Parliamentary Briefing
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Natural Resource Governance Institute

State Participation in Oil, Gas and Mining

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 (SOE), though in some countries the government exercises its ownership stake via ministries or other government institutions.

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

Table 1. Models of state ownership in the petroleum sector

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.

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.

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.

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, leading to disappointing dividends for states.

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

Precept 6,
Natural Resource Charter

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. They can become a "state within a state" pursuing internal priorities with little attention to broader national objectives, but can also be used as an opaque vehicle to avoid public scrutiny.

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.

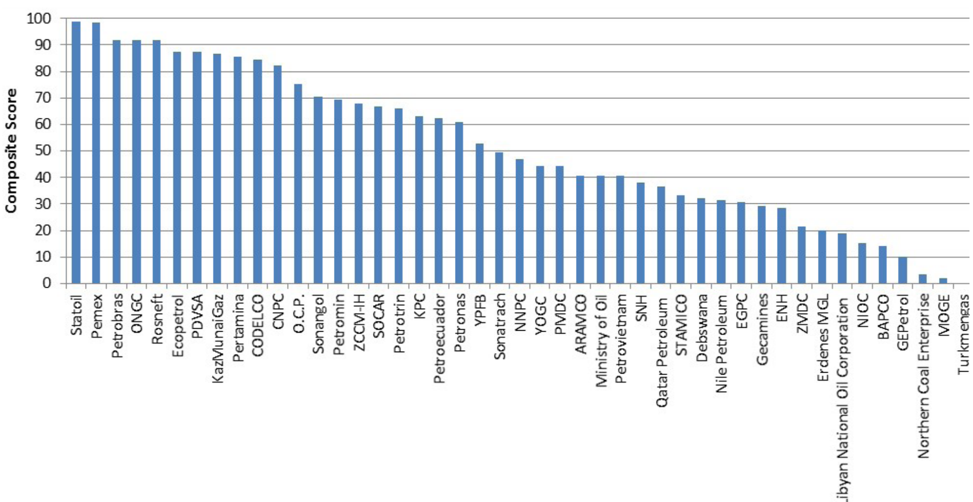

Figure 1. Governance of state-owned companies

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.
- 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.

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.
- 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?
- Contact peers from countries that have state-owned companies to learn from their experience.

Further reading and engagement

- 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.

The Natural Resource Governance Institute, an independent, non-profit organization, helps people to realize the benefits of their countries' oil, gas and mineral wealth through applied research, and innovative approaches to capacity development, technical advice and advocacy.
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Oil, gas and mining for development