NRGI Reader
March 2015

Natural Resource Governance Institute

State Participation and State-Owned Enterprises

Roles, Benefits and Challenges

KEY MESSAGES

- Many countries create state-owned enterprises (SOEs) that focus on the extractive sector with hopes of building the country's capacity to participate in the lucrative field of resource extraction, to increase the government's revenue take, and to improve the government's ability to monitor what other companies are doing in the country.
- SOEs, often referred to as national oil companies (NOCs) in the oil and gas sector, play a variety of roles in different countries. These roles can include operating in the commercial sphere, regulatory responsibilities, creating policy, and financial expenditures.
- While some SOEs are extremely successful companies, others have trouble being competitive with international companies and demonstrating strong benefit to the populations they serve.
- While needs often vary from country to country, NRGI's research has shown a few trends that lead to successful NOCs, including clarifying roles between the SOE and other government entities, developing a clear revenue retention model, investing in staff and practicing transparency.

"The creation of nationally owned resource companies can be a key component in a country's strategy to harness the development potential of its subsoil assets. Despite these opportunities, national companies can pose a risk to a country if assigned inappropriate roles and governed poorly."

— Natural Resource Charter, Precept 6

THE RATIONALE FOR STATE PARTICIPATION

When natural resources are discovered in a country, governments often invite companies with experience in natural resource extraction to explore and extract the product. Many governments do this because they do not have the expertise, capital or equipment to bring resources out of the ground and to market. In this situation, the government makes money either by retaining ownership of the resource or charging taxes and royalties on the company's profits.

In some countries, the government decides that it can increase its potential earnings and control over the extraction process by creating a company focused on natural resource extraction. Government owned companies are usually called *state-owned enterprises* (SOEs). SOEs tend to be industry specific, with one SOE focused on mineral extraction and another focused on oil and gas, usually called a *nationally owned oil company* (NOC).

This reader is intended for use in conjunction with Precepts 1 and 6 of the Natural Resource Charter.

Extraction-focused SOEs, including NOCs, can play a variety of roles in helping to convert a country's natural resource wealth into better development. This reader outlines the benefits of SOEs, different roles played by SOEs, the challenges that face some SOES, and some of the lessons learned on best practice of governance of SOEs.

BENEFITS OF STATE-OWNED ENTERPRISES IN EXTRACTIVES

Proponents of SOEs see the government's involvement in the industry as an opportunity build capacity, increase the government's take, and improve the government's monitoring of the industry.

- **Capacity building**: An SOE has the opportunity to become a domestic expert in commercial management of oil or mining. Over time, this can promote broader industrial development and reduce dependence on foreign partners. It can also lead to international expansion in a very lucrative business. Success requires a consistent commitment to training and the strategic use of private partners to supplement and build capacity.

- **Direct financial benefits:** Many countries view participating in the production of an extraction project as an opportunity to collect additional revenue. As the owner of an extraction company, the state not only receives revenue as a tax collector but also profits as a corporate operator.

- **Improved monitoring:** By having a seat at the table in an oil or mining venture, many governments expect to enhance their ability to monitor the activities of private partners.

THE ROLES OF STATE-OWNED ENTERPRISES IN EXTRACTION

Before the oil boom in the 1970s, private companies conducted most of the oil production. The oil boom spurred a wave of nationalization, leading to the massive expansion of the roles of NOCs. This domination, as depicted in figure 1, continues today. Ninety percent of the top 60 oil producers per capita have an SOE. SOEs are not as widespread in the mining industry, but they do play a key role in a number of countries.

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Governments can create national companies that focus on extractives to play several different roles. The responsibilities can be divided into commercial roles, regulatory responsibilities, policymaking and national development.

Commercial roles

Some state-owned companies choose to act like a traditional extraction company and directly participate in the exploration, development and production of an oil field or mine. Often these companies are part of a *joint venture*, an agreement between different companies to work together on the development of a mine or oil field. This type of cooperation can take different forms. In some joint ventures, one company takes the lead in terms of providing personnel and equipment while the others provide financing and oversight. In such cases, the SOE will reap profits just like the other companies participating in the venture and bear the risk of a potentially unproductive field. The level of involvement of an SOE in a particular project varies based on country and project. For example, Saudi Arabia's Aramaco is the *exclusive operator* in most fields in Saudi Arabia and does not typically own fields as a joint venture member. Meanwhile, Ghana's GNPC is usually the *minority partner* in a joint venture with private companies. Some countries have provisions in their laws that automatically allow the SOE to participate in every exploitation contract.

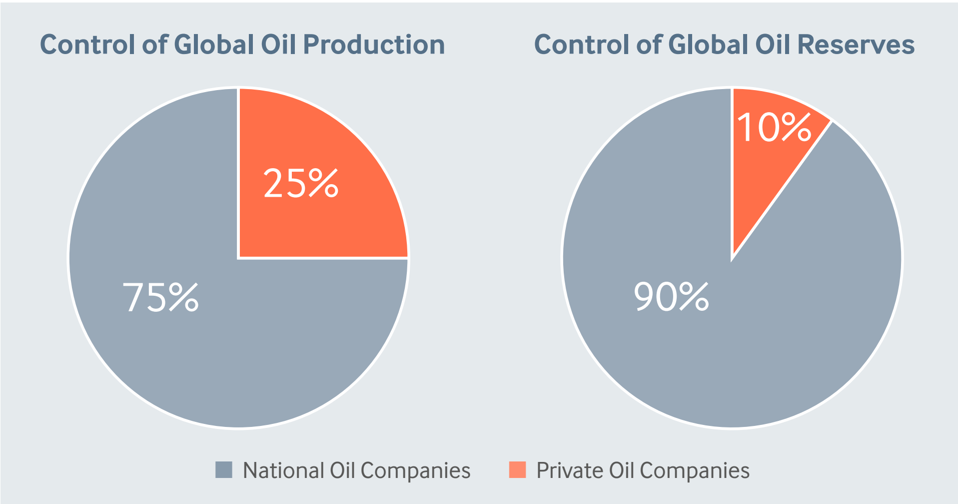

Figure 1. National oil companies control the majority of oil production

Source: NRGI elaboration of World Bank data, available at http://go.worldbank.org/UOQSWUQ6P0

When a country has learned from experiences with extractive industries at home, some SOEs start to participate in exploration and extraction in other countries. Petronas, a Malaysian state-owned company, has extensive reach throughout Africa and Asia. Similarly, Chinese national oil companies such as PetroChina and Sinopec are well known for having a strong influence around the world, including in the development of African oil fields. Countries with successful NOCs tend to develop their operational capacities, such as Petrobras in Brazil growing expertise in deepwater oil extraction.

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Some NOCs choose to invest in *downstream* development. This means they work to refine crude oil into a format that is available for an end user, such as gasoline for a car, or import these refined products. This type of business requires different skills, related to refining, transportation and marketing, than participating in extraction projects.

SOEs often have a role in selling the mineral or oil that is obtained by the state. The state could receive minerals or oil through a number of arrangements, including the NOC's own extraction, its ownership shares in a joint venture, participation in a production-sharing agreement, and oil paid by companies to the government to cover their royalty or tax liabilities. Sales of oil by SOEs often represent a large portion of the government's revenues: From 2011 to 2013, the total value of NOCs oil sales equaled 56 percent of combined government revenues for sub-Saharan Africa's top 10 oil producers. Coordinating these types of sales, called *commodity trading*, requires advanced knowledge of the industry and market economics (see reader on commodity trading for more information).

Regulating roles

In addition to commercial or moneymaking roles, SOEs often have a larger responsibility in managing the development of the extractive sector in the country by promoting efficient exploration and production, channeling a fair share of revenues to the state, managing the stability of agreements, and monitoring operations and revenue collection. The specific roles for SOEs vary from country to country but can include tax collection, assignment of operating rights, monitoring and management of cadasters, setting rules governing performance, ensuring compliance by companies with legislation, regulation and contracts, and approving key decisions by partner companies.

Revenue and roles for SOEs

This image shows how revenues can flow to and from state-owned enterprises with different roles. The blue arrows represent flows to the SOE, from collecting payments from companies on the bottom right, from participation in operations on the top right, and from the national treasury on the left. Revenues flow from the SOE to the national treasury on the left, to finance extraction projects on the top right, and toward quasi-fiscal expenditures at the bottom.

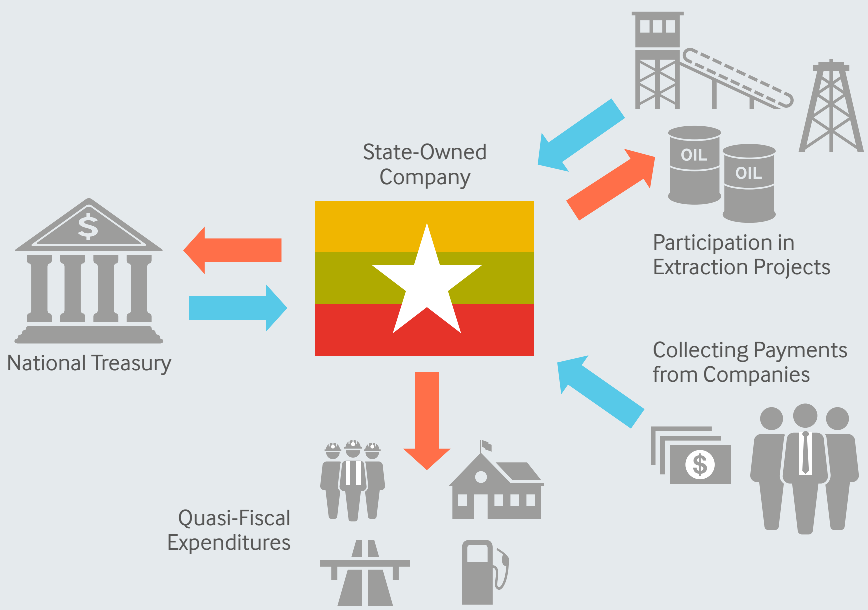

Figure 2. Types of revenue flows to and from SOEs
Source: NRGI

National development: quasi-fiscal roles

Some SOEs take on roles that would typically be carried out by ministries responsible for government expenditures, such as the ministry of finance or transport. Instead of transferring the revenues to the treasury, the SOE directly pays for projects such as servicing national debt, building or maintaining infrastructure, promoting health and education, providing consumer fuel subsidies, and purchasing arms. This practice can often be concerning because it avoids the usual review of the national budget process and can harm the commercial viability of the company. For example, in Venezuela the SOE PDVSA spent $1.5 billion more on social programs than on oil projects in 2012. Domestic *fuel subsidies*, the mechanism for providing a discount to consumers who buy fuel in their own country, tend to be one of the largest quasi-fiscal expenditures by NOCs.

"Instead of transferring revenues to the treasury, SOEs can directly service national debt or build infrastructure (among others). This practice can often be concerning because it avoids the usual review of the national budget process."

Policy

Many SOEs are involved in setting the overall strategic objectives for the sector. This can include drafting legislation and making big-picture decisions.

Tale of two approaches: NOCs and other ministries

In **Norway**, the policy, national development, commercial operations, and monitoring and regulation roles are split between four different government agencies. The NOC Statoil runs the commercial activities; the Storting, the national parliament, oversees policymaking; the Norwegian Petroleum Directorate conducts monitoring and evaluation; and the Ministry of Finance and line ministries oversee the pursuit of national economic development.

In contrast, Sonangol in **Angola** conducts all of these activities within one agency. It sets the national policy, oversees commercial activities, monitors international companies operating in the sector, and spends significant resources on development projects, including servicing the national debt and building housing.

CHALLENGES OF SOEs IN EXTRACTIVES

Well-managed state-owned companies can become large multinational enterprises with global renown. That said, many SOEs struggle to operate in a competitive manner that produces a sustainable benefit to the local population. The challenges SOEs face are myriad and particularly strenuous when institutions are weak and roles are not well defined. If not effectively staffed or supervised, state-owned companies can slow project development, decrease the revenue accruing to the state and exacerbate corruption. In many countries these enterprises have served as vehicles for public officials to steer valuable contracts toward their own interests, or to create bloated bureaucracies that do little to advance broader development. State equity investment also brings risks by exposing the country to a share of project costs and increasing dependence on non-renewable natural resources as a core economic driver. Commercially, NOCs record lower profits per employee than other international oil companies. (See figure 3.)

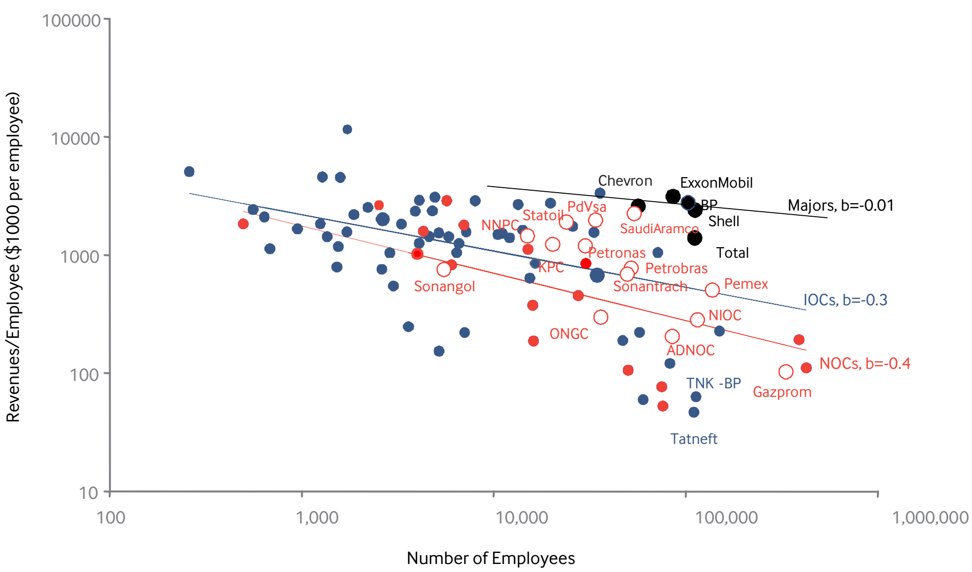

Figure 3. NOCs (red), Majors (black) and International Oil Companies (IOCs) (blue) revenue per employee vs. number of employees in 2004

Source: Nadeja Makarova Victor, *On Measuring the Performance of National Oil Companies (NOCs)*, Stanford University Program on Energy and Sustainable Development, Working Paper #64, 2007, http://iis-db.stanford.edu/pubs/21984/WP64,_Nadja_Victor,_NOC_Statistics_20070926.pdf

NRGI RECOMMENDATIONS

NRGI has researched the challenges facing SOEs in balancing the establishment of a commercially viable company and serving the public interest. NRGI recognizes that each SOE exists in a different context, with different demands and opportunities.

Cameroon's SNH, which only participates as a minority shareholder and acts as a quasi-regulator, may not need the same corporate structures and resources as a corporation such as Norway's Statoil, which competes with international companies to manage full projects. Focusing on oil companies, NRGI's research has resulted in nine recommendations for NOCs.

	Recommendation	Core features
Defining and financing a commercial mandate	1. Carefully define commercial and non-commercial roles. Limit non-commercial activities where sophisticated or expensive commercial activities heighten the risk and cost of conflicts of interest.	• Define a clear commercial strategy, and adhere to it. • Clearly define what the NOC will not do, and enforce consistently. • Limit regulatory role at stage where NOC aspires to true competitiveness.
	2. Develop a workable revenue retention model.	• Navigate competing pressures: NOC needs access to sufficient revenue flows to cover costs, but where NOC has too much control over state finances, it risks becoming a parallel state. • Other things equal, the higher the NOC's investment needs, the higher the justification for it to have autonomy over revenue flows. • Other things equal, the higher the share of overall public revenues passing through the NOC, the lower the justification for it to have autonomy over revenue flows.
	3. Procure external financing by listing some NOC shares on public stock exchanges or issuing external debt where appropriate.	• Take advantage of capital-raising and corporate governance impacts of markets.
Limiting political interference in technical decisions	4. Define clear structures and roles for state shareholders.	• Limit the number of government shareholders to promote coherent management.
	5. Empower professional, independent boards.	• Make appointments according to well-defined, meritocratic processes. • Emphasize technical expertise rather than political patronage.
	6. Invest in NOC staff integrity and capacity.	• Adopt strong employee accountability provisions. • Promote training and merit-based promotion. • Restrict conflict of interest. • Encourage learning orientation throughout company.
Ensuring transparency and oversight	7. Maximize public reporting of key data.	• Disclose revenues, costs, revenue flow between NOC and the state, production, plans, results of oil trading and quasi-fiscal activities.
	8. Secure independent financial audits, and publish them	• Commission audits by skilled independent professionals, and make results available to citizens.
	9. Choose an effective level of legislative oversight.	• Ensure responsibility of NOC and its officials to answer to the legislature without unduly constraining

Figure 4. Nine recommendations for reforming national oil companies

Source: Heller et al, Reforming National Oil Companies: Nine Recommendations (NRGI 2014)

QUESTIONS TO ASK

- Are there SOEs in my country? If so, in what sectors?
- What roles does the SOE play in my country?
- How does the SOE in my country operate commercially? Is there mandatory participation for all projects? Does it operate at all outside my country?
- What are the national goals of our SOE and state participation?
- Is it possible for find information about the SOE's performance (see Resource Governance Index)?
- What return is the SOE providing to the national budget? Is the SOE involved in funding projects? If so, what types of projects?

ADDITIONAL RESOURCES

Natural Resource Charter, Precept 6

Heller et al, *Reforming National Oil Companies: Nine Recommendations* (NRGI, 2014), available at: http://www.resourcegovernance.org/sites/default/files/NRGI_9Recs_Web.pdf

Heller, Patrick and Dr. Valerie Marcel, *Institutional Design in Low-Capacity Oil Hotspots* (NRGI, 2012), available at: http://www.revenuewatch.org/publications/institutional-design-low-capacity-oil-hotspots

Marcel, Valerie, ed. *Guidelines for Good Governance in Emerging Oil and Gas Producers* (Chatham House, 2013), available at: http://www.chathamhouse.org/publications/papers/view/194059