attention to health, safety, environmental and technical issues than the government as a whole expects.

In many (but not all) petroleum-dependent countries, environmental regulation is in the hands of an environmental ministry or agency and the NOC is expected to comply with its regulations. Similar considerations apply to health, safety and employment regulation. But typically such ministries and agencies are politically less strong than the petroleum ministry and the NOC, which have great influence over the drafting of regulations and their enforcement. This influence applies especially, for obvious reasons, to regulations which are specific to the petroleum sector.

Over time, state agencies (whether the ministry of petroleum, an independent regulator or parliament) may develop their knowledge and expertise in order to take on this regulatory responsibility more effectively. This should unburden the NOC, enabling it to concentrate on its operating objectives. The NOC often has more knowledge about the necessary standards and achievable targets than government. Over time a regulator can build up expertise because its personnel may be more specialized and more permanent than civil servants or political authorities.

Chart 7 illustrates how regulators can function independently of the NOC.

**Chart 7: A model for petroleum sector regulation**



Some producing countries have successfully built strong state agencies to monitor the performance of operators (US, UK, Canada, Norway, Brazil and Algeria are following this path). The process is often a difficult one. Building up the capacity of an independent state regulator is a key challenge in all cases, but particularly difficult for new producers. In established petroleum-dependent countries, there may be resistance from entrenched interests. For example, the NOC management may fear a loss of control and an extra layer of bureaucracy which may slow down decision-making. These concerns will have to be addressed and communicated in any plan to alter the division of responsibilities.

Regulation can be key to building trust in the political system. For this purpose, the regulatory functions may need to be carried out under the scrutiny of the public and relevant civil society representatives. Many 'independent' regulators derive their authority from primary legislation (rather than the executive ministry) and are accountable to parliament, or the ruler, rather than the ministry concerned.

The establishment of new regulatory agencies does not automatically guarantee better results. Such agencies would face important challenges regarding their autonomy and ability to diagnose aspects in need of correction. Self-rule is fundamental since an agency needs to be as isolated from political tampering as possible. However, independence is not something that can be achieved without a proper institutional framework (as outlined in the *Draft Principles of Good Governance*,<sup>21</sup> for instance). Such frameworks are in very early stages of development in many of the countries with a large national petroleum sector. Additionally, new regulatory bureaux have tended to encounter not only important technical obstacles, apart from the normal period of learning by doing, but also political barriers that have made their performance discouraging.<sup>22</sup>

### Key questions for regulation

- What are the areas to be regulated?
- Which entity is best suited to each of the external (independent) regulation and monitoring functions (e.g., licensing, HSE, technical upstream and downstream activities, IOC spending, NOC development plans and accounts)?
- What are the processes for transferring knowledge and capacity from the company to the regulator?
- What are the checks and balances necessary to ensure there is no conflict of interest between rule-setter, monitor and operator?
- What kind of legal framework is needed to ensure the regulating body has the necessary authority?
- What are the processes for continuous re-evaluation and improvement of standards?

<sup>21</sup> This is available at: [www.chathamhouse.org.uk/pdf/research/sdp/GGprinciples.doc](http://www.chathamhouse.org.uk/pdf/research/sdp/GGprinciples.doc)

<sup>22</sup> For more on this, see Pedro Gómez, *Governance in the Mexican Petroleum Industry: Assessing prospects of reform* Oxford: Oxford Institute of Energy Studies, UK (forthcoming 2007).

### **Toolbox for regulation**

- Political backing to ensure the necessary muscle to effectively regulate the sector
- Means to build capacity:
  - a. Set up programmes for training civil servants in petroleum engineering, accounting *etc.*
  - b. Agreements can also be made with investors to introduce nationals into the companies as secondees
  - c. Reserve funds to attract skilled experts and train them further.
- Independence (allowing regulators to self-rule)
- Time will be needed to develop an agency this way:
  - d. Bridge the power and knowledge gap: pay and train regulators well
  - e. Movements of key personnel may facilitate change so long as regulatory authority and independence are not compromised.

## 5. ENABLING GOOD DECISIONS

Accurate information and the right levels of **transparency** are essential for accountability and making good decisions. There is a large body of literature on transparency and international corporate standards for private companies which we do not replicate here. However, in cases of both listed and non-listed NOCs, the special relationship between NOC and government shareholder may require specific transparency measures.

### Benchmarks for transparency

- A simple, comprehensive guide to the petroleum sector governance structure is available publicly.
- The government and other shareholders receive timely and accurate financial and operational information from operators.
- Where information about the sector remains confidential (not available publicly), the rationale for that confidentiality is explained and justified, for example by the need to preserve commercially sensitive information.
- The cost of any non-market pricing of supplies of products to national consumers (including government and national companies) is identified, taking account of the appropriate market reference.
- Criteria for awarding licences are published and licensing decisions are explained.
- Criteria for awarding major government procurement contracts for the sector (including those awarded by the NOC) are published and major award decisions explained.
- Employment policy for each agency within the sector is transparent.

As the earlier section 4 on Accountability dealt with revenue transparency, the following looks at two other areas where transparency is an important issue: licensing (or contracting) and local content procurement or similar development commitments.

### Transparency in licensing, leasing, and exploration and production contracts, (including Production Sharing Agreements (PSAs))

In countries using the private sector or mixed national and private sector, the system for awarding oil and gas contracts, licences or leases is crucial to maximize the value and competency of resource development. Licensing, leasing and contract awards is one area within the oil and gas sector where the drive for more transparency has become an issue in recent years. Civil society groups have been questioning awards of licences to companies linked to individuals and have been fighting for more openness in the bidding process to ensure a fair outcome. The subject is extremely complex and different countries have adopted different systems. These involve defending the countries' sovereignty over natural resources, establishing property rights for private-sector companies, sharing the profits of petroleum development between the state and the investor, setting the pace of exploration and development, and establishing conditions for private-sector operation. There are three critical areas:

- The fiscal structure – whether government revenues are gained through a tax system which has the discretion to change, or through 'Production Sharing Contracts' where the government undertakes not to change the taxes in the project but receives an agreed share of future profits;

- The allocation process: individual project by project negotiation, or competitive bidding rounds;
- The inclusion of 'national mission' or similar development objectives such as local content.

Where there are national development objectives – e.g. infrastructure – the government influence is likely to be stronger and strategic partners may be chosen by direct negotiations and influenced by country-to-country memorandums of understanding. In some cases, the choice of winner through a transparent licensing system has been overridden by such diplomatic agreements, in which the government has offered first rights of refusal on certain fields to the national oil company of another country

Transparent processes can increase competition and raise the standards of work programmes and generate more investment. Countries such as Brazil, Venezuela, Algeria, Libya and Nigeria have introduced more transparency into the competition for awards of production sharing contracts. The transparency of the contract between the winning bid and the host country can also build greater public trust.

Transparency in licensing and contracting is important, but does not necessarily mean that a country has to run an open bidding process. Flexible bidding can ensure long-term value for the country as it can be tailored to the individual parameters of the given project. For example, in big projects, direct negotiations with potential investors can be beneficial. Pre-bid qualification is a key process to ensure the most suitable candidates for licences have a chance to bid. This is especially important for projects with specific technical needs. Whichever system a country chooses, the selection criteria (e.g. the investment commitment, operations record, transfer of technology, best practices, standards of business conduct, etc.) and reasons for the choice of winning company should be explained publicly.

### **Key questions for licensing, leasing and contracting**

- Are licences and contracts granted through a competitive process?
- Is the process clearly defined and public?
- Are the criteria for awards public and well-defined?
- Do you have a model licence or production sharing agreement (contract)?
- Is there a pre-qualification process and are its criteria public?
- Are the production sharing agreements (contracts) made public?
- Can the process for choosing the winning bid be overridden or vetoed?

### **Toolbox for licensing, leasing and contracting**

- Public notice of award process and criteria
- If NOC is a bidder, evaluation by separate agency of government
- Public information about successful bid

### **Local content policy (and similar development policies)**

Local content policies have been adopted in many countries in an attempt to capture finance – particularly at the front end of a petroleum project – and to build national capacity. Governments in countries such as Nigeria, Angola, Trinidad and Tobago, Iran, Venezuela, Russia and Kazakhstan have set ambitious targets and introduced legislation or regulations to secure more employment and more local value creation from the oil and gas sector.

Decisions over this type of policy require an accurate assessment of the needs of the industry and the national capacity.

#### *Distortion in the procurement process*

The risk is that the distortion to the procurement process created by local content requirements could lead to delays and cost increases, and unnecessary tensions between the IOCs and NOC. For most countries, the rational solution should be to develop a local supply of some competitive goods and services required by the petroleum industry, but not to demand an indiscriminate use of local suppliers. In the case of minimum local content requirements, waivers will often be required because the local capacity is too limited. This may easily create a situation of bureaucratic delays as applications for exemptions are processed. It may also prepare the ground for increased corruption aiming at avoiding such delays.<sup>23</sup>

#### **A neutral and transparent local content policy**

Some of the above problems can be avoided through a thorough assessment of the sector's needs and national capacity to provide services to the sector. For example, as a result of analysing the gaps in its national capacity, Brazil has initiated an extensive qualification programmes to strengthen the competitiveness, the capabilities and the capacity of the Brazilian petroleum industry and improve the business climate. Brazil's National Petroleum Agency (ANP) – the government's regulatory body - has expanded its rules for 'goods of national production' and has set minimum requirements for local content in the different stages of the development of a project, depending on where the project is located. There is less local content in the deep water projects, far more in the onshore activities. Petrobras – the national oil company – is also very specific in its local content requirements.

Some countries such as Norway and UK have neutral organizations (Achilles, Offshore Supplies Office) to facilitate efficiencies in the supply chain management, and to provide objective information to the oil companies on potential and actual capabilities of suppliers and contractors and to provide suppliers with consistent and up-to-date information on potential contracts and purchasers in the markets. In Nigeria, the oil industry has been arguing strongly for a similar system to ensure fairness and transparency, and the Nigerians have accepted the need for an independent body to register and pre-qualify the companies to avoid some of the pitfalls often linked to local content policies.

Helpful processes may include the introduction of tools to monitor national content or adherence to labour standards of supplies related to such new developments and other measures to maximize local / national value creation from local / regional oil and gas developments. The local supply chain will be more successful if combined

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<sup>23</sup> See Hildegunn Kivik Nordas, Eirik Vatne and Per Heum 'SNF Report 08/03: The Upstream Petroleum Sector and Local Industrial Development, A Comparative Study', Institute for Economics and Business Administration, Bergen, April 2003.

with exposing the local suppliers to the discipline of the market competition after a relatively short period of protection.

#### **Key questions for local content and development policies**

- Are development requirements clearly specified?
- How is performance measured and by whom?
- Is there a process for adjusting obligations in light of changed circumstance?
- Are development requirements public?

#### **Toolbox for local content (development) commitments**

- Public criteria for development commitments (e.g. minimize discretionary support for individuals, competitive processes for gaining support)
- Benefits of development programmes should be public (not private deals for political favourites)
- Special agency (like UK OSO (Offshore Supplies Office) with knowledge of local development to:
  - Advise on feasibility of requirements
  - Monitor performance
  - Adjust commitments
  - Report to government and companies involved

*For further information about the Good Governance of the National Petroleum Project or to comment on this Report, please visit the website [www.chathamhouse.org.uk/goodgovernance](http://www.chathamhouse.org.uk/goodgovernance) or contact [eedp@chathamhouse.org.uk](mailto:eedp@chathamhouse.org.uk)*

## APPENDIX 1 - RELEVANT NATIONAL CONTEXT CATEGORIES

A) Political: These factors focus on the relationships between the executive government, state institutions, the population and the national company:

- The nature of the political system: institutionally, the political system can be centralized or present checks and balances to executive power (for instance, a congressional or parliamentary system).
- The allocation of government powers affecting the petroleum sector.
- The level of public trust in state institutions.
- Whether state institutions are better equipped than the national company to undertake development and welfare roles.

B) Economic: These factors focus on the dependence of the national economy on the oil sector:

- Degree of economy's dependence on oil: This can be measured by the size of petroleum reserves per capita and the extent to which the non-petroleum economy depends on petroleum revenues to support government expenditure and provide export earnings to pay for its imports.<sup>24</sup>
- The size and growth of the population, especially the labour force.
- Level of economic development of the country: A simple measure would be the non-petroleum GDP per capita. Other indicators would be human capital (quality and relevance of education and training) and industrial and commercial service infrastructure (availability and quality of national supply chains), availability of general infrastructure such as power, communications and transport, ease of doing business in the private sector.
- Levels of per capita income and proportion of population in poverty.

C) Petroleum system: These factors relate to the legal, political and historical parameters within which the NOC and/or IOCs must operate in the country.

- The legal structure of the petroleum system: the ownership of resources, degree of monopoly for state company, scope and structure for private-sector participation;
- Contractual and international obligations affecting the petroleum sector (OPEC or WTO memberships, for instance).
- The relationship between government (usually the ministry of petroleum) and the national oil company: informal structure and balance of capacity, knowledge and political influence.
- The history of the oil sector: past confrontations with international companies and their governments create extensive legacies in petroleum governance in some countries.

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<sup>24</sup> See John V. Mitchell, "Economic Challenges" in Valerie Marcel, *Oil Titans: National Oil Companies in the Middle East* (Washington, DC: Brookings/Chatham House, 2006).

## APPENDIX 2 – COMPOSITION OF GOVERNING BODIES IN SELECTED COUNTRIES

### The Composition of the NOC Board of Directors in Selected Countries

<b>NOC</b>	<b>Government Representative</b>	<b>Company and non-government representative</b>
ADNOC	n/a	n/a
KPC	Chair: Minister of Energy Seat: Ministry of Finance	Deputy chair: KPC's CEO Seats: 7 MDs, including subsidiary heads (not KUFPEC)
PEMEX	Chair: Secretary of Energy Secretary: Chief of Legal Affairs, Ministry of Energy (no vote) Seats: Secretary of Finance and Public Credit, Secretary of Foreign Affairs, Secretary of Communications and Transportation, Secretary of the Environment and Natural Resources, Secretary of the Economy Public Commissioner: Delegate of the Energy Sector from the Secretary of Public Functions (no vote)	Seats: 5 oil workers' union representatives
PDVSA	Chair: Minister of Energy and Mines Seats: Hydrocarbons Vice Minister, OPEC representative	Seats: 5 PDVSA managers, 2 senior military officials
Petronas	Seat: Member of the Malaysian Communications and Multimedia Commission	Chair: President and CEO Seats: 7 Petronas executives
NIOC	Seat: Ministry of Petroleum (OPEC representative)	Chair: NIOC's managing director Seats: Deputy MDs and 6 directors of operations
Saudi Aramco	Chair: Minister of Petroleum and Mineral Resources Seats: Minister of Finance and Representatives from the Capital Market Authority, the Shura Council and the Communications and Information Technology Commission	Seats: Saudi Aramco's CEO and 3 VPs, retired presidents of Marathon and Texaco, former vice chairman of J.P. Morgan & Co.
Sonatrach	Chair: Minister of Energy and Mines Seats: Governor of central bank, other ministers	Seats: CEO of Sonatrach, CEO of Sonelgaz

Source: V. Marcel, *Oil Titans*, *op. cit.*, p. 83; Good Governance of the National Petroleum Sector research.

### The Composition of the Supreme Petroleum Council (or equivalent) in Selected Countries

Country	Government representative	Company representative
Abu Dhabi	Chair: President of UAE Seats: Governor of Central Bank, Abu Dhabi Investment Authority representative, 8 Abu Dhabi government officials	Secretary General: ADNOC's CEO Seat: ADNOC's deputy CEO
Kuwait	Chair: Prime Minister Seats: Governor of central bank, 5 ministers	Deputy chair: KPC's CEO Seats: 9 non-government members
Iran	Chair: Minister of Petroleum Seats: Other ministers	Seats: NIOC's managing director/deputy minister of petroleum, NIOC's deputy MD
Saudi Arabia	Chair: the King (prime minister) Deputy chair: the Crown Prince (deputy prime minister) Seats: 8 ministers	Seats: Saudi Aramco's CEO
Algeria (General Assembly)	Chair: Minister of Energy and Mines Seats: Governor of Central Bank, a representative of the presidency, 3 leading ministers	None

Source: V. Marcel, *Oil Titans*, *op. cit.*, p. 84 (updated); Good Governance of the National Petroleum Sector research.

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