Parliamentary Briefing
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Natural Resource Governance Institute

State Participation in Oil, Gas and Mining

KEY MESSAGES

- State participation in oil, gas and mining often occurs through the involvement of state-owned companies in key extractive projects.
- When participating properly, states can create financial benefits, promote capacity building, and improve monitoring of the oil, gas and mining sectors.
- However, state participation can also create obstacles to private investment, become a drain on public coffers, or create opportunities for patronage and corruption.
- Parliaments should enforce regular reporting and rigorous oversight of state-owned enterprises and undertake hearings on their performance to ensure that these entities manage valuable national resources efficiently and support national development goals.

Nationally owned resource companies should be accountable, with well-defined mandates and an objective of commercial and operational efficiency.

Precept 6,
Natural Resource Charter

INTRODUCTION

Many countries seek, through state-owned companies, an ownership interest (or "state equity") in projects in order to maintain control of the technical and commercial elements of oil, gas and mineral extraction.

In some countries, such as Brazil, Chile, and Norway, effective state-owned companies have developed strong commercial capabilities and helped manage oil, gas and mining projects according to the goals of the country and the interest of citizens. As these companies gain experience, they can reduce dependence on foreign partners, deliver sizable returns to the national budget, and fuel the development of locally owned service providers. In other cases, particularly in the early years of their existence, state-owned enterprises (SOEs) in countries such as Ghana and Angola have played a more limited role, often as minority partners to multinational enterprises.

However, state participation also carries serious risks. If not effectively staffed or supervised, state-owned companies can slow project development, decrease the revenue accruing to the state, and accommodate corruption. In many countries these enterprises have served as vehicles used by public officials to steer valuable contracts toward their own interests or to create bloated bureaucracies that do little to advance the country's broader economic development goals. State equity investment can also bring risks by exposing the country to a share of project costs, and by increasing dependence on non-renewable natural resources as a core economic driver. Parliaments can play a critical role in designing and ensuring the application of rules that define the roles of state-owned enterprises, mandating good corporate governance and transparency and creating incentives for strong and effective management. National companies and the administrators of local content programs should be subjected to regular reporting and vigorous oversight by parliaments.

FUNDAMENTALS OF STATE EQUITY PARTICIPATION

State participation has been particularly prominent in the oil and gas sector since the 1970s, when a wave of nationalizations in Organization of Petroleum Exporting Countries (OPEC) countries shifted the balance of control from private to state companies. Many governments take a direct ownership stake in oil or mineral and gas ventures, either as the sole commercial entity or in partnership with private companies. In many cases this participation is exercised through a state-owned entity, though in some countries the government exercises its ownership stake via ministries or other government institutions.

Table 1. Models of state ownership in the petroleum sector

Rule on participation of SOE in oil and gas projects	Example(s)	Pros	Cons
SOE has monopoly over exploration and production, and role of private companies is limited to being a "service provider" to the SOE	Saudi Arabia, Mexico (pre-2013)	Total national control – the SOE is the dominant manager of all projects	Investment in the sector will depend 100% on SOE's financial capabilities; Lack of competition creates disincentives to strong performance
SOE is "concessionaire", can choose the private companies it wants to cooperate with in projects	Angola, Malaysia, Ghana	Guaranteed SOE leadership in the selection of partners, but benefits from the skills brought by private companies.	Risk of conflict of interest, some disincentives to performance/investment since the SOE is basing the selection of partners on its own internal goals
SOE is given a guaranteed ownership stake/role in the project but another government body picks the private partners to participate in the project.	New Brazilian off-shore fields, Indonesia	Guaranteed SOE role in a project, but stronger checks and balances on SOE decision-making	Some disincentives to maximum SOE performance or maximum foreign investment remain by virtue of guaranteed SOE role
SOE has to compete/negotiate to participate in projects, but is given a privileged position to participate.	Kazakhstan, Mexico (2013-present)	Creates greater incentives for SOE to become competitive, but still makes it likely that SOE will have a strong role in many projects	The performance incentive is more limited than in full competition
Full competition – SOE has to bid on projects just like a private company	Norway, Colombia	Creates maximum quality of companies operating in the country, and strong incentives for SOE to develop its performance	Could hurt SOE's development, especially in the early years –will be difficult for it to win competitions, and therefore limits opportunities to learn and grow
No SOE	United States	Full competition – market forces and innovation can contribute to strong economic returns for the state via taxes	No opportunity for the state to use an SOE as an engine for the achievement of state development goals or local content

GOALS OF STATE EQUITY PARTICIPATION

Proponents of government ownership of shares, or equity stakes, cite three principal benefits:

Capacity building

If a government holds equity through a national company, that company can become a domestic expert in commercial management of oil, gas or mining. Over time, this can promote broader industrial development and reduce dependence on foreign partners, as has been the case with Brazil's Petrobras and Malaysia's Petronas. However, state ownership alone does not ensure this kind of capacity building; many state-owned companies have failed to develop. Success requires a consistent commitment to step-by-step training and the strategic employment of private actors to supplement and build capacity.

Improved monitoring

By having a seat at the table as a shareholder in an oil, gas or mining venture, officials in many governments expect to enhance their ability to monitor the activities of private partners. Experience here has been mixed. While countries like Trinidad and Tobago have used equity as a tool for stronger enforcement, many government shareholders remain excluded from major decisions. In these nations, the arrangement provides scarcely more authority than the government's basic regulatory powers. Governments should negotiate shareholder agreements carefully, to ensure an active role and full information-sharing. And it is important to ensure that the government's representation at board meetings or joint operating committees is exercised by technically adept executives who invest time to scrutinize documents and plans.

Direct financial benefits

In some countries, an equity ownership stake entitles the state to a share of the resource produced, which the state or a state-owned company might sell itself, or which might be monetized via cash payments from the private company to the state. In other cases, equity participation entitles the state to some form of dividend payment if a project is profitable, much like payments to shareholders in a publicly traded company. With this sort of arrangement, however, private companies often control the accounting procedures that lead to the declaration of dividends. As a result, dividends are paid only after a project has recovered all upfront costs, meaning that they are often awarded years after the project's start and they can be vulnerable to financial manipulation—leading to disappointing dividends for states.

TYPES OF STATE EQUITY

With **paid equity**, the state pays a market rate for its shares and may have to meet cash calls for project development expenses, as a private partner would. This can increase a state-owned company's focus on maximizing profits and accelerate its development as a viable, competitive entity. But in cash-strapped countries, the need to pay upfront or unanticipated costs can strain public resources and increase the economy's dependence on volatile oil, gas or mineral prices. Alternatively, governments can receive equity on preferential terms (or "**carried equity**"). In this case, the private-sector oil, gas or mining partner finances the operation upfront and the government pays for its equity via foregone dividends, which absolves the state of the responsibility to pay cash out of pocket, but delays financial returns to equity. With **free equity**, the government pays nothing for its equity, but it does not come without costs to the state. Free equity can deter investment and where instituted, typically obligates states to make trade-offs elsewhere in the fiscal package, in the form of lower taxes or royalties.

GOVERNANCE AND MANAGEMENT OF STATE-OWNED ENTERPRISES

Without strong mechanisms for oversight and accountability, holding equity through a state-owned company can exacerbate governance problems and lead to sizable losses of revenues for the state; extra-budgetary spending that bypasses parliament's budget oversight; and patronage (see Table 2). Inefficient companies can bog down oil, gas or mineral operations in poorly coordinated processes that slow or diminish revenue creation. Such a company can become a "state within a state" pursuing internal priorities with little attention to broader national objectives, but it can also be used as an opaque vehicle to avoid public scrutiny on major issues from infrastructure development to arms purchases and political payoffs.

Table 2. Examples of lack of strong mechanisms for oversight and accountability

COUNTRY	COMPANY	ISSUES EXPERIENCED
Angola	SONANGOL	Between 2007 and 2010, poor reporting by the national oil company on its revenue and the expenditures it carried out on the state's behalf were key causes of a $32 billion public accounting gap, representing a quarter of total national GDP.
Azerbaijan	Socar	In its report *Azerbaijan Anonymous*, Global Witness discovered that a single individual, Anar Aliyev, held ownership stakes in at least 48 deals with Socar, including production-sharing agreements and joint ventures.
Nigeria	NNPC	In 2011, the finance ministry overestimated oil revenues by 39 percent, mainly due to non-remittance of funds by the national oil company.

Thirty-three of the 45 state-owned enterprises assessed by the 2013 Resource Governance Index were deemed to have unsatisfactory transparency and accountability practices.

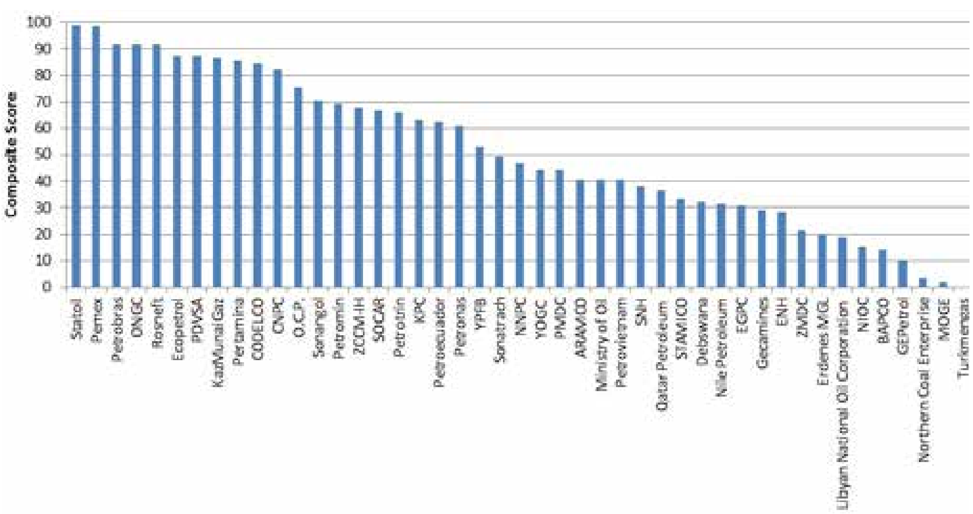

Figure 1. Governance of state-owned companies

Source: results from the 2013 Resource Governance Index

Several measures can help reduce risks and promote effective and accountable state-owned enterprises:

- The division of responsibilities between the national company and other institutions should be clearly defined in legislation and should avoid duplication that can serve to create parallel processes. If state-owned companies are to play anything more than a purely commercial role—for example, if they monitor private partner compliance with national rules—the contours of these responsibilities must be transparent.
- In accordance with the 2013 EITI Standard, state-owned enterprises should report publicly on revenues, budgets, production, reserves, financial transfers to and from the treasury, and any "quasi-fiscal activities," such as infrastructure construction, in which they engage. They should be subject to independent audits, the results of which should also be published.
- Boards of national companies should be selected based on professional qualifications rather than political patronage. Boards should make decisions independently.
- State-owned enterprises should develop long-term commercial strategies, and should be held to account by the Executive and/or parliament for the implementation of those strategies.

STATE-OWNED ENTERPRISES IN MYANMAR

In 1989, Myanmar enacted its State-Owned Economic Enterprise Law, identifying key areas of economic activities where the state would exercise control via SOEs. These enterprises hold considerable sway over the management of public money—as is illustrated in Table 3, oil, gas and mining sector SOEs were responsible for 28 percent of all public revenues and 15 percent of public expenditures in Myanmar's 2012-13 fiscal year.

Table 3. Extractive sector SOE shares of public revenues and public expenditures, FY 2012/13

Enterprise	Scope of activities	Percentage of public revenues	Percentage of public expenditures
Myanma Oil and Gas Enterprise (MOGE)	Upstream oil and gas	15.84%	10.17%
Myanma Petrochemical Enterprise (MPE)	Petroleum refining, processing, conversion into fertilizer/ methanol	5.34%	1.99%
Myanma Petroleum Products Enterprise (MPPE)	Marketing and distribution of petroleum products	5.22%	1.44%
No. 1 Mining Enterprise	Lead, zinc, silver, copper, iron, antimony, nickel, chromite	0.08%	0.02%
No. 2 Mining Enterprise	Gold, tin, tungsten, rare earth, titanium, platinum	0.25%	0.23%
No. 3 Mining Enterprise	Coal, limestone, industrial minerals, manganese, decorative stone	0.04%	0.02%
Myanmar Gems Enterprise	Gemstones	1.62%	1.13%
Myanmar Salt and Marine Chemical Enterprise	Salt and marine chemicals	0.03%	0.00%
Myanmar Pearl Enterprise	Pearls	0.04%	0.02%
Total		28.46%	15.02%

Source: Ni Ni Swe, Director, Budget Department, Ministry of Finance, "The Role of the State Economic Enterprises in Myanmar Government Budget."

The principal vehicles by which the SOEs collect these revenues appear to be their production sharing and joint venture contracts, which entitle them to the government share of profit petroleum or minerals (40 to 60 percent for oil and gas, and 35 percent for mining, according to details released by the government), production bonuses and other fees for training and development purposes (aiming at helping increase MOGE's capacity). Beyond their revenue collection and marketing responsibilities, these SOEs play major roles in the allocation of licenses; the monitoring of implementation of the country's legal regime; and efforts to develop commercial capacity.

In addition to the official SOEs, the Union of Myanmar Economic Holdings Limited (UMEHL) and the Myanmar Economic Corporation (MEC) are largely controlled by military and other public officials. The two entities are believed to be key players in the government's strategy for generating benefits from extraction, particularly in gemstones and timber.

In spite of their economic significance and their influence over the management of the complex petroleum and mineral sectors, Myanmar's SOEs disclose very little information to the public about their activities or performance. The 2013 Resource Governance Index showed that out of 44 SOEs assessed for their transparency and accountability, Myanmar's MOGE ranked 43rd. (Only Turkmengas from Turkmenistan had a lower score.) Among the types of information routinely published by other SOEs that MOGE does not systematically disclose are details on reserves, production volumes, sales on the state's behalf, production costs/budgets, quasi-fiscal expenditures, and auditing procedures.

The mining-sector SOEs disclose even less information than MOGE; little is known about their roles in the allocation of licenses, revenue collection, or management of local content. They disclose almost no details about the joint ventures in which they participate, their revenues, expenditures, or relationships with subcontractors. This opacity is the biggest obstacle to good governance of these enterprises.

PARLIAMENTARY STRATEGIES FOR EFFECTIVE NATIONAL PARTICIPATION

Through their *legislative role*, parliaments can impact state participation initiatives via the following instruments:

- Overarching upstream oil, gas or mining laws, which frequently spell out the nature of relations between various government entities or state and private investors, including in administrative and fiscal matters.
- Laws establishing state-owned companies, which supplement the legal framework for oil, gas and mining laws in some countries and detail the roles and reporting requirements of the companies.
- Tax laws, which determine revenues gained by the state. These laws do not usually touch directly on state equity or local content, but they influence the overall balance of benefits between companies and the government, which is deeply intertwined with equity and local ownership.
- Contracts that contain details on equity, in countries where parliamentary approval is required.

Through their *oversight* role, parliaments should:

- Insist upon regular reporting by state-owned companies and hold their executives accountable for their performance in revenue generation, capacity building and transparency.
- Periodically assess the overall impact of the oil, gas or mineral sector on broader economic and private-sector development, and call for an adjustment of strategy if national participation policies are not working.

QUESTIONS PARLIAMENTARIANS CAN ASK

- If the state has an equity stake, is it paid, carried or free? How much are we spending in fulfillment of our equity obligations? How much are we earning?
- Does our equity stake entitle us to a share of production, or only to dividends in the event of profits?
- Do the state equity participation plans effectively balance the goals of monitoring and capacity building against the government's payment obligations and risks of other economic trade-offs?
- Are adequate mechanisms in place to ensure that the state-owned company is held accountable for its activities?

FURTHER READING AND ENGAGEMENT

- Ask civic groups or parliamentary staff to prepare a briefing that identifies options, challenges and available tools.
- Contact peers from countries that have state-owned companies to learn from their experience.
- Read NRGI's "Reforming National Oil Companies: Nine Recommendations", or the analyses of state-owned enterprise transparency and accountability in the Resource Governance Index. Read Precept 6 of the Natural Resource Charter, which focuses on state-owned enterprises.

ABOUT THE SERIES

Technically complex and often opaque, the oil, gas and mining industries require legislation and informed, effective oversight. To ensure gains from the sector are maximised, NRGI provides background information on crucial areas for parliamentary engagement. These parliamentary briefs are available at revenuewatch.org/parliaments.

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