Petroleum Revenue Management Workshop

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Preface

The World Bank Oil, Gas, Mining and Chemicals Department, and the World Bank/UNDP Energy Sector Management Assistance Programme (ESMAP) hosted a Workshop on Petroleum Revenue Management on October 23-24, 2002 in Washington, D.C. The Workshop brought together petroleum industry, civil society, developmental agencies, academics and country representatives to discuss the recent and current experience, the most challenging operational problems that have been faced by various stakeholders, and emerging best practices with respect to petroleum revenue management. This document contains the proceedings of this conference. It includes the introductory remarks, the sessions on revenue collection, management, and distribution, and the roundtable and closing discussion.

As awareness of the critical importance of petroleum revenue management increases, stakeholders have determined to do something about it. These proceedings are intended to contribute to ongoing discussions and debate, enhancing understanding of the issues involved, and identifying emerging best practices.
Acknowledgments

On October 23-24, 2002 the World Bank Oil, Gas, Mining and Chemicals Department, and the World Bank/UNDP Energy Sector Management Assistance Programme (ESMAP) hosted a Workshop on Petroleum Revenue Management, that for the first time brought together all the interested stakeholders to discuss problems and challenges they had been facing in respect to oil revenue management. The workshop was organized by Charles McPherson, Senior Adviser, and Anastasiya Rozhkova, Consultant, the Oil, Gas, Mining, and Chemicals Department of the World Bank Group. It was financed by the Energy Sector Management Assistance Program (ESMAP). The hosts wish to thank all the colleagues who contributed to the organization of the workshop and to extend special thanks to Katharine Gratwick, Consultant, Fikerte Solomon, Program Assistant, Marketa Jonasova, Program Assistant, Abigail Tamakloe, Executive Assistant, and Margarita Atilano, Program Assistant. The report, which comprises all papers and presentations made at the workshop, was compiled by Anastasiya Rozhkova, Consultant, and edited and formatted by a team consisting of Esther Petrilli, Team Assistant, Carmen Pineda, Team Assistant, and Silvana Tordo, Senior Energy Economist, Oil and Gas Policy Division, Oil, Gas, Mining, and Chemicals Department, World Bank Group. Ms. Marjorie Araya from ESMAP supervised production, printing, distribution, and dissemination of this report.
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Abbreviations & Acronyms

ESMAP  Joint UNDP/World Bank Energy Sector Management Assistance Programme

UPR  Upstream Petroleum Regimes

IOC  International Oil Company

HGC  Host Government Contract
Executive Summary

Welcome and Introductory Remarks

*Peter Woicke, Managing Director, World Bank Group, Executive Vice President, International Finance Corporation*

Thank you for joining us this morning. I am particularly pleased to be here among so many stakeholders and noted experts who have come together to tackle the crucial and as of yet unresolved issue of natural resource revenue management.

Revenue management of natural resources in general, and petroleum in particular, has emerged as a key development issue. For oil-producing developing countries and countries in transition, petroleum revenue management could make the difference between an end to poverty and deepened economic and social distress.

Petroleum revenues contribute significantly to the gross domestic product, the national and state budgets, and the foreign exchange earnings of many of our client countries.

To take just one example, Nigeria’s GDP in 2001 was approximately US$40 billion—US$20 billion of which came from oil exports. During this same period, petroleum sales accounted for 70 percent of the country’s budget revenue and 95 percent of its foreign exchange earnings. In the last 25 years, oil rents generated in Nigeria are estimated at US$300 billion.

Petroleum revenue on this scale presents an enormous potential for positive impact on development, and yet GDP per capita in Nigeria, as in many developing countries, remains at less than US$1 a day; infant mortality stands at nearly 80 per 1000 births; female adult illiteracy is greater than 53 percent.

This “paradox of plenty” is attributable in large part to a lack of proper petroleum revenue management. Management depends on a number of factors, including institutional capacity; however, in the end it boils down to good governance. And we have learned that while weak governance may predate the discovery of petroleum, there is some evidence that petroleum revenue could actually erode governance and undermine development where institutions are inadequate.

In fact, resource rich countries like Nigeria, Angola, Venezuela, and Indonesia not only have failed to meet minimum developmental targets; in many cases they have actually fallen behind resource poor countries in achieving poverty reduction and growth. These same resource rich countries also appear to be more prone to political instability and violent conflict.
There are, however, some success stories, for example in Malaysia and Botswana, with oil and diamonds, respectively. Here, resource revenue management has been associated with progress on the development front.

The challenge for us collectively is to learn from these positive and negative cases alike and target issues of governance and revenue management to ensure that natural resources make positive contributions—not the reverse.

The World Bank Group has made the promotion and achievement of good governance in the energy sector one of its top priorities.

We are working with both existing and emerging producers to accomplish these goals with programs in Algeria, Nigeria, Angola, Equatorial Guinea, Chad, Azerbaijan, Indonesia, and East Timor, to name just a few.

In Chad specifically, the Bank Group has helped to design a revenue management strategy whereby 10 percent of all royalties and dividends from petroleum production will be allotted to a Future Generation Fund to alleviate poverty; the bulk of all remaining funds will be earmarked for education, health, social services, rural development, infrastructure, environment, and water resources programs in the present.

Bank loans are also supporting efforts to build capacity in Chad to ensure that the money goes exactly where it is intended.

The Bank is certainly not alone in its work. The IMF is a key contributor to advancing the resource revenue management agenda—along with the G8, NEPAD, and countless others, including, perhaps most important, representatives from civil society and country governments. Many of these stakeholders are here with us today.

Even with all these efforts, we can each do more to address these issues of governance and revenue management. Last month, I called on all natural resource companies to make their transfers of royalties, fee payments, and other revenue to host governments fully transparent.

The argument is that this level of transparency would, in turn, introduce a new level of accountability. The public at large would know just what governments have received. Governments would then have to address the issue of what they ultimately do with their revenue.

What we are beginning to see is that companies and countries adopting sustainable practices are being rewarded by the financial markets. As far as transparency contributes to sounder revenue management and distribution, transparency is a sustainable practice.

Transparency is just one of a range of issues to be addressed under the heading of petroleum revenue management and, to my mind, is one of the most important.
Today and tomorrow, we have the opportunity to exchange views and experiences on these critical issues. But we also have the responsibility to start devising and committing to better strategies for managing natural resource revenue; if we fail to do so, the social, political, economic, and environmental costs incurred by mismanagement will continue to mount. We all know what mismanagement is and does; let us do differently.

Thank you.

Resource Revenue Management and the World Bank Group Agenda

_Rashad Kaldany, Director, Oil, Gas, Mining and Chemicals Department, the World Bank Group_

Let me just say a few words about the background of this workshop, what is the purpose of it from my perspective. The group I head covers the oil, gas and mining industries. It is a joint World Bank-IFC department. For the most part today the World Bank is focusing on the regulatory issues affecting these industries in our client countries. The World Bank is no longer in the business of financing new productive assets. We firmly believe that these industries should be funded by the private sector, and government involvement is no longer necessary. In addition, the Bank focuses on environmental and social issues and can also play a role in catalyzing private sector investments through the partial risk guarantee instrument. IFC finances projects in these industries with partners from the private sector. Our roles are complementary.

But what is our purpose? Our purpose as you all know is to ensure sustainable development that will lead to alleviation of poverty and improvement of people’s lives. And how do the extractive industries do that? The activities in the extractive industries have many skeptics and much criticism. There are many failures, as Peter Woicke has already described, but there are also some successes. What leads to these successes? There are many factors. There is a consensus that building strong institutions with capacity to manage revenue flows from these industries is a critical success factor. Hence our conclusion some time ago that we need to focus on the issue of proper revenue management.

More than a year ago, we initiated an intensive study of the issues surrounding revenue management. Very much part of this study is learning from others. The IMF held a conference about six months ago on a very much related topic, perhaps a slightly different angle. We are learning from our colleagues at the IMF. There are many academics as well as bilateral and multilateral agencies who are interested in this topic. We are also learning from our experience. Peter mentioned a prime example, the Chad-Cameroon pipeline project. But there are many other experiences we can draw upon, and not just in the oil and gas sector. For example, in the mining industry a mining project in Laos, in which IFC has been involved, has taught us a lot.
This workshop is one component of this effort to share experiences and learn from the past and from our various experiences, represented by all the participants here. We intend to publish our proceedings. The key is how to implement these lessons. It is an ongoing process. It is evolving, and we are learning. We are involved in new projects and we are trying to apply our lessons to these other projects. There are other countries, many of which Peter mentioned—Timor Leste, Mauritania, Sao Tome and Principe—where we are increasingly involved in the challenge of revenue management.

Perhaps I can mention one last issue. As many of you have heard, we are engaged in a consultative effort called Extractive Industries Review. I am very pleased that the eminent person leading this effort, Dr. Emil Salim, has been able to join us. We are about half way through the process. We have held two regional workshops in Latin America and Europe and Central Asia and we have two more coming up in addition to a global one where we will present and discuss draft conclusions. Natural resources revenue management is a key component of the Extractive Industries Review process, and I think the deliberations here will feed into that process.
Overview of the Issues

Philip Daniel, Director, Transborder

Charles McPherson:

Philip Daniel will present us with an overview of what the next two days will look like. He is the Director of Transborder which is a company specializing in advice on natural gas resource investments in developing countries particularly and in economies in transition. He is based in Lewes, England. His two main current assignments are to act as petroleum fiscal adviser to the government of East Timor and also as adviser on economics and finance to the National Hydrocarbons Company of Mozambique and to Mozambique on a two country project selling gas to South Africa. His academic background includes Oxford where he has also held academic posts, as well as in Cambridge.

Philip Daniel:

Thank you very much for the introduction Charles and Rashad, and thank you for the invitation to attend this gathering. Distinguished participants, I am delighted to be able to present this overview but must give us more health warning. In connection with my work in East Timor, I was recently in Australia visiting the offices of an oil company with interest in the Timor Sea. We were taken to what they call a visionarium, wearing glorious three-dimension spectacles, we saw and explored a reservoir in the Timor sea. The very enthusiastic geologist who was taking us through it said now at last you will understand the gas molecule point of view. I relate this story simply to say that even an overview cannot contain all possible perspectives.

Oil wealth has come to be seen more often as a curse than as a blessing. This presentation covers the principles measures and techniques that might allow better petroleum revenue management in future. Petroleum revenue management is a linked complex of issues to be addressed in our discussions today and tomorrow: the collection, management, and distribution of petroleum revenues. We will be covering the design of petroleum fiscal systems and fiscal administration in Session One and revenue management in Session Two. I will make a
few remarks on each of these topics, especially on revenue management in the shape of special petroleum funds. Everybody is interested in the topic of special funds, either vehemently for, or vehemently against the idea of using such funds. Finally, I will comment briefly on the topics that will be considered in much greater depth in Session Three, namely, expenditure and distribution issues.

Petroleum resource rent is the value of petroleum resources minus all the necessary costs of production. A petroleum tax system with rent as the tax base interferes least with pretax decisions on investments and production. That is what we call tax neutrality. A tax system can be designed to capture rents using what we can call conditional payments—payments that are closely linked to actually realized rents. That is you pay if you meet the criteria to pay. The fiscal system must offer incentive to explore and invest and at the same time secure a fair share of revenues for public use. Stability in fiscal terms reduces investor risk and allows states to tax more of the rent. The petroleum tax system cannot move too far out of line with those countries of similar prospectivity. It can be structured to reduce investment risk and secure higher government revenue. A petroleum tax system can differ from the general tax system and still remain neutral. A petroleum fiscal system can use production sharing, taxes and royalties, or degrees of state—ownership each with equivalent fiscal effect.

Investors themselves will be interested in the overall impact of the tax regime under a range of assumptions about output costs and prices. This impact has two aspects: The tax burden and the tax structure. The tax burden—strictly the average tax burden—is the share the government takes in taxes, duties, and royalties over the life of a petroleum field. The tax structure is the way in which the tax burden is imposed at different points in the petroleum field life. In appraising a petroleum project, large companies will examine first the intrinsic economics of the project under the given fiscal regime. This usually involves estimation of an expected rate of return in discounted cash flow terms, in constant prices, in an all equity case. This return will have to exceed the corporate threshold adjusted for special projects risks and political risk. The average tax burden will be vital to this assessment, but so will the timing of the major part of the tax burden and thus the tax structure. The later a given tax burden is imposed, the higher will be the investors’ expected rate of return. Expectations of stability in fiscal terms will reduce investors’ perceptions of risk and increase the rents that the states can secure.

There are some principles for collecting petroleum revenue. Much concern and much effort put in by the World Bank on issues of the flow of funds and fiscal administration. Flow of funds analysis helps to check that the fiscal system delivers what it should. This and effective fiscal administration rely upon reconciliation of flows at each point in the chain supported by an audit strategy. Does the inflow of funds match the measured volume of production and the calculated entitlement to production? Where the state or the national oil company has petroleum entitlements, there should be an audit trail following the disposal of these entitlements—receipts by the selling institution and record of deposit of the funds in the banking system. Under a tax and royalty system, the trail of receipts and disbursements should likewise trail the calculated tax obligations. At each step the payments of one institution from
petroleum revenues should match the receipts of another. Export revenue should reflect available export prices. In any tax or sharing system that depends on profit or cash flow, the control and monitoring of costs become a central issue. Wherever joint ventures with the private sector are involved, the venture partners can usually be relied upon to set in place mechanisms to ensure efficient and least cost performance by the operator. In the case of a solely owned venture or of operations by the national oil company, periodic evaluation of costs by the government is essential. In a number of economies with national oil companies, Azerbaijan for example or Nigeria, the problem of arrears in payment has arisen. The emergence of arrears is a significant distortion of the fiscal framework and usually implies the creation of extra budgetary subsidies. Analysis of the flow of fund provides an opportunity to identify arrears and plan for their elimination. Under a tax and royalty system, the funding of the petroleum sector does not rely on a specific outflow of the revenues received by the state. Under other systems, however, a specific outflow may occur. In these cases, the government needs the capacity to monitor the deployment or allocations of funds, reconcile allocations with the expenditure records of the state oil companies or joint ventures, and control costs within the recipient organization. We have no time to dwell on them at length, but a number of fairly straight-forward measures can radically simplify effective fiscal administration: forward estimates for provisional tax payments; self-assessment rules; use of pool depreciation instead of asset registers; reconciliation of taxpayers’ corporate accounts with their tax computation; joint venture operators having an obligation to reconcile partners accounts for tax purposes giving the tax authorities a view of the project, rather than of the individual taxpayer. The tax authority should have a field audit strategy rather use of audit only in response to disputed items.

Let’s come now to some of the economic management questions. Governments in petroleum economies seek to maximize revenue receipts and then confront the consequences of uncertainty and instability in actual flows. The taxation problem they face is to establish, in the face of this uncertainty and instability, a system of revenue sharing between petroleum companies and the government that maximizes the flow of government revenue over time. A fiscal system that efficiently taxes petroleum rent may maximize revenue flows but shift risk of instability to the government. A government that organizes macroeconomic management to enable it to bear this risk will do better in revenue terms over time and will set in place a macroeconomic framework leading to efficient use of revenues. A petroleum revenue boom requires that either absorption is increased, or a trade surplus is leading to accumulation of foreign financial assets. In other words, a revenue boom has to be somehow absorbed by saving abroad, raising imports, reducing savings, or increasing investments. A slump requires the reverse processes. When a shock lowers national income, then either absorption or the trade surplus must fall, and either domestic expenditure must be cut or a trade deficit must be financed.

General economic stability has value because it reduces the investors’ risk premium, avoids disruption of public and private investment, and strengthens the government’s international negotiating and trading position. Stability is also vital to poverty reduction. Those
without assets and skills tend to be damaged most by instability. Fiscal and monetary instability jeopardizes any program of social transformation or redistribution. Other rules for keeping medium-term stability in the face of booms and slumps, might include:

?? First, keep spending within the sustainable growth path and save excess revenues abroad

?? Second, use conservative—below medium-forecast for future revenues

?? Third, allow the foreign asset position to swing, while keeping domestic absorption steady

There is no need to fine tune—rely as far as possible on the automatic stabilizers that exist in both upswings and downswings. If in doubt, save the money. The vital rule is to err on the side of caution. Some of the economic judgments required may appear sophisticated, but as the well known Swedish mineral economist, Marion Rodesky, wrote about a decade ago, “No sophistication is needed for the wise decision to deposit fast-growing mineral income in the bank pending the emergence of sensible opportunity to spend the money.” On the other hand, even a financially sophisticated government can squander the public income if it is unwise, or dishonest, or is not concerned with social and economic development. Whether or not to use a petroleum fund or a nonrenewable resources fund to keep the savings is a second order question. The first question is settling the overall macroeconomic framework and a savings strategy. If a fund will buttress sound management and political support, then go for one. If not, or if the risk of raiding the till is too great with the fund, then avoid the fund mechanism.

Let me say a little about the concept of permanent income which often comes into thinking about these matters. Permanent income means the amount of petroleum wealth that can be safely consumed while maintaining financial wealth for future generations. Calculation of permanent income offers a yard stick for sustainable petroleum revenue management. It can only be a guideline with large uncertainties. It has political appeal because its use shows a leadership concerned about equity amongst generations.

Nonrenewable natural resource funds—special funds to store and manage petroleum revenues—may have three broad motives: stabilization, savings, or precautionary motives. A stabilization fund shields an economy from revenue instability. A savings fund stores funds for future generations. A precautionary fund preserves revenue in the face of uncertain prospects, or where absorptive capacity is poor. Funds are not substitutes for good fiscal management, Important producers operate without funds—the United Kingdom, Saudi Arabia, Indonesia, Australia, Russia. The integration of any fund with overall fiscal management is vital. There should be a consolidated budget framework and domestic expenditure should occur only through the budget. In the event of a liquidity constraint on the general budget, there should be no borrowing to offset the savings in the fund. There should be strict limits on domestic investments by the fund. The timing of petroleum revenues does not follow a known path.
Fiscal management supported by a fund can shift the path of absorption and reduce the effects of uncertainty. I have illustrated in the table below some of the types of funds linked to countries which have endeavored to implement them.

### Table 1.1: Nonrenewable Resource Funds (NRFs)

<table>
<thead>
<tr>
<th>Stabilization Funds</th>
<th>Savings Funds</th>
<th>Precautionary Funds</th>
</tr>
</thead>
<tbody>
<tr>
<td>Receive all revenues &amp; inject regular amounts to budget (Papua New Guinea)</td>
<td>Fixed percentage of petroleum revenues (Alberta, Alaska)</td>
<td>Assign all or part of revenues to NRF in early stages of petroleum development</td>
</tr>
<tr>
<td></td>
<td>Percentage of total government revenue (Kuwait)</td>
<td>Goal to ensure financial viability if revenues are lower than expected</td>
</tr>
<tr>
<td>Finance deficit or receive surplus (Kuwait or Norway)</td>
<td>Net government revenues (budget surplus) (Norway)</td>
<td>Guards against absorptive capacity</td>
</tr>
<tr>
<td>Receive revenues above a reference price; spend when below floor price (Chile, Venezuela)</td>
<td>Petroleum revenues in excess of forecast budget amount (Oman)</td>
<td>Recent examples in Azerbaijan and East Timor</td>
</tr>
</tbody>
</table>

Poor fiscal management can occur with or without a fund. The key elements for an efficient fund, and I draw here particularly from the example of Norway, seem to be: accountability to elected representatives; independent audit of transactions and activities; a clear investment strategy, relying on most part on investments in foreign assets; benchmarking of the desired investment returns in different market segments; and competition in the appointment of investment managers.

Some suggest that we should not use these devices at all. Rather particularly for stabilization, we should try market-based alternatives. Hedging offers an alternative solution for the stabilization role. A futures strategy reduces price uncertainty without the initial cost. An options strategy operates like insurance and carries an initial premium cost. Because these strategies require direct access to markets, an over-the-counter or OTC arrangement with a financial institution might better suit developing country requirements. It could provide for longer term instruments, but with some credit risk to both parties. Hedging carries political difficulties, especially if spot prices exceed the hedge prices. Institutional capacity for hedging may be weaker than required. Over time, hedging could form part of a revenue management strategy and, because companies engage in it anyway, government should address the revenue consequences of private hedging. Long-term gas contracts in any case often contain some form of internal hedging with gas price moving only in some proportion to movement in oil or other fuel prices such as in the Japanese market or even fixed with a simple inflation adjustment, such as exist Australia.
Now let us come to the topic of Section Three of this conference. Petroleum revenues, like any other revenue, need expenditure management rules for effective use. The prominence of petroleum revenues and the frequent desire to earmark them make it vital that the rules do apply to petroleum revenues. These rules cover adequacy of data, budget preparation, budget execution, and cash management arrangements. Earmarking for specific expenditures and disbursements through extra budgetary funds may exceptionally have a role, but are usually best avoided. The use of extra-budgetary funds and earmarking may create better public support for saving and targeted spending. Extra budgetary funds can also increase efficiency by simulating private market conditions where market standards are linked directly to fees or charges, for example, management of road user charges in a fund dedicated to road maintenance. This benefit, however, hardly applies to management of petroleum revenues. More plausible will be the use of petroleum revenues to provide a consistent source of funds for expenditures that yield high benefits, but are often unrecognized and subject to cuts. The Chad petroleum revenue management scheme created extra budgetary funds to ensure both savings and specific targeting of expenditure from petroleum revenues to poverty reduction programs.

We will round off this workshop with the question of national/regional distribution of revenues. In many countries, the balance between local (that is resource-producing areas) and national distribution of petroleum revenues is highly sensitive. Inappropriate distribution can soon undermine the integrity of the fiscal system. That said, a program for decentralization and revenue sharing is important. For onshore oil and gas project there is particular difficulty in reconciling local interest with the integrity of public expenditure management. Local governments and communities often seek a direct share of revenue, raising questions about equity among resource rich and other regions of an individual country. In Nigeria, as you all know, such tension has been the source of major unrest and loss of life in the Niger Delta area and led under the present democratic government to the decision to assign 13 percent of the revenues to the region of origin. In Chad, the petroleum revenue management program calls for assignment of 5 percent total revenues directly to the producing regions. In Papua New Guinea, royalties of 2 percent of output have long been assigned to the province of production with part assigned directly to what are called the landowners. The royalty is now treated as a credit against companies’ income tax liabilities and is supplemented by another levy payable to landowners and provincial governments. These measures may have made some contributions to local political acceptability of projects, but at considerable cost to the integrity of the national budget. In the table below, drawing from some works by Allen Clark and colleagues at East West Center in Hawaii, I have set out a list of possible public sector managerial guidelines for handling relations between the local level and the national level.
Table 1.2: National/Regional Distribution of Revenues Guidelines

?? National/local consultation
?? Each level to plan and forecast
?? Local impact studies
?? Link revenue-sharing to overall local plans
?? Explicit agreements between each level
?? Preparatory social programmes
?? Training programs
?? Reduce inter-regional inequality
?? Political consultation mechanisms
?? Stress uncertainty of petroleum revenues and resource depletion at projects

Distinguished participants, that in brief, is an overview of the challenge for discussion in this conference. Concerning the more technical facets of petroleum revenue management others will address important issues in political economy, governance, and the sad relationship of petroleum revenues with violence and war. I did not include the perspective from the gas molecule, but I hope I have covered a reasonable amount of ground!

Thank you.
Revenue Collection


Daniel Johnston

The science of petroleum engineering is more highly evolved than the science of petroleum fiscal system analysis and design. One of the key aspects is the absence of standardized terminology with petroleum fiscal system analysis. For example, if two engineers want to discuss the virtues of a reservoir, they can quickly and efficiently communicate to each other the essence of the reservoir by summarizing such things as rock type, porosity, permeability, thickness, water saturation, and reservoir pressure. It doesn’t matter what company or country they are from; they will both be comfortable with the concepts, terminology and “units” used—everybody measures permeability in Darcies, for example. They may discuss or debate which method would be appropriate to use to determine porosity or even permeability, but at least they can communicate.

Unfortunately though, if two individuals from different companies or countries want to discuss the virtues of a contract or fiscal system, they will not likely communicate so efficiently. Statistics that capture much of the financial and economic aspects of a contract are not as widely known nor understood. The one concept that receives the most attention, “government take,” goes by MANY different names:

- State take
- Tax take
- Fiscal take
- Fiscal net
- Net net
- Net cash margin
By contrast, there is only one term for porosity and only one term for permeability. Reservoir thickness may be quoted in meters or feet, but that does not seem to cause too much trouble. A dozen different terms for a concept as simple as government take and different ways of calculating it—now that is painful.

Furthermore, sometimes people use the term “government take” (the most common term) to indicate the division of revenue, not profits! From an analytical point of view, the division of revenue has little meaning. Table 2.1 summarizes some of the key aspects or parameters that capture the essence of either a reservoir (Reservoir Engineering) or a contract (the Science of Petroleum Fiscal System Analysis/Design).

Table 2.1: Reservoir Engineering versus Petroleum Fiscal Analysis/Design

The science of reservoir engineering is much more highly evolved than the science of petroleum fiscal system analysis/design.

<table>
<thead>
<tr>
<th>The Science of Reservoir Engineering</th>
<th>The Science of Petroleum Fiscal Analysis/Design</th>
</tr>
</thead>
<tbody>
<tr>
<td>Key Characteristics of a Reservoir</td>
<td>Key Financial Characteristics of a Contract</td>
</tr>
<tr>
<td>?? Rock type</td>
<td>?? Type of System “R” Factors or ROR Features?</td>
</tr>
<tr>
<td>?? Trap type</td>
<td>?? Bonuses</td>
</tr>
<tr>
<td>?? Pay thickness</td>
<td>?? Work program</td>
</tr>
<tr>
<td>?? Depth</td>
<td>?? Government take</td>
</tr>
<tr>
<td>?? Productive area</td>
<td>?? Effective royalty rate/entitlement</td>
</tr>
<tr>
<td>?? Porosity</td>
<td>?? Savings incentive crypto taxes</td>
</tr>
<tr>
<td>?? Water saturation</td>
<td>?? Ringfencing</td>
</tr>
<tr>
<td>?? Permeability</td>
<td>?? Relinquishment</td>
</tr>
<tr>
<td>?? Pressure gradient</td>
<td></td>
</tr>
<tr>
<td>?? Fluid properties</td>
<td></td>
</tr>
<tr>
<td>?? Drive mechanism</td>
<td></td>
</tr>
</tbody>
</table>
Government Take Is Not a Perfect Statistic

While we still have trouble communicating, we have made progress over the past decade. People are better able to communicate now than even 10 years ago, though it still can be frustrating and inefficient. The “government take” concept is the focus of criticism now and then. And while much of it is fair, because there are definitely weaknesses, some is perhaps a bit extreme.

Some feel that too much attention is placed on this metric or that, while there is some importance, it is minor. For example:

“International petroleum economist Daniel Johnston refers to the IOC’s share of the revenue as the IOC's ‘Access to Gross Revenue,’ and he refers to the Host Government's share of the revenue as the ‘Effective Royalty Rate.’

Daniel Johnston refers to the IOC's share of the profit as the ‘Contractor Take’ (also referred to by others as the ‘IOC Take’ or the ‘Company Take’). He refers to the Host Government's share of the profits as the ‘Government Take’ (also referred to by others as the ‘State Take’).

While most HGCs are from 50 to 200 pages in length (and the associated petroleum legislation, petroleum regulations, foreign investment laws and other elements of the applicable UPR often are even more voluminous), normally only four to eight pages of an HGC, in addition to pertinent provisions of the tax code, are devoted to the fiscal terms pertaining to the ‘revenue splits’ and ‘profit splits.’ The balance of the HGC, and/or the associated pertinent legislation, describes the remainder of the relationship between the Host Government and the IOC. Indeed, there is vastly more at issue in each UPR than the ‘revenue split’ and the ‘profit split.’

I do not agree with much of the theme developed above. First of all, if parties to a potential contract (HGC) cannot agree on the appropriate “revenue split” and or “profit split” if that is what you want to call it, then there is no need for crafting or negotiating all that other contract language. There is no deal. There is a balance between prospectivity and fiscal terms that includes among many things the “profit split” and “revenue split”. It is not easy finding the proper balance. The exercise involves geophysicists, geologists, petrophysicists, engineers, economists, lawyers, accountants and financial types and space-age technology. Nothing trivial about that.

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The attitude reflected above reminds me of a project I worked on three years ago. I was working with government representatives from a land-locked country with no oil or gas production. Geological potential was not well understood. Furthermore, no drilling had taken place in nearly 15 years. Costs were expected to be high because all goods and services would have to be mobilized and brought in from a long way off. There were no indigenous oilfield services of any sort.

The country had tendered some blocks in an official license round, but there was virtually no interest—except for one company. This company was coming to the country for an official visit to submit a bid. The government officials and I agreed that a reasonable government take, considering the geology and conditions, would be around 50 percent or possibly even less. This would be consistent with frontier terms around the world, and we considered these blocks to be in this category.

To our surprise the company offered terms that yielded a government take of around 70 percent. World average is less than that! These were not world average rocks or conditions—they were worse. The government representatives had to accept the offer. Their hands were tied. Since then the company has not been able to find partners—the terms are too tough. Governments know that finding partners is part of the service that companies provide—they are in effect raising capital for and on behalf of the government this way. Unfortunately, this company blundered. But the company had a good contract with around 200 pages of well-crafted contract language. It just had a bad deal. Now, both parties suffer.

In defense of economists, accountants and financial analysts/advisors who deal with petroleum contracts and negotiations, I believe it is fair to say that few, if any, confine their analysis of a contract to just “four to eight pages”. Most of us read the whole contract. Sometimes there is some debate about various contract elements and just what constitutes an economic or financial issue and what the implications are.

There are numerous other examples: a contract may have a dispute resolution clause that provides for binding international arbitration, in English, in a third-party country, under a recognized convention such as the Paris Convention or equivalent, to which the host government is a signatory with parliamentary ratification. Or the contract may not have an “arbitration clause”. Is this a financial issue? I believe it is. It makes a difference. There are many other similar issues.

I believe the government take statistic suffers from both underuse and overuse. When people are unaware of the weaknesses (and I believe few are intimate with all the weaknesses associated with the “take” statistics) then overuse is extremely likely. To focus only on weaknesses is perhaps a bit narrow. But it is fun, so here is more discussion on the subject:

?? It does not explain “how” the government “takes.” It doesn’t adequately capture the effect of:

○ Signature bonuses
Revenue Collection

- Ringfencing provisions
- Front end loading
- Reserve/lifting entitlements and “ownership”
- Block size and relinquishment provisions
- Work program provisions
- Crypto taxes
- Time value of money

**It Does Not Explain “How” the Government “Takes”**

Take statistics are simply not standalone. Two countries can have the same government take—say 80 percent—but the similarities could easily end there. What if one country were guaranteed a minimum of 40 percent of production each and every accounting period (due to a combination of cost recovery limit and profit oil split and/or royalties) and the other country were guaranteed only 10 percent? Now there is a big difference. The one country is much more “front end loaded”.

**Its macroeconomic scope is too narrow.** Ordinary measures of government take throughout the 1990s made the United Kingdom government appear irresponsible. And while this reasoning has natural logical appeal to most people, it is founded on a weakness of the take statistic. It is not able to measure everything that matters to a government. The “gross benefits” to the UK government go way beyond direct tax revenue and royalties received from the upstream sector of the petroleum industry. The economic impact of the industrial hyperactivity in the UK sector of the North Sea, a direct result of the “lenient” terms of the 1990s, is difficult to measure. Furthermore, the activity in the UK started in the late 1980s and early 1990s, when the UK government dropped the ringfence for the 75 percent PRT before government take, as it is ordinarily measured, was drastically reduced (see Table 2.2). The UK offshore became the most active offshore province in the world. Reducing the government take in the following years has managed to sustain that boom. Activity and employment in the British petroleum sector is healthy and robust. How do we measure the benefits of that? Not with government take.
Table 2.2: UK Petroleum Taxation History

<table>
<thead>
<tr>
<th>Year</th>
<th>Royalty</th>
<th>SPD</th>
<th>PRT</th>
<th>CT</th>
<th>Old Fields Marginal Take</th>
<th>New Fields Marginal Take</th>
</tr>
</thead>
<tbody>
<tr>
<td>1974</td>
<td>12.5%</td>
<td>52%</td>
<td>58.0%</td>
<td>58.0%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1975</td>
<td>12.5</td>
<td>45%</td>
<td>52%</td>
<td>76.9</td>
<td>76.9</td>
<td></td>
</tr>
<tr>
<td>1976</td>
<td>12.5</td>
<td>45%</td>
<td>52%</td>
<td>76.9</td>
<td>76.9</td>
<td></td>
</tr>
<tr>
<td>1977</td>
<td>12.5</td>
<td>45%</td>
<td>52%</td>
<td>76.9</td>
<td>76.9</td>
<td></td>
</tr>
<tr>
<td>1978</td>
<td>12.5</td>
<td>45%</td>
<td>52%</td>
<td>76.9</td>
<td>76.9</td>
<td></td>
</tr>
<tr>
<td>1979</td>
<td>12.5</td>
<td>60%</td>
<td>83.2</td>
<td>83.2</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1980</td>
<td>12.5</td>
<td>70%</td>
<td>87.4</td>
<td>87.4</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1981</td>
<td>12.5</td>
<td>70%</td>
<td>87.4</td>
<td>87.4</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1982</td>
<td>12.5</td>
<td>75%</td>
<td>91.9</td>
<td>91.9</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1983</td>
<td>75%</td>
<td>50%</td>
<td>87.5</td>
<td>87.5</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1984</td>
<td>75%</td>
<td>45%</td>
<td>86.3</td>
<td>86.3</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1985</td>
<td>75%</td>
<td>40%</td>
<td>85.0</td>
<td>85.0</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1986</td>
<td>75%</td>
<td>35%</td>
<td>83.8</td>
<td>83.8</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1987</td>
<td>75%</td>
<td>35%</td>
<td>83.8</td>
<td>83.8</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1988</td>
<td>75%</td>
<td>35%</td>
<td>83.8</td>
<td>83.8</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1989</td>
<td>75%</td>
<td>35%</td>
<td>83.8</td>
<td>83.8</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1990</td>
<td>75%</td>
<td>35%</td>
<td>83.8</td>
<td>83.8</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1991</td>
<td>75%</td>
<td>34%</td>
<td>83.5</td>
<td>83.5</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1992</td>
<td>75%</td>
<td>33%</td>
<td>83.3</td>
<td>83.3</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1993</td>
<td>50*</td>
<td>33%</td>
<td>66.5</td>
<td>33</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1994</td>
<td>50*</td>
<td>33%</td>
<td>66.5</td>
<td>33</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1995</td>
<td>50*</td>
<td>33%</td>
<td>66.5</td>
<td>33</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1996</td>
<td>50*</td>
<td>33%</td>
<td>66.5</td>
<td>33</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1997</td>
<td>50*</td>
<td>33%</td>
<td>66.5</td>
<td>33</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1998</td>
<td>50*</td>
<td>33%</td>
<td>66.5</td>
<td>33</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1999</td>
<td>50*</td>
<td>31%</td>
<td>65.5</td>
<td>31</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2000</td>
<td>50*</td>
<td>31%</td>
<td>65.5</td>
<td>31</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2001</td>
<td>50*</td>
<td>30%</td>
<td>65.5</td>
<td>30</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2002</td>
<td>50*</td>
<td>40%</td>
<td>65.5</td>
<td>40</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

* New fields receiving development approval after 16 March 1993 exempt from PRT. Also, these take statistics ignore the effect of “uplifts” on the PRT.

SPD = Supplementary Petroleum Duty
PRT = Petroleum Revenue Tax
CT = Corporate Tax

The UK had one of the “toughest” systems in the world here.

The “ringfence” is dropped for the PRT. The boom begins.

The UK becomes famous for “lenient” terms. The boom continues.
Government take is not relevant in some important situations. The government take statistic is almost totally meaningless in some of the extremely important Middle Eastern countries. In the “buybacks” in Iran, where the contracts focus on existing, well-known oil and gas fields, the take statistics are rarely mentioned. Depending on oil prices and various other things, the government take may be from 95 percent to 97 percent with these buybacks. This sounds harsh, but that may or may not be the case depending on the potential internal rate of return that can be achieved. The risks are low relative to the harsh cold risks associated with exploration. When exploration risk is missing, government take statistics move away from center stage. Discussions focus on internal rate of return (IRR). This is also true of the proposed Operating Service Agreement (OSA) in Kuwait for field rehabilitation and for the three massive projects contemplated in Saudi Arabia under the Gas Initiative tendered in December 2000, when 10 foreign oil companies were invited to express an interest in bidding.

In presentations last year to the Kuwait parliament, the government take for the proposed OSA was quoted at 98 percent, and this was subsequently published in Kuwait newspapers. What was not published was that the statistic represented a “discounted” figure. Government share of “discounted cash flow” discounted at 5 percent was estimated at 98 percent. Government take statistics are usually quoted “undiscounted”. Government take always goes up when present value discounting is factored in. Five percent discounting is not so much; yet some parliamentarians in Kuwait believe the proposed terms grant potential foreign contractors too high an IRR. Some Kuwaitis point to the kind of returns their government’s investments obtain in the west and ask: “Why then should westerners get a higher IRR for their investments in Kuwait?” Similar discussions are taking place in Saudi Arabia.

This is where negotiations focus in low-risk projects, and it is appropriate. There is a lot at stake. What would be a reasonable rate of return for a relatively well defined, low risk project where a company can put from US$5–20 billion to work? Should the companies be allowed an IRR that is equal to or greater than their corporate cost of capital? Should companies be allowed an IRR that is greater than the IRR they receive for their exploration efforts? Most people agree that IRR for exploration generally speaking is not robust. Most too agree that returns (or rather potential returns) should be lower where risk is lower. These are complex issues. These are the central issues now in Saudi Arabia and Kuwait and with any government contemplating tendering “non exploration” contracts. And these are the key issues around which negotiations have stalled in Saudi Arabia. The Kingdom is contemplating rates of return of around 8 percent to 10 percent, consistent with water and power projects in the Gulf and in Europe. The IOCs are reportedly demanding assured IRRs for the integrated projects as a whole. And some targeted IRRs quoted by the oil companies are as high as 15–20 percent. This is unrealistic. What is realistic though is that the negotiations are properly focused. government take has little meaning here.
Examination of the imperfections associated with the government take metric provides important insight. Using any metric like this is more meaningful if both strengths and weaknesses are understood. Furthermore, it is not intended to serve as a standalone statistic.

While it is appropriate to discuss, measure and negotiate using IRR with development or rehabilitation projects, it is not appropriate for exploration projects. It is impossible to predetermine an appropriate internal rate of return for any given exploration project. When it comes to exploration projects, government take is extremely important. And it
is a function of prospectivity—there must be a balance. Heavy science goes into determining that balance, ranging from geoscience to political science.

If a balance can be determined and negotiators can agree upon basic terms, then a deal can be struck. A lot goes into this. There is important work to be done sorting out the other contract terms and language to ensure the document represents the deal as accurately as possible. There is nothing trivial about any aspect of this process.

Figure 2.2 compares government take from various Southeast Asian contracts or systems and how these systems compare with the universe of systems worldwide. Southeast Asia is a microcosm of what is happening around the world—there is a little bit of everything represented in the region.
Figure 2.2: International Petroleum Exploration and Development Contracts

<table>
<thead>
<tr>
<th>Country</th>
<th>Government Participation %</th>
<th>Effective Royalty Rate %</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nicaragua</td>
<td>0</td>
<td>2.5</td>
</tr>
<tr>
<td>UK</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>New Zealand</td>
<td>0</td>
<td>5</td>
</tr>
<tr>
<td>Falkland Islands</td>
<td>0</td>
<td>9</td>
</tr>
<tr>
<td>Argentina</td>
<td>0</td>
<td>14.6</td>
</tr>
<tr>
<td>US OCS</td>
<td>0</td>
<td>16.7</td>
</tr>
<tr>
<td>South Africa</td>
<td>20</td>
<td>2.4</td>
</tr>
<tr>
<td>Trinidad</td>
<td>0-25</td>
<td>25-33</td>
</tr>
<tr>
<td>Mongolia</td>
<td>0</td>
<td>31</td>
</tr>
<tr>
<td>Philippines</td>
<td>0</td>
<td>13.5</td>
</tr>
<tr>
<td>Bolivia</td>
<td>0</td>
<td>18</td>
</tr>
<tr>
<td>Australia</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Ecuador</td>
<td>0</td>
<td>25</td>
</tr>
<tr>
<td>Pakistan II</td>
<td>20</td>
<td>12.5</td>
</tr>
<tr>
<td>MTJDA</td>
<td>0</td>
<td>36</td>
</tr>
<tr>
<td>Morocco</td>
<td>25</td>
<td>10</td>
</tr>
<tr>
<td>Peru</td>
<td>0</td>
<td>23</td>
</tr>
<tr>
<td>Namibia</td>
<td>0</td>
<td>5</td>
</tr>
<tr>
<td>Malaysia Deepwater</td>
<td>0</td>
<td>12</td>
</tr>
<tr>
<td>Azerbaijan AIOC</td>
<td>10</td>
<td>0</td>
</tr>
<tr>
<td>Thailand III</td>
<td>25</td>
<td>8.5</td>
</tr>
<tr>
<td>Canada Alberta</td>
<td>0</td>
<td>8</td>
</tr>
<tr>
<td>Angola</td>
<td>20</td>
<td>7.5</td>
</tr>
<tr>
<td>Colombia</td>
<td>30</td>
<td>7</td>
</tr>
<tr>
<td>Indonesia Frontier</td>
<td>10</td>
<td>10</td>
</tr>
<tr>
<td>Turkmenistan</td>
<td>0</td>
<td>18</td>
</tr>
<tr>
<td>Uganda</td>
<td>25</td>
<td>19</td>
</tr>
<tr>
<td>Russia Sakhalin II</td>
<td>0</td>
<td>6</td>
</tr>
<tr>
<td>PNG</td>
<td>22.5</td>
<td>2</td>
</tr>
<tr>
<td>Norway</td>
<td>30</td>
<td>0</td>
</tr>
<tr>
<td>Tunisia</td>
<td>0</td>
<td>30</td>
</tr>
<tr>
<td>Egypt Onshore</td>
<td>0</td>
<td>47</td>
</tr>
<tr>
<td>Myanmar</td>
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<tr>
<td>Malaysia R/C</td>
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<td>12.5</td>
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<td>13</td>
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<tr>
<td>Indonesia Standard</td>
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<td>16.7</td>
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<td>Venezuela</td>
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Government Take
(for Oil)

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International Exploration—Pain and Anguish?

International petroleum exploration has always been extremely challenging. But the challenges are magnified these days with declining potential, maturing basins, and tough fiscal terms. While the amount of exploration acreage available worldwide has more than tripled in the past 15 years, there are also more companies seeking opportunities than ever before. From the point of view of most governments this is a healthy environment, but it has not been healthy for most companies. For the past two decades the exploration end of the business has been notoriously unprofitable. Part of the reason is that fiscal terms are onerous in most countries. This is because the industry has been plagued by chronic overbidding that has shaped the market for exploration acreage and projects. Bid rounds and negotiations in the industry have been strongly influenced by both increased competition and overly optimistic estimates of oil prices, costs, prospect sizes, and success ratios.

This cannot help but result in overbidding and, ultimately, loss of value.

“All in all, such exploration for new giant fields destroyed value rather than creating it in the 1980s and early 1990s.

Exploration, as a corporate function, lost credibility.” (Rose, 1999).

A McKinsey & Company report estimated for the petroleum industry:

“US$400 billion value destruction over the 1980s.” (Conn and White, 1994)

Most of this US$400 billion loss (more than US$100 million per day for 10 years) was from the exploration end of the industry. Similar conclusions exist for the bonus bidding in the US Federal Offshore.

“In 1970 after about a decade and a half playing this gambling game, the estimate was that bidders were over US$4 billion in “deficit.” After about three decades, our estimate is that bidders are about US$48 billion behind.” (Lohrenz and Dougherty 1983)

This US$48 billion estimated deficit is interesting considering cumulative bonuses for the U.S. OCS were only US$47 billion by 1983. The statement by Lohrenz and Dougherty would imply that any bonus was an overbid. And this conclusion is shared by others.


Cumulative bonuses for the U.S. OCS were only US$55 billion in 1989 so even a “zero” bid would presumably have been too high—losses exceeded cumulative bonuses by US$15–25 billion.

Additional analysis of the Gulf of Mexico—studies done through 1982 (before the U.S. Minerals Management Service went “area wide”) indicated that:
“The average block had three bidders and the average winning bid was US$8 million. The second highest bid averaged US$3.2 million and the lowest bid was US$1.4 million.” (Warren, 1989)

It is extremely common in bonus bidding situations that the highest bid is about two times greater than the next highest bid. Almost all the literature dealing with bidding performance like that outlined above will refer to the highest bid as an overbid. Typically too, the amount of overbidding quoted in the literature will correspond to the difference between the highest bid and the next highest bid (the money left on the table). In my opinion it is more likely that, in situations where there are multiple bids, the highest bid is not the only overbid.

A classic example would be a single bid of US$5 million. This is considered an overbid of US$5 million relative to zero. Why zero? What is the magic in that? The real value, considering prospectivity, oil prices and fiscal terms, could have been less than zero. Let’s face it, if royalties and taxes are too high relative to the geopotential of a province, then even “no bonus” (zero) is too high.

**Overly Optimistic Oil Price Estimates**

Our industry has been dramatically overestimating oil prices for the past 20 years. Figure 2.3 is a common type of illustration of actual versus expected prices over the years. In 1990 the Department of Energy expected oil prices to increase by 65 percent by the end of the decade; instead, prices had decreased by about 3 percent (Kah, 2002). This is typical of numerous such examples. Expectations have not matched reality. Unfortunately, expectations—not reality—drive competitive bidding.
Overestimating oil prices is only one of many reasons for chronic overbidding in the past two decades. It is, however, an important factor in the development and evolution of fiscal systems around the world today.

*Real US refiner acquisition prices (from EIA) in 1996 dollars using gross domestic product implicit price deflators.

Data Sources: Energy Information Administration and Oil & Gas Journal Energy Database

**Overly Optimistic Cost and Timing Estimates**

Over optimism in estimating costs may not be as consistent a problem as others, but it is a problem. Going over budget seems to happen a lot more often than bringing projects in on time and under budget—particularly with megaprojects and frontier regions.

The industry has dramatically reduced time requirements to get from discovery to startup and then to peak production. Still, with hindsight, we find our estimates to mobilize large scale exploration efforts and/or development projects into remote provinces were usually overly optimistic. And, like oil price (over) estimates, this too has an influence on what a company may be willing to bid or negotiate.

**Post mortem Analysis Indicates Rampant Overoptimism**

Post mortem analysis of exploration portfolios of the 1980s and 1990s shows consistently over optimistic estimates of two key variables: prospect size and success ratio. For any exploration portfolio, there is an average prospect size in addition to estimates of success probability for each prospect. However, the average size of actual discoveries consistently is
smaller than the anticipated (estimated) prospect size, and actual success rates are lower than what was estimated.

**Overly Optimistic Prospect Size Estimates**

Overestimating reserve potential of an undrilled structure (a “prospect”) is an extremely common problem in the industry.

“. . . it must be acknowledged that overestimation of prospect reserves is a widespread industry bias that has proved difficult to eliminate (Johns and others., 1998; Alexander and Lohr, 1998; Harper, 1999).” (Rose 2001)

Notice the dates associated with this statement (above). The industry became acutely aware of the problem in the late 1980s and early 1990s. While many company personnel these days feel that much of the problem has been resolved, it is still a problem. The main cures include internal peer review and “team” approaches to exploration. Table 2.3 summarizes the results of studies that evaluated the difference between estimated versus actual reserves. The overestimates ranged from 30 percent to more than 160 percent. One of the most common explanations for this tendency is that geologists and explorationists “must be optimistic” in order to sell their projects and compete for funds internally.
Table 2.3: Examples of Reserves Prediction Accuracy

<table>
<thead>
<tr>
<th></th>
<th>Overestimated by:</th>
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<tbody>
<tr>
<td>Various</td>
<td>30–80% (1)</td>
</tr>
<tr>
<td>Rose, 2001</td>
<td></td>
</tr>
<tr>
<td>US Lower 48 States</td>
<td>73%</td>
</tr>
<tr>
<td>Capen, 1991</td>
<td></td>
</tr>
<tr>
<td>Gulf of Mexico</td>
<td>100% roughly</td>
</tr>
<tr>
<td>Capen, 1992</td>
<td></td>
</tr>
<tr>
<td>Deepwater</td>
<td>122%</td>
</tr>
<tr>
<td>BP-Amoco</td>
<td></td>
</tr>
<tr>
<td>15-year retrospective since early 1990s</td>
<td>(Harper, 1999)</td>
</tr>
<tr>
<td>Norway</td>
<td>163% (2)</td>
</tr>
<tr>
<td>8-14th Rounds</td>
<td></td>
</tr>
<tr>
<td>(Rose, 2001)</td>
<td></td>
</tr>
</tbody>
</table>

(1) “Since 1993, most oil companies have acknowledged that their geotechnical staffs persistently overestimate prospect reserves, commonly by about 30%–80%.” (Rose, 2001).

(2) For example, if a company estimated a prospect at 200 MMBBLS but the discovery yields 76 MMBBLS the estimate exceeded reality by 163% \( \frac{(200-76)}{76} \).


**Overly Optimistic Success Ratio Estimates**

Estimating the probability of success (some refer to this as “chance factor”) is an absolutely critical element in exploration risk analysis. And most companies have been making these estimates directly (expected value analysis) or indirectly (gut feel) for decades. Either way, though, we have been overestimating and it is killing us.

“Almost pro forma, explorers use 10 percent to 15 percent for high risk prospects; in reality, however, most should be 1 percent to 5 percent.” (Forrest, 2002)

One of the larger oil companies in the mid 1990s decided to implement a new strategy because of the failures of the 1980s and early 1990s. The new exploration strategy was based on a decision to avoid further “high risk” exploration. No more exploration would be undertaken unless the probability of success was greater than 20 percent. And the hurdle rate (target rate of return) was set at 15 percent. Over the next five years, overall exploration success increased to around 45 percent. But it was acknowledged internally that the 15 percent target internal rate of return threshold was not being met. In fact, the investments were not even obtaining an internal rate of return equal to corporate cost of capital. Value was not being
added. If value is not being added then it is being eroded. The five years of exploration represented hundreds of millions of dollars of investment. What is most significant is the fact that the problems had been identified before the new policy was instituted—the problems were obviously not completely fixed.
This is what one very large company did!

New exploration strategy was based on (1) a target internal rate of return ("hurdle rate") of 15 percent and (2) only "low-risk" exploration, i.e. estimated success rate had to be greater than 20 percent.

Results? Exploration success went way up – up to 45 percent or so.

Is that good?

Only if you are "adding value"! (It wasn’t adding value.)
Perspectives on Competitive Bidding

There is almost always a determining factor of some sort including bonus bidding, work program bidding, fiscal terms such as royalties or profit oil spits or combinations of these elements. The variety of means by which governments allocate licenses is diverse. Determining what to bid can be an agonizing process that requires art and science.

Signature Bonus Bidding

Two workhorses of the exploration business are discounted cash flow (DCF) modeling and expected value (EV) risk analysis. But these tools, as widely accepted as they are, provide only boundary conditions for a typical competitive bidding situation. Figure 2.5 depicts a simple “two-outcome” expected value model of a possible drilling prospect subject to a competitive bonus bid. For the sake of convenience, simple two outcome models are used in these examples instead of the more common multi outcome decision tree models used by almost all companies. The principles, though, are the same.

In this example, the potential “reward” is based on contractor discounted cash flow resulting from a potential discovery that yields an unrisked value of US$200 million (excluding the effect of any bonus). But dryhole costs (not including a bonus) are estimated at US$25 million. The EV assuming a 30 percent chance of success is US$42.5 million \[\text{EV} = (\text{US}$200 \text{ million} \times 0.3) + (- \text{US}$25 \text{ million} \times 0.7)\].

The analysis then provides the boundary conditions for a possible bonus bid. The company should not bid more than US$42.5 million, nor can it bid less than US$0 (zero). So what should the company do?

The most credible recommendations suggest bidding some percentage of expected value, say 20 percent to 30 percent, or less depending upon the circumstances and expected competition (Capen, and others, 1991 and Rose, 2001). This would yield in this case a bid of US$8–12 million or less.

It takes both science and art. Defining the boundary conditions is pure “by the numbers” DCF and EV science. Deciding what percentage of EV to bid, say 25–35 percent or so, requires a little more art, instinct, gut feel—whatever it may be called. In provinces such as the Gulf of Mexico, where there is substantial public data, the determination of how much of EV to bid becomes more scientific. But frontier areas are different—with less history and less public data.
Figure 2.5: Two Outcomes—Expected Value Graph

Assume:

?? A potential discovery would be worth $200 MM to the company (not including the bonus)
?? Dry-hole cost (risk capital) is US$25 MM (not including the bonus)
?? Estimated probability of success is 30%

So, what do we have?

?? Expected Value (EV) is US$42.5 MM – Cannot bid more than that!
?? Cannot bid less than zero!
?? So what should the company bid?
**Bidding Contract Terms**

Imagine evaluating a block/prospect in order to develop a bid based solely on profit oil split. Assume economic and risk analysis of the prospects on the block, with varying levels of profit oil split yield the following relationship between overall government take (which includes the effect of profit oil split, royalties and taxes) and company EV. A summary of the analysis is shown in Figure 2.6.

An example like this certainly requires some of the “art” of bidding.

**Figure 2.6: Profit Oil Split as the Bid Item Bidding Situation**

Imagine a bidding situation in which the profit oil split is the bid item. You company’s analysis of various profit oil splits results in different government take and of course various expected values for the company. What to bid?

<table>
<thead>
<tr>
<th>Government Take (%)</th>
<th>Company Expected Value* ($MM)</th>
</tr>
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<tbody>
<tr>
<td>50</td>
<td>170</td>
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<tr>
<td>55</td>
<td>150</td>
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<tr>
<td>60</td>
<td>125</td>
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<td>65</td>
<td>97</td>
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<tr>
<td>67</td>
<td>85</td>
</tr>
<tr>
<td>Range for last 10 contracts</td>
<td>Average of past 10 contracts</td>
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<tr>
<td>70</td>
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<td>75</td>
<td>48</td>
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<td>83</td>
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</tr>
<tr>
<td>85</td>
<td>-13</td>
</tr>
<tr>
<td>90</td>
<td>-29</td>
</tr>
</tbody>
</table>

*Assume the discount rate corresponds to corporate investment criteria “hurdle rate” close to or slight greater than the capital cost.

**What to bid:**

1) What if the past 10 contracts in the country had 60–70 percent government take?
2) Assume the average of the past 10 contracts was 67 percent government take.
3) What if the geopotential/prospectivity of the last 10 blocks awarded was better than the block you are looking at?
Combination Bid—Bonus and Terms

Assume the government will award exploration rights for a particular block to the highest bidder and both “terms” (profit oil split and/or royalty) and a signature bonus are biddable. The government receives two bids:

**SUMMARY OF BIDS**

- **Company A—Bid #1**  US$10 million + government take of 66 percent
- **Company B—Bid #2**  US$5 million + government take of 78 percent

Bid #1 relative to Bid #2 has a larger bonus but a lower government take. This provides a classic tradeoff—part of the government take is guaranteed (the bonus) and part is “at-risk” or at least “uncertain” (it depends upon whether or not a discovery is made). Analysis of these two bids requires discounted cash flow analysis and risk analysis. Depending on the prospectivity, either bid may be superior to the other. If the prospectivity is extremely poor, then it is likely the government would prefer Bid #1. On the other hand, if prospectivity is quite good, the Government will likely prefer Bid #2. It depends upon the probability of success and the potential size and/or value of a potential discovery (or discoveries).

Analysis of the two bids is shown in Figure 2.7. It assumes that the chance of success is 30 percent and that the present value of a discovery (to the government due to royalties, taxes, profit oil etc, based on discounted cash flow analysis) would be US$250 million for a government take of 66 percent and US$290 million for a government take of 78 percent. The EV for the government is greatest with Bid #2 as shown in Figure 2.7. Notice there is only about an 8 percent difference between the two bids from this perspective, even though the highest bonus was twice as high as the next. If the US$10 million bid is too high, is it not possible that the other bid, which is only 8 percent lower (based upon EV analysis), is also too high?
The development and evolution of fiscal terms worldwide in the past 20+ years has taken place in an environment of intense competition and overly optimistic expectations. It has resulted in terms that, generally speaking, are simply too tough to justify the harsh cold risks associated with petroleum exploration. Certainly many countries have modified and/or improved their terms, but relative to dwindling prospectivity as geological basins matured in the past two decades, the terms are tougher now than they were 20 years ago.

The average government take worldwide is around 65 percent, but this is too high for “average” geological potential (or prospectivity). For countries with better than average
potential, the government take is closer to 80 percent. However, better than average geological potential is rarely sufficient to sustain such a high government take. This is why the industry is losing money exploring for hydrocarbons.

It is not because greedy governments have forced these terms on an unwilling industry. It is the other way around. Industry has determined what the market can bear, and it is almost unbearable. Governments have little choice than to allow a competitive marketplace to work its magic as they have for many years.

International exploration acreage has taken on more and more of the characteristics of a commodity. Many governments are only beginning to apply Madison Avenue marketing strategies and tactics in order to compete for capital and technology. Intense competition between the oil companies has given many governments an advantage. However, for those with less than average potential, the job of attracting oil companies is more difficult. Lenient fiscal terms are often not enough—companies focus on “barrels.” By understanding oil company needs, countries with less potential can better compete.

There are many things governments can do to encourage and/or accelerate foreign investment. Some strategies require the government to take on added risk. Dropping or modifying ringfences can enhance investment but will increase risk to the government. But more governments are allowing their national oil companies to go outside their own borders and explore. They are taking on exploration risks that many have traditionally shunned. If oil companies, which have been in the exploration business for many years, are losing money in exploration, is there any reason to believe that government-owned agencies can do better? If a country had to make a choice between modifying a ringfence and sending its national oil company overseas (both choices come at a cost and place the government at greater risk) then most would be better off staying home working on the fence.

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Transfer Pricing in the Oil Industry

Jurgen van de Kemenade, Senior International Tax Advisor, ENI GROUP

In a letter to Jean-Baptiste Leroy in 1789, the year of the French Revolution, Benjamin Franklin wrote what may be his most famous quotation: “In this world nothing is certain but death and taxes.” If he were alive today, he might well have added: “…but in the world of transfer pricing, nothing is certain at all.” Today, I would like to take a few minutes to look at the problems that arise from this lack of certainty in my own industry, and to offer some thoughts on how things might be improved.

The cause of the problem is very simple. If I might misquote another great statesman Churchill: “The arms-length test is the worst form of test that there is—apart from all the others.”

Nobody doubts that it is necessary for revenue authorities to effectively police the matters of transfer pricing. To answer this need a new power to tax has been widely accepted. However, to be legitimate a power to tax must have certainty. In taxation, as in any walk of life, a vague law is a bad law. Policymakers have assumed that the arms-length test provides the degree of objectivity needed for a legitimate charge to tax. However, the reality is that it is a test that can only rarely be applied with any confidence in the modern corporate world. Consequently, both taxpayers and revenue authorities usually default into a subjective world of mark-ups, netbacks and horse-trading. In this world, the simple question “what did it cost” has many answers, which is hardly surprising given that the key practitioners in this world are not lawyers or accountants, but economists. Today I would like to reflect on what can be done to give greater certainty to transfer pricing, and to make a plea—that as long as we have to operate with an area in the profit and loss account that has a totally different level of certainty to the rest of that calculation, legislators should recognize that uncertainty when they legislate punishments for alleged defaults by taxpayers.

It is an old saying in the petroleum industry that oil has three characteristics:

- ?? There is usually no market for it in the places where it is found.
- ?? It is completely useless in the state in which it is found.
- ?? Nobody would want to go and work in the places where it is found.

These characteristics determine the economic characteristics of the oil industry. We have long value chains, and those chains cross the boundaries of many countries. They
involve many different business activities that have quite different levels of risk, and so require very different levels of reward.

Oil has to be found. This is an expensive high-risk business—a business in which high rewards are essential, because each success must pay for 10 failures. Inevitably those high rewards attract high levels of taxation and intense scrutiny from revenue authorities. Much of the next generation of those rewards will come from oil development and production in transitional and developing economies, such as the former Soviet Union and Africa. Once state entitlements to share in production are taken into account, the effective tax rate in the upstream is often as high as 80 percent. But if the companies are to survive, and the world is to go on enjoying an abundant supply of energy, the companies must be allowed to retain a fair reward for the risks that they have taken. A super profit does not look like a super profit when a company is offering to gamble several billion dollars on exploration that has a less than 20 percent chance of success. Of course the picture looks very different once a discovery is made. There is a danger that the risks will be quickly forgotten. Companies may be confronted with demands to move the goalposts either by an outright renegotiation of deals honestly struck, or by more subtle pressures at the margins, of which transfer pricing is one area that can be most burdensome to defend.

Having been discovered and produced, oil has to be transported, perhaps across several countries; it has to be refined into useful products that are part of our everyday lives; and those products have to be marketed. These activities are part of the regular manufacturing and trading realm of business, and they are taxed accordingly, generally at around 30 percent. There is therefore a fundamental fissure between the two tax worlds of our industry—the highly taxed upstream and the typically taxed downstream.

The place where that border between these two worlds is drawn is usually the frontier between the transitional and developing economies, where new reserves are found, and the developed world, to which oil is transported and in which it is refined and sold. I would like therefore to focus on some aspects of day-to-day life on this tax frontier. If oil groups have one defining characteristic, it is that we are truly citizens of the world—guests in many countries, but ultimately residents in one—often by historical accident. We can only operate with the consent of our host governments, and in constructive co-operation with them. I am concerned that the approach to transfer pricing that is currently being adopted in many transitional economies, will make our task, and ultimately that of our hosts, unnecessarily difficult.

To their great credit the developed economies have generally been willing to support and encourage market-orientated developments in transitional economies. In the area of taxation one example of this has been the negotiation of double taxation treaties at a very early stage in the development of those economies. For example in the early 1990s many of the OECD countries initiated the negotiation of double taxation treaties with the newly independent states of the CIS. Generally this was in response to requests from potential investors such as oil
companies. However, this early negotiation and consequent signing of treaties has had somewhat mixed consequences.

The tax laws of most of the former CIS nations have changed beyond recognition since many of these treaties were negotiated. Generally the laws have moved from the old “Soviet” model to broadly Western style systems. However, inevitably there is still relatively little experience in operating this type of tax system in the host countries, and very little experience at all in the administration of transfer-pricing legislation, although these countries are now equipped with some of the most aggressive transfer-pricing legislation in the world. The consequences of that will become apparent in the next few months.

Although treaties were put in place in the early 1990s, a common understanding of what they meant was not. Particular points have tended to be dealt with in a series of Protocols to the individual treaties, as difficulties have arisen. What is most lacking though is an agreement on the overall framework within which treaties are to be interpreted—in particular the role of the Commentary to the OECD Model Tax Treaty and the OECD Transfer Pricing Guidelines for Multi-National Enterprises and Tax Authorities.

Two things would be particularly helpful. First of all, it would be helpful for the relevant competent authorities to agree that treaties will be interpreted in accordance with the OECD Commentary and Transfer Pricing Guidelines, rather than, as it tends to happen, be interpreted in accordance with the OECD documents so far as the Western authorities are concerned, and in accordance with locally adopted rules of interpretation so far as the transitional states are concerned.

Secondly, it would be helpful to develop a wide-ranging Protocol of general application to OECD-style treaties that would deal in detail with some of the uncertainties that I am going to outline. The latter is necessary because, although the OECD documents do provide a framework for approaching these issues, they do so in a highly theoretical way, and rarely provide a clear answer to a real question. The thing that is needed most both by taxpayers and revenue administrations in transitional economies is clarity and certainty in practical applications. This may involve a degree of “rough justice” given the various conflicting interests that are involved. However, the effort involved in achieving it may well be less that the effort involved in resolving the disputes that are likely to arise without it.

*The Scope of Transfer Pricing*

In the comments that follow I intend to focus on Kazakhstan, although it would be quite unfair to suggest that the issues are unique to Kazakhstan. It is simply a country with which I am particularly familiar, and in which these issues are particularly acute at the moment. I also intend to focus on just two areas: aspects of the administration of article 7 of the OECD-style treaties in respect of the allocation of head office charges, and article 9 in respect of charges from affiliates. Of course there are many other areas that could be discussed, but not within the time available today. I simply use these for purposes of illustration.
Article 9 of the OECD Model Treaty deals with “Associated Enterprises” and authorizes the adjustment of profits where one enterprise participates in the management of another, and the conditions on which they trade differ from those that would have existed between parties dealing at arms length.

I would like to start with the most basic question: is a relationship between two particular entities within the scope of the Kazakh transfer-pricing legislation or not? The answer depends on what “participates directly or indirectly in the management, control or capital” means. Does it mean 10 percent of 51 percent? Does it mean owning voting stock or simply having influence by whatever means? It could mean virtually anything. If it is accepted that the OECD Commentary is the guiding authority, then the situation clarifies because it is clear from the Commentary to article 9 that it means the ability, one way or another, to exercise decisive and exclusive control, though it would certainly be helpful if the point was made in the Treaty itself.

The issue is important in the context of countries such as Kazakhstan, because the scope of the transfer-pricing law there is very widely drawn. It will catch for example any international transaction between:

- Two entities that are under common ownership to the extent of 10 percent
- Any transaction by an entity that has made losses for the past two years
- Any transaction of which either party has a bank account in a tax haven
- Virtually any entity that has an oil production concession in the country

Bearing in mind that the only defense against a transfer-pricing attack is generally to have assembled, at the time the transaction occurred, documentation to demonstrate that the price was arms length, it can be seen that the administrative burden alone is immense.

All of these tests have their own difficulties, but for the purpose of my argument the first one is the key one. At the very least, an agreement that the relevant tax treaties, which do over-ride Kazakh law, are to be construed in accordance with the OECD commentary, so that 51 percent control is needed for transfer pricing to be in point would be very helpful. I might add that at least in one case—in the case of the United States—the equivalent of Article 9 specifically provides that domestic transfer-pricing legislation may apply notwithstanding the other provisions of the associated enterprises article. The relevant clause was, of course, put in before Kazakhstan had transfer-pricing legislation. It is one that, I suspect, many U.S. investors will regret.

I am particularly concerned about the scope of the application of transfer pricing because I am looking at transactions that cross the border between the transitional economies and the developed economies. Costs in the West are obviously higher than they are in the East, and so this is an area that is likely to attract close scrutiny. The Kazakh legislation recognizes
that to be comparable services should have the same country of origin. Therefore, by definition local Kazakh prices do not provide a comparable uncontrolled price for services provided by affiliates from the West. This is helpful, but the question remains as to what does provide a comparable price? Is it necessary to seek a comparable price in the market of origin? If so, we know from experience that for most of the intra-group services that flow within an oil group such comparables do not exist, but we need to prove that, and proving a negative is always difficult. If a cost-plus basis is adopted, the requirement of the Kazakh legislation is that only “confirmed” costs may be included. Does this mean production of original documents? Will internal cost allocations be accepted? How remote can indirect costs be before they are disallowed? What is the appropriate rate of mark-up?

It would be helpful to limit the cases that need such onerous analysis to those where genuine common control of the parties exists. This is clearly not the case at 10 percent ownership. It would also be helpful to have clearly defined safe harbors as to the key aspects of what makes a comparable service. The commercial reality is that the great majority of intragroup services are so specific to the group that they have no true arms-length comparison, and can only be dealt with on a cost-plus basis. Common ground for a range of acceptable cost bases and acceptable mark-ups would also be most helpful. Finally, and perhaps most controversially, if an operator—a single company - implements a project on behalf of a consortium of which it is a member, as is usually the case in our industry, on a no gain/no loss basis, it would be helpful to have this commercial reality be specifically protected from a transfer pricing attack—both so far as the operator itself is concerned, and also in the case of services that the operator acquires on a no gain/no loss basis from its affiliates, though in this latter case the problem lies not in the host country, but in the home country of the affiliate.

My concern regarding article 7 and the question of head office costs is as follows. Article 194 of the Tax Code of Kazakhstan contains a statement with which I have some difficulty: “The administration of international agreements shall take place in the manner established by the authorized State body in accordance with Articles 193–204 of this Code.” The articles to which article 194 refers contain two quite different things. On one hand they contain a description of various rules of genuinely administrative nature about how treaty applications are to be made (which are to an extent helpful). On the other hand these articles also contain provisions about how the deduction of head office costs are to be determined—in other words not so much administration as the quantification of the charge to tax. These rules could be construed in a way that would result in a significant disallowance of legitimate head office costs —costs that on an OECD basis would be fairly chargeable to operations within Kazakhstan.

We are all familiar with the OECD approach to the attribution of head office costs. This divides costs into three main categories:

1. Shareholder costs—those that a head office incurs for its own purposes, its statutory audit for example. Such costs should not be recharged.
2. **Stewardship costs**—the costs that the head office incurs to protect its interests as an owner of other entities, but which also benefit the entities or activities being monitored. Shared administrative functions such as a group-wide accounting system may be an example. Based on the extent, to which such costs give rise to benefits outside of the head office, an appropriate share of these costs should be charged out.

3. **Specifically identifiable services** which must be charged out.

   Articles 195–197 of the Kazakh Tax Code provide that costs of “Management and General Administrative Expenses” shall either be charged into a permanent establishment in Kazakhstan for treaty purposes by using an indirect method—the ratio of turnover in Kazakhstan to global turnover for example, or a direct allocation method, but NOT both. In reality, and as envisaged in the OECD Guidelines, stewardship costs are allocated on an indirect basis, and specifically identifiable services are allocated on a direct basis. There is therefore a real danger that a home office tax authority may apply the OECD Guidelines in its treaty interpretation to require a substantial cost allocation into Kazakhstan, and Kazakhstan will apply its legislation for treaty interpretation to force a disallowance. The unfortunate result would be that the existence of the tax treaty would be instrumental in creating double taxation, though, to be fair, if there were no treaty, Kazakhstan would simply refuse any deduction at all.

   This is particularly unfortunate, because Joint Operating Agreements—the agreements under which one oil company may carry out the work of implementing a project on behalf of a consortium of which it is a member—universally provide for both methods of charging costs to the joint operations to be employed in parallel, recognizing the commercial validity and practical necessity of employing both methods simultaneously to give a fair result.

   I have focused on the problems of the pricing of intercompany services, and the questions of cost allocation because the provision of intragroup services from either administration or knowledge centers within international groups is a key part of the benefit that multinational companies bring to the transitional countries in which they operate. The use of such services creates a myriad of uncertainties from a tax point of view. Worse still, those uncertainties can lead to automatic and severe penalties.

   I have made a plea earlier that policymakers should recognize that transfer pricing is an art, not a science, and should design their penalty regimes for tax violations, that would differentiate between transfer-pricing disputes and other sources of alleged underpayment of taxes. This thought can be further developed. Clearly, there are areas of transfer pricing, in which rules can be developed that will create a certain and fair tax environment. These are the pricing of commodities—most obviously oil in my own case. The price of oil can easily and clearly be established for any given date by reference to openly available market data such as Platt’s Oilgram. Moreover, it is this area that is of most importance to transitional economies to police. There have been many rumored cases of abuse in the past, when allegedly up to 90 percent of the oil exports of certain CIS states were being sold to such well-known oil
consuming nations as the British Virgin Isles. I would suggest that it is on these areas that transfer-pricing rules should be focused. And it is only in these areas that automatic indiscriminate penalties should apply. So far as issues such as the pricing of intercompany services are concerned, or the allocation of costs within groups, there should at the very least be a scope for a wide range of acceptable answers before penalties are applied, and there should be a clear acknowledgement of the role of the OECD publications in this respect. For one party to a bilateral treaty to create its own law to interpret that treaty is to undermine the very purpose of the treaty itself.

I would like to conclude by making a prediction, a suggestion and a plea. My prediction is that in five years time the busiest people in the Revenue Services of most of the OECD nations will be the staff who deal with competent authority disputes with transitional economies, unless we can bring clarity and certainty to these issues soon.

My suggestion is that a protocol should be developed, perhaps between the CIS nations and the major Western oil companies and the tax authorities of their home jurisdictions, to provide specific and detailed guidance on how the OECD double taxation treaties will be applied to oil companies and their subcontractors. If it seems presumptuous to single out my own industry for a special treatment, it should be remembered that the oil business accounts for the major part of the GDP of most of the transitional nations about which I am talking.

My plea is that policymakers should recognize that in transfer pricing nothing is certain, and design penalty regimes accordingly. It would be a great shame and a great waste of scarce resources if we were to end up trying to do honest commercial business in a transfer-pricing world in which the only certainties were penalties and competent authority disputes.

**Petroleum Revenue Reporting**

*Peter Macnab, Senior Advisor, AUPEC*

I would like to start by asking the simplistic questions that I think we all should know the answers to. Revenue management for any country: what does it actually mean, and why do we do it? The effective stewardship of public resources with regard to revenue management is obviously a very important component. Financial management and government have the task of encouraging cost consciousness in the use of resources. So, why do it? Well, to satisfy obviously good governance. If we look at good governance a little further, we will see accountability where those in positions of public trust should account for their actions and decisions within the limits of their authority. And within accountability itself, there are a number of mechanisms, two of which I would like to mention in passing because they are very important in my opinion. That is the auditor general within a country—the officer responsible for auditing government income and expenditure, who should monitor the financial credibility of the reported financial flows in accordance with government legislation.
The second mechanism is the public accounts committee. The auditor general ideally should report to this committee. This is a representative committee, which should hold the executive to account. I believe, South Africa is rather a good example, as the whole parliamentary process is open to the public. All select committees, including the public accounts committee, I believe, are required to meet in public. If they have to go into closed session the reasons must be debated in public. With regards to transparency that is where the procedures and methods of decisionmaking and the disbursements of public funds are open and visible to all. This obviously relates to budgets, audited financial statements, confirmation of compliance with statutes regarding tax assessments, and collection.

Understanding and reconciling the difference between taxes due, paid to, and received by the government is a subject I want to go into a little more detail further on. A taxpayer—the oil industry or oil companies—within a particular country has taxes which are assessed and which are due for payment. Ideally the taxes paid should be the same as the taxes due. And then, finally there are taxes received by the treasury or the Ministry of Finance. Very simple: A=B=C. As we know, that is how it really should work.

However, in practice, it is not always so simple. There is a taxpayer and taxes due. Then, there might be the problem of arrears between taxes due and taxes paid, but the third step is the one where most often problems arise. In many cases there are a variety of ways of how taxes paid by the taxpayer ultimately finish up in the treasury as taxes received. When the taxes are received by the state Ministry of Finance, internally there has to be a reconciliation that the taxes received finally and ultimately go to the treasury department.

Let us look now at the intermediate steps between taxes paid and taxes actually received. Taxes paid may flow to the state bank. In other words, the oil industry will pay the state bank in dollars, which go into a particular account and from there could be converted into local currency and finally go into taxes received by the Ministry of Finance. Or taxes paid may go directly to the state oil company, and the state oil company then pays the ministry. Another interesting case is when the oil companies may in fact pay at least part of the taxes that are due directly to regional governments. A case in point is Russia where large elements of royalties, profits tax and VAT in fact go to the regional governments, and the balance goes to the federal government. In all of these cases there is obviously a major reconciliation problem or at least a potential for the reconciliation problem.

When we talk about missing taxes, we should remember among other things that missing taxes can mean that a country’s or a government’s reconciliation procedures are at fault. There are several reasons for missing taxes, and reconciliation problem is a major one, because if there is no proper reconciliation process in place then all sorts of problems can occur.

Let us look now at the effect of some of these intermediate steps. If we look for example at barter arrangements, the state oil company may have a setoff or barter arrangement whereby in return for selling cheap product the government allows the value of this to be offset
against the specific taxes the state oil company is due to pay. Perhaps the state oil company and
the foreign oil companies have an arrangement whereby the foreign oil company pays a
proportion of the state oil company's share of joint venture costs in return for the government
agreeing to reduce the foreign oil company's tax bill—another reconciliation item. I mentioned
about the direct payment to the regional governments.

Another problem of course and a major problem is timing—a timing problem of
tax settlement. Many emerging countries, as we know, have a dual problem of hyperinflation
and a depreciating local currency against the US dollar. If, for example, arrears and interest
charged are not monitored, the taxpayer can make a profit and effectively is given a free loan by
the government. The longer the taxpayer delays payment, the more these arrears increase.
When the taxpayer finally converts the dollars to local currency to pay its taxes, the original
value of the taxes has eroded due to the depreciating currency, and of course there is a cash
flow impact on the government as well.

I think this is a very important point: is there a reliable ongoing process by which
taxes due to be paid are compared and reconciled to taxes actually paid and received by the
government? Why this is so important again is because if the government uses a model
forecasting future tax flows, then it is obviously vital that the information on taxes received can
be properly compared.

Let us look at the reconciliation process for a given year. For example, a
taxpayer (the oil industry) is due to pay US$100, but in fact the government receives US$15.
There is a difference of US$85. What does the government have in place to try and identify why
where the taxpayer has paid US$100 it has only received US$15? This is why it is so important
to have a proper Reconciliation Unit within the Ministry of Finance that will monitor the flows of
taxes and identify at each stage perhaps the barter arrangements that I mentioned earlier. Let us
assume that the barter arrangement equated at US$15; setoffs at US$25, the direct payments to
regional governments at US$10, and the arrears at US$35. If all of these are taken into
account, when you add them up you should be able to come back to the original US$100 that
in fact the taxpayer—the oil industry—has paid. I am putting this obviously in very simplistic
terms.

I would also like to note that countries such as Angola and Russia, where we
have worked, do have a reconciliation process but it is fragmented, and there is a problem of
skill there as well. This is highly complex to keep trace of, and the lack of proper skills is one of
the fundamental problems that the oil-producing developing and transition countries face.

What is required to manage this reconciliation process? First of all, reliable base
data. What does that mean? There are taxes due and taxes paid by the oil companies. That is
the start-off, and what we need there is properly, independently audited fiscal declarations. That
is the bedrock start for our later comparison.
There is a need in excellent interentity communication at each point in the revenue flow process. What that means is that there is a need for a little group, which would be reconciling at the state bank or at the state oil company these flows of taxes, that are being received from the oil industry, and accounting for these and sending them on ultimately to the Ministry of Finance. This department for monitoring, or a Central Reconciliation Unit would be accountable directly to the government (bearing in mind what I suggested earlier), the auditor general and the select committee and so on. But the whole importance of the Reconciliation Unit is absolutely vital in order not only to monitor the taxes that are being received, but also to set the various stages in the process. It should be responsible for setting up procedures and perhaps placing their own people within the state bank or whatever link in the chain between when the oil company pays the money and when the government gets it. The role of the Reconciliation Unit is very important.

I would also like to mention the importance of government audit to monitor the reconciliation process. Ideally the audit of public finances should represent a detailed investigation of the gaps that I was talking about, the measurement of the gaps and so on. But audit goes a bit further. An audit would be looking into the reasons why these gaps exist. This may not at the moment be acceptable to the governments concerned. But what I feel very strongly about is that there is no excuse not to have an audit function, because the audit function could commence by introducing the concept through looking at the efficiency of the reconciliation process and the Reconciliation Unit. Are the necessary procedures in place? Are they being maintained? Are they being updated to reflect changing operational conditions? Does the skills problem still exist or has it been addressed? These are issues an audit group could actually be looking at and checking the actual basic reconciliation process in order to find any gaps there.

The financial model and reconciliation functions would be linked as follows. Basically the Revenue Management Unit or Agency we propose would have two functions. One would be the monitoring and development of the model while the other would be the reconciliation of the taxes paid by the oil industry with what is actually received by the government. The actual taxes paid for each year may be broken down by quarter or monthly. At the end of each year there should be an annual look back to compare the actuals with what was projected for that year.

It would be essential that both functions would be working together. It really depends on the country whether it wants the functions as two units within a new department or one, ideally probably one independent unit. This "independence concept" and to whom to report are very important. Perhaps, to emphasize independence and importance, the department could be described as a Revenue Management Agency, independent of the Ministry of Finance, having an experienced senior manager reporting directly to the Minister of Finance or Deputy Prime Minister.
Finally let us talk about the legislation. In practical terms in a lot of emerging
countries governments usually work on a short-term basis. For various reasons, they do not
have long-term policies. For example, an education and skills policy is something that evolves
over years. It takes time to establish the education policy in order to bring up the necessary
skills to do what I am suggesting here. Similarly with forecasting and the model: again the high-
level of skills is required to do this, and David will be talking about some of the powers of the
model, and how important it is to have the requisite skills. But again that is a long-term process
to have the necessary local people able to manage the model and to manage the other aspects
of the tax administration that I have been talking about. However, it is essential, because in
order to gain international investor confidence and to aid transparency it is obvious that these
countries need something pretty quickly to get the whole process going.

Yet one of the main problems that exists in most emerging countries is the
quality of the civil servants. Their salary structure is not commensurate with the skills they are
meant to have to do these things. So, let us look at one or two little ideas on how the skills
process might be kick-started.

There is the oil industry, staffed by experienced personnel. The PSAs usually
have a provision to train local people in a range of appropriate skills and various disciplines,
such as economics, accounting, and so on. An idea might be for the local government
concerned to negotiate the secondment of key locals who have been trained by the oil industry
in finance and economics to support the Ministry of Finance and/or other key ministries. This
would be a short-term measure on a rolling two-year basis, and it would provide a breathing
space in order for the government to bolster its human resource policies and to introduce
improved conditions to attract permanent people. The funding problem could be overcome if
the oil industry, as part of the agreement, would be paying these secondees. These trained local
people would actually administer the model and be responsible for the reconciliation function.
This would be a good example of a partnership between the government and the oil industry. It
would also aid transparency through demonstrating that certain funds earmarked under the PSA
for training were being used to practical affect in supporting the government. That is one option,
and it buys time in order for the country to start developing its own long-term skills.

Another obvious thing is to simplify the whole process of paying taxes. Why to
go through all the pigeonholes in order for the money to go from taxpayer to government? Can
this process not be streamlined? Is there the necessary legislation in place? It probably is, but in
many cases the legislation is not being applied. So, let us see if the legislation, if needs to be, can
be streamlined, and is also made in accordance with reality. Let us also remember that the
requisite legislation may be in place after all but is simply not being adhered to. This requires
government’s will to change.

In summary, I think there are a lot of practical things we can do in partnership
with countries to assist the process of transparency and revenue management. The foregoing
examples I hope will stimulate some interest.
Thank you!

Petroleum Revenue Reporting

David Reading Senior Advisor; AUPEC

I want to take up where Peter left off. I want to talk about modeling. I have been doing a fair bit of modeling over the last ten to fifteen years in various countries. What is an aggregate financial model? Under a broad definition it is a tool with which to measure and monitor current revenue and project future revenue to the state from the petroleum industry. In Russia, where we have been working in partnership with other consultancies, we have been building an aggregate model, which covers both the upstream and downstream sectors. It really is what I would call an aggregate financial model. In Angola, we have been focusing pretty much on the upstream.

Having said that about a broad definition of what an aggregate financial model might be, in my experience this definition gets stretched quite quickly, and in a sense the model is what you want it to be.

I find that governments that I have worked with are often not sure what they want from such a model. I would like to stress that certainly before any government starts to build an aggregate financial model, it should first ask itself what are the basic requirements for this model. Is the government looking for a high level strategic tool that will give it pointers and will help it to make decisions at a high policy level? Or is the government looking at a more detailed budgetary type model that will enable the government to compute monthly taxes to the nth degree for every company that is producing in the province? This is a critical decision for governments to make, and this decision has to be made at the outset, because it will have an effect on how this model is going to be constructed and how ultimately it will be used. I sympathize with what Daniel Johnson was saying earlier about the whole variety of terms used in petroleum economics. There really are many different terms and performance measures that the government might want to compute. Therefore, it is absolutely critical that any government setting out to develop a model understands what it wants out of it, what outputs are required from the model.

I had a look last night at the aggregate model that we have created for the Angolan project, and I counted about 50-100 variables in one of the first sheets. If you multiply that up, looking at monthly and quarterly outputs for every company across all the projects that are going in Angola, you get about two to three thousand outputs to begin with. This explains why it is critical that any government that is setting out to build and to use an aggregate model understands what it wants out of it.

It may be not that much. The government just needs something usable. But it needs to know how the output is going to be reported, how it is going to be used. If the government is going to build a very detailed budgetary type model, then it needs to know whether there is access to very good information and data; whether there are skilled resources available that will be able to use this type of model. It also has to know how the model is going to be used. So, before one
even begins to talk about the use of financial models in revenue management, I would say that we should start simply. You do not actually need more than a spreadsheet or a few spreadsheets. Governments should get the idea of using the model, building confidence and credibility in the model. This is critical for any government that wants and begins to implement this kind of work.

Let us assume the government has the model. How can the government use it? Peter talked a lot about the reconciliation process. This in a sense is a question of looking backwards. But, of course, none of us would drive a car just using the rear view mirror. We have to look forward as well, and this is a very important aspect of revenue modeling—enabling the government to have a tool that it can use to project forward. But the model is an important tool that can assist the reconciliation process. It can help identify the anomalies and to cross check data of taxes received and taxes due.

I would like to show you an illustrative example of output from one of the models we have created. What we have got here is a project with three partners: companies A and B have a 40 percent equity share in the project, and company C has a twenty percent equity share in the project. There are tax projections due by each company and the taxes actually received by the ministry of finance from each company. There is an anomaly here. There are two companies with the same equity share but taxes received from them are very different. Is it a material difference? If it is a material difference, then it needs to be explained. As Peter argued, there are a number of reasons why that material difference might exist, and it will be part of a reconciliation unit’s work to look into those differences. That is just one example where a model of this type might be able to assist in pointing to the anomalies.

An aggregate model can also help the government in a many other ways, not just in terms of revenue management. It can provide help in macroeconomic policy formulation, helping governments planning, maybe assist in preparation of national budget and policy decision making. Again, it is rather straightforward. I would argue that a model of this nature could be used in a number of ways, just using simple scenario analysis. I have listed a few scenarios that I would consider to be fundamental in terms of petroleum revenue modeling, and that a government would want to be on top of and would want to review. These include price scenarios (as change in price clearly has an impact on tax revenues), cost-curves scenarios, scenarios based on production decline rates in oil fields, and fiscal instruments scenarios. It is very rare for any fiscal regime to remain stable. How did the changes in fiscal instruments impact revenues? How did phasing of projects over time impact tax revenues? These are very fundamental scenarios for which governments can use these types of models.

I would like to give you again a very simple example (Figure 2.8). This graph shows that somewhere (as in Angola) where the economy is driven by oil, having a handle on what price can do in the coming years in terms of its impact on the country’s tax revenues is absolutely critical. The graph illustrates two extremes. It shows total taxes due under a US$30 price and a US$12 price.
Another area where this type of model can be used is cash management, particularly in places like Angola where there is a lot of oil-backed loan commitments and loan servicing. I think, an aggregate model of the type that we have constructed in Angola should help the government understand the price below which servicing some of the loans becomes unattainable. To be able to establish that benchmarking is very important.

In terms of cash management, this type of modeling can also help the government understand its financial exposure if there is a high level of state participation in oil projects. The existence of a state oil company that is heavily investing heavily might significantly increase the financial pressure on the government. In the low oil price environment, there is almost a double whammy effect where the government is under double pressure both to service loans, that which might be oil-backed, and to provide financing to a state oil company that is investing in projects.

Again, I would like to show you an illustrative example of the sensitivity to the oil price of the post-tax net cash flow of a state oil company in a period of heavy investment (Figure 2.9). This kind of graph can help governments understand the exposure that they face when there are periods of heavy investments coinciding with periods of low prices.
Another area that is also important and where a financial model can help is monitoring contract arrangements. What I have found in my experience working with the governments is that there is a lack of understanding in some cases as to how fiscal instruments can, at an aggregate level, impact tax revenues. It is important that the management of these revenues is understood in terms of how these contract arrangements are constructed. In Angola, for example, there are a number of incentives, including cost recovery limits, tax credits and investment uplifts. Without implying whether these fiscal incentives are good or bad, my question is whether the government really understands what impact they have on future tax revenues.

I would like to give you an example illustrating what total taxes might be due when there is an investment uplift in place and versus when there is no investment uplift is in place. At an US$18 (Figure 2.10) price in the first four years, there is no real impact. However, at the price of US$28 (Figure 2.11) a barrel over the four-year period, when there is an uplift in place, there is a significant impact in terms of tax revenue in the fourth year. Again I come back to the point that I am not necessarily saying that it is a good or a bad thing. The question is whether the government understands that these types of fiscal instruments have this type of impact on future tax revenues.
I would like to turn now to some of the issues that I think are important in sustaining an aggregate financial model. By sustainability I mean that at some point the government has to be able to continue to maintain, update, enhance and develop the model as and when it sees fit on its own. In most of the projects on which that I have worked with it is very common and sensible to work with government counterpart teams. In my experience it is a great way to go, and I have done it many times in the past. The key issue in terms of
sustainability is access to skilled resources. The counterpart teams have to establish a set of skills. In many of the places where I have worked it is an issue. The type of modeling I have done in these countries requires technical skill resources. Having said that, I would like to stress again that no model needs to be more complicated than it has to be. Simple spreadsheets to begin with are perfectly acceptable. However, there is a need for technically skilled personnel who will be able to competently operate the model, who can maintain and update the model, who can generate outputs and reports, who can enhance the model and can communicate in a way that will enable them to gather the right type of data and to be able to interpret that data as well. Technical skill resources are very important. I also think that what is even more important, and this in my opinion is often lost, is a higher-ranking set of skilled resources—people who truly understand the power and value of a model, who understand what the model can do for them, who are able to direct the operation of the model, who are able to analyze and interpret the outputs (and the outputs can be significant), and who are able to communicate this as well. I also think that it is critical to have the higher-ranking officials and experts fully involved in all aspects of constructing and developing this type of model.

How to get there? Peter Macnab has mentioned some of the ways to get the right skills and begin to build and use an aggregate financial model. People in charge need to organize. They need to define the process and procedures. They need to get the best people. And, very importantly, they need to promote the value of such a model within the government. The model should not just sit in one place known by only a few people. It really has to be promoted as a valuable tool throughout the government.

Finally, I would say that you have to have government’s commitment. Peter mentioned it in his presentation and I absolutely support that. If there is a strong backing and strong commitment from the government then you can do anything. I do think that it is very important.

I hope I have given you a flavor for what I think an aggregate financial model is and how it should be used. There are many other ways in which, I am almost certain, you can use this type of modeling, but I hope I have given you a flavor today about how I see it. Thank you for your attention.

Petroleum Revenue Management Government Perspective

Manuela Ceita Carneiro, Vice President, Sonangol USA

My name is Manuela Carneiro. I am the vice president of finance and administration of Sonangol USA, the Houston-based subsidiary of Sonangol Exploration-Production (EP). As most of you know, Sonangol EP is an Angolan public sector company, charged with managing the country’s petroleum reserves, ensuring the supply of petroleum products in Angola and promoting energy related projects such as LNG and a new refinery.
I would like to give you some insights into the relationship that exists between Sonangol and the government with respect to petroleum revenue collection. Angolan crude oil production has been increasing at a steady pace for years. For the past nine months of this year, 2002, total Angolan crude production has been 913,000 barrels per day. Crude production is forecasted to remain steady in 2003, and rise again in 2004 as Block 15, operated by ExxonMobil, comes onstream. The crude oil production in 2004 is expected to top one million barrels a day. Production from Block 15 fields Xikomba, Kizomba A, and Kizomba B could reach as high as 450,000 to 500,000 barrels per day, once all of the fields are onstream in 2005 and 2006, which will give Angola’s oil production a substantial boost. Further increases are expected as well from Blocks 14 and 17, which are already in production, and from the new ultra deep off-shore—Blocks 31, 32, 33, and 34. These productions increases will be partially offset by a smaller production decrease in many of the older, more matured fields.

Approximately 40 percent of Angolan crude production accrues either to the Angolan government, as concessionaire, or to Sonangol P&P, a Sonangol upstream subsidiary. Sonangol commercializes this entire volume to ensure that fair market prices are received for each cargo, thereby maximizing Angola’s revenue stream. Many of these cargos are sold on a long- term basis to dedicated off-takers who support Angola’s and Sonangol’s financial strategy. Other cargos are sold to end users that have a specific interest in one or more of the Angolan grades of crude oil.

Although Sonangol commercializes its cargos on behalf of the government and Sonangol P&P, the Angolan government, specifically the Ministry of Finance, determines the destination of the funds received from each and every cargo sale. The destination of funds is planned several months in advance in accordance with the national budget to ensure that all of Angola’s financing and payment commitments are met, and that there is no risk of triggering a default event.

I would like to give you an example of the types of projects that the Angolan government can champion as a result of the additional revenue that will result from the forthcoming crude oil production increase. The Angolan government is encouraging Sonangol to develop LNG production facility in Angola to take advantage of reliable sweet crude and cost-competitive supplies for offshore Angolan LNG. The partners for this project are Sonangol, ChevronTexaco, ExxonMobil, TFE, BP, and Norsk Hydro. The government is also encouraging Sonangol to develop a 200,000 barrels per day refinery in Lobito specifically designed to increase the value received for Angola’s particular mix of crude oils.

Thank you for your attention. Now I would like to introduce our Ambassador Ms. Josephina Pitra Diakite. She is going to continue to give you an update on Angola.
Petroleum Revenue Management—Government Perspective

Josefina Pitra Diakite, Ambassador of the Republic of Angola to the US

When we are discussing Angola, its oil revenue and its oil sector, I think it is essential that we take into account some specificity of the Angolan economy. The discussion so far has related to countries experiencing a normal life. Angola is a post-conflict country, a country that has emerged from 26 years of civil war, which had its roots from the Cold War era. To understand Angola, we need to understand the country’s situation.

Angola is turning from a war economy to a postwar economy. It is important to stress that Angola is really committed to facing the challenge of developing a market economy. Although we have been working with the IMF, we have not yet reached an agreement. The monetary agreement that was supposed to give Angola the good housekeeping seal of approval has not been finalized. But what is important is that the government is still committed and is still implementing all the measures that were identified in our dialogue with the IMF. Angola is expecting another IMF mission. The mission will probably be accompanied by KPMG, which has worked with the government in conducting a diagnostic of the oil sector. The Angolan government is presently analyzing the first report produced by KPMG. I also wish to emphasize the importance of trust in developing relationships among partners. And trust is something, I realize, often missing in our partners from the international community. The government may not always be as well informed as may be desirable. As a consequence, its input is often not given due consideration. Our partners may wish to receive a second opinion from independent institutions, like KPMG, but the information provided directly by the government should be given due consideration.

I believe it was Peter Macnab who mentioned that in Angola we have a lack of capacity. That should not come as a surprise. Angola has been facing many transitions. Soon after independence, Angola passed from the capitalist system of the colonial time to a central planning socialist system. More recently, Angola moved from central economic planning to a market economy. We also had a political transition from a monolithic system to democracy and a transition from war to peace. As you can see, we have faced a lot of transitions in Angola. When we are addressing the issue of development in emerging countries, it is important to take into account their history. With this thought, I would like to conclude my remarks today.

Petroleum Revenue Management and Industry Perspective

Willy H. Olsen, Senior Adviser to the President of Statoil

Introduction

I have been asked to address revenue management from an industry perspective. Let me start with a warning. I have spent more than 20 years in leading positions in
the development of the Norwegian national oil company, Statoil. My views will naturally be
influenced by my background and experience.

Statoil was established in 1972 shortly after oil was discovered offshore
Norway. Our role was clearly defined. The government’s ambition was for Statoil to be
instrumental in the development of a strong and competitive domestic oil and gas industry in
Norway. Statoil was created at the time of the first United Nations Conference on the
Environment in Stockholm in 1972, and it developed in a country with strong environmental
awareness and very strict environmental regulations.

Statoil’s responsibilities have changed over the last 30 years. Its initial role is
long gone. Statoil has expanded internationally both upstream and downstream and is operating
in 25 countries. Last year, the government decided to float part of the company—not because
the country needed the money, but to give Statoil added flexibility and to strengthen the
company’s ability to compete internationally. However, the government maintains a strong
shareholding position and currently holds 82 percent of the shares. Statoil was listed on New

Statoil defines corporate social responsibility rather broadly:

?? It is about sound business practices.
?? It is about how we earn our profits.
?? It is about solid performance along three bottom lines.
?? It is about our impact on people, the environment, and society.
?? It is about conducting business in a manner that maximizes benefit and minimizes
cost.

Statoil subscribes to these principles because it is both the right thing to do, and
the smart thing to do. It is right in a moral sense, and smart from a business perspective. It is
neither misguided virtue, nor an impediment to business performance. It is a means to achieve
robust profitability, which implies striking a balance between short term earnings and long term
growth.

The Norwegian Objective – Also Increasingly a Global Requirement

When oil was discovered in the late 1960s, the Norwegian government had
clear ambitions. There was a profound belief that the resources discovered offshore Norway
belonged to the nation, and the development of the offshore resources should have benefited the
society as a whole. The goals and strategies were set out in 10 “oil commandments” by
Parliament. They sought national involvement throughout the value chain and focused on
protecting the environment.

The objectives were clear. Norway should develop a competent and advanced
domestic industry to participate in the offshore projects and gradually be able to compete in the
global market place. High focus was given to technology and competence. The universities and educational institutions adapted rapidly to the new industry and its requirements.

Another key feature was sound resource management. A petroleum directorate was established to ensure that all development plans for new fields benefited the society as well as the companies. A no flaring policy was one of the principles in the “oil commandments” and was implemented at once as a basic element of the resource management strategy. Natural gas was too valuable to be vented or flared offshore. Natural gas should be utilized.

As oil and gas production grew throughout the 1980s, the government became increasingly concerned about oil revenue management. Already in the early 1980s a commission had recommended the establishment of a petroleum fund, both as a stabilizing fund and as a saving fund. In the early 1990s, the surplus from the oil and gas sector enabled the government to establish such a fund.

The “Norwegian model” is now frequently looked at by other international oil and gas producers around the world. Can they replicate the Norwegian experience of developing a strong, competent, and competitive domestic industry? Can they afford to take a long-term outlook on resource management? And finally, can they ensure that the oil activities benefit the whole society through a transparent and active management of the hydrocarbon revenue?

In the Caspian, in the Middle East, in West Africa, and in Latin America, the focus is more and more on local content, local competence and resource and revenue management.

I increasingly hear officials making the right statements, but is this a reality or just rhetoric? The jury is still out.

Revenue Management the Norwegian Way

The oil and gas industry has become the most value creating industry in Norway. In 2001 some 23 percent of Norway’s GDP was from the oil and gas sector. The oil and gas revenue represented some 35 percent of total government revenue, and the oil and gas industry’s share of total exports was 44 percent.

Norway decided to establish a petroleum fund in 1990. In a working paper produced by the IMF in 2000\(^2\) the Norwegian fund was considered a successful institutional arrangement:

“Norway, (one of the world’s richest economies and its second largest oil exporter,) has been a model of prudent economic management of resource wealth in recent years. The policy of investing

abroad a substantial part of the government’s oil and gas export revenue through the government petroleum fund has helped insulate the mainland (non-oil) economy from fluctuations in oil revenue. Coupled with an income policy framework, this strategy has been generally successful in managing the economic cycle and helped raise the living standards markedly over the past quarter century.”

One might argue that Norway is better suited than most other nations to deal with an abundance of resource wealth. Norway is a stable democracy with long-standing traditions of transparency, unrestricted media attention and accountable political leadership. A democracy like Norway can limit the risk of exploitation of resource wealth for personal benefits by an authoritarian public management and the nomenclature.

However, a democracy is no guarantee against bad decisions. Norway has an opportunity to turn petroleum wealth into a long-term advantage. A positive outcome is, however, dependent on the country’s ability to learn from the mistakes of other resource abundant nations. A cautious phasing of oil revenue into the Norwegian economy counteracts instability related to oil prices. Norway has so far been able to avoid the resource curse by applying a cautious and long-term approach to spending the oil revenue.

The rapidly growing oil wealth is, however, posing challenges—and the key issues in today’s political debate relate to the use of the rapidly growing revenue. Why can more oil and gas revenue not be used to improve the health and education sectors? Why can more not be spent on strengthening the local economies? Why can more of the revenue not be invested as venture capital in the country? Why do we have to invest this revenue outside Norway?

Large revenues from the sale of oil and gas make the Norwegian state one of the richest in the world. Almost regardless of what happens, this revenue will remain very large and continue to increase Norway’s collective wealth. The problem today is that the Norwegian population has limited conception of the size of the oil wealth, feels no ownership, and has difficulty understanding what politicians say about its use.

The ambition should be to be one of the first petroleum producing nations with sufficient spine to handle the wealth from the natural resources without suffering from it, and with the strength and ability to utilize the possibilities offered by the oil wealth. But the question remains: will Norway be able to handle its oil wealth as successfully in the future as it has in the past decade?

A New Global Agenda for the Industry

The world has changed in the past decade, and so has the oil industry. The industry agenda is different. The days are gone when an oil company could simply state that its job was to find, produce and refine oil to meet an increasing demand for oil products. The oil
industry is now questioned on its track record on the environment, human rights and socioeconomic development.

This new, expanded agenda requires a different understanding of the predicament of petroleum rich states, the developing countries that are critically dependent on oil and gas for their future prospects. They are often not just resource rich countries, but also countries caught in a development phase replete with social tensions, economic challenges and political contradictions.

How can oil and gas projects contribute to sustainable development and poverty reduction? It is a question we have to address, and it has become familiar to Statoil as we expand our activities beyond the Norwegian Continental Shelf. It reflects a growing concern among our stakeholders about the impact of our activities on people, the environment and the society. It affects the general acceptability of oil as a commodity and as a business. It represents new risks for the petroleum industry, risks that could jeopardize our future license to operate unless properly managed.

Acceptance rests on a general sense that a company or a project promotes growth and development. But the stakeholders are many and varied, and perceptions differ as to what constitutes the common good. Employees, customers, investors, business partners, local communities, governments, nongovernmental organizations, multilateral institutions, and the public at large have diverse, sometimes even contradictory, interests and concerns. Securing a license to operate implies being able to manage different demands, expectations and constraints locally, nationally and globally all at the same time.

Some stakeholders find international oil companies “guilty by association” when the presence of major oil and gas deposits in developing countries seems linked to negative phenomena like corruption, human rights abuses, environmental degradation, and continued widespread poverty.

And given that the legitimacy of the oil and gas industry is being questioned, we need to demonstrate in a tangible way that we are, indeed, a force for good, in the sense that those directly affected by our investments are better off because of our presence as well our practices. Creating value and conveying values—setting an example of responsible business conduct—go together, much as financial, environmental and social performance are inextricably linked.

Statoil has always viewed itself as a source of human progress. We provide some of the energy that the world needs and without which there would be no development. Our primary contribution to the communities in which we operate is measured in terms of value creation. This is the impact of our investments on employment, tax revenue, transfer of skills and technology, procurement of goods and services, and social infrastructure. Increasingly, however, we find that our economic contribution is ignored, belittled or discounted. In the public
arena, our arguments about positive spinoffs and multiplier effects are largely overshadowed by concerns about the environmental and social impacts of our activities.

The key to successful implementation of corporate social responsibility is good governance, with transparency, clear accountabilities, proper and effective controls, checks and balances, and sound risk analysis and risk management. This is, of course, also the recipe for business success in general, which is why a growing number of ethical and socially responsible investors look at corporate social responsibility as simply a proxy for good management.

Success also hinges on our ability to listen to those who affect and/or are affected by our activities, to understand what is happening in society, and to argue our case with anyone at any time.

This marks a radical departure from the recent past, when corporations and NGOs largely refused to listen to each other. It is hopefully a step toward establishing a culture and practice of pragmatic solution finding through cooperation.

*The Role of National Oil Companies*

To understand the challenges and new issues facing the oil industry, it is also important to understand the changing relationship between national oil companies (NOCs) and the international oil companies (IOCs). Many of the national oil companies were created as a defense against the international oil companies, and as a perceived way of maximizing oil resources. But the mission of the national oil companies has been altered. National oil companies are increasingly expected to perform according to the demands of international competition while at the same time carrying out its national role.

The international oil companies have to look for a new partnership with national oil companies to access new oil and gas reserves and to grow. Close to 90 percent of the world’s oil and gas reserves belong to governments, including partially privatized national oil companies. Any investment in the oil sector has to involve close interaction with an NOC or a government agency.

And in addition, virtually every aboveground issue facing the industry has changed during my time in the industry. Many new players that have emerged in today’s competitive arena, either through privatization or industry consolidation, did not exist 15 years ago, while other important players have disappeared. Of the “seven sisters” that dominated the sector in the 1960s, only four remain. The oil and gas industry has far more opportunity globally today than was the case 15 years ago. Almost no country is closed for foreign investors, even in the upstream sector. Both international oil companies and producing countries face new priorities and challenges. The oil companies are primarily driven by the demands of capital markets and the investment community, while the producing countries are driven by socio-economic and political demands.
National oil companies are the focal point for accomplishing a broad range of national economic, social and political objectives. The national oil companies are often the largest local enterprises by a wide margin, and they enjoy a near monopoly on local technical and commercial talent.

Weak governance, lack of transparency and accountability have, however, undermined the performance of many national oil companies. Where the government is the only shareholder, the national oil companies are subject to little pressure to be transparent in their operations. Few national oil companies publish accounts that are either consistent with International Accounting Standards or are independently or externally audited. Their boards of directors frequently are politically appointed without independence, and many national oil companies rely on annual allocations from state budgets to finance ongoing operations or new investments.

Many oil and gas producing nations are currently reassessing the way they operate their oil and gas sectors. The lessons learned over the last decades are that the most efficient oil and gas producers are benefiting from a separation of roles and responsibilities between ministries, regulatory bodies and the commercial operations of a national oil company. The governments, which own the underground resources, have to set broad national priorities in developing the hydrocarbon resources, formulate hydrocarbon laws and policies, and create the necessary regulatory bodies and the regulatory environment. The national oil company must turn underground resources into commercial assets and add value to the resources.

Norway is a perfect example of such separation of functions, which led Statoil to evolve into an independent and competitive operating company and prepare for eventual privatization. But in most developing countries there is still considerable overlap between the functions of the petroleum ministry and that of the national oil company.

The Norwegian experience is based on the establishment of a 100 percent government-owned national oil company under the same rules that are applicable to private shareholding companies and with transparent accounts. The articles of association described the responsibilities of the nonexecutive and professional board of directors in Statoil. An annual investment plan was presented to Parliament, but the national oil company was not financed from the state budget. The company’s focus was on developing a profitable, commercially operated oil and gas company.

In the mid-1990s, the government used international banks to assess the value of the company and the company’s performance. The national oil company benchmarked its own operations against other operators in annual surveys made by independent consultants. When Parliament in 2001 decided to list Statoil on the stock exchange in New York and Oslo, the company did not have to go through a major restructuring process. Statoil’s financial performance, payments to the government, to members of the board and to the executive management are publicly available.
The pressure from civil society on the international oil companies for more financial transparency of the resource revenue streams is growing. The pressure on the national oil companies for more accountability will also grow, both from their own governments and from civil society.

**Will the Population See the Benefits of Oil? The Case of Azerbaijan**

In the last decade we have seen increased attention from academics and civil society on the glaring contradictions in most oil rich countries between natural abundance and economic and social misery. How can it be that oil is not a blessing, but rather becomes a curse?

Two years ago, Statoil asked Norwegian research institutions to analyze two countries, Angola and Azerbaijan, and look at the challenges facing them and the oil industry. Our involvement in the two countries was growing fast, and we were facing major investment decisions in both countries. To better understand the future of the two countries, we asked the researchers to address the following question: will the oil revenue trickle away, or trickle down?

Angola’s starting point was in many ways worse than that of Azerbaijan, because of a malign civil war and a conspicuously low literacy level, but I will use Azerbaijan as my case since I have worked on Caspian issues for more than 10 years.

A few years ago journalists visiting Baku brought back articles that reflected the optimism in the region. They wrote of expectations in Azerbaijan of a “wall of money” coming their way. One could read in American newspapers that "the region’s wealth will shower unimaginable wealth on people whose annual per capita gross domestic product today hovers between US$400–600, building a new El Dorado in nations where camels still outnumber automobiles in 1998.”

A Central Asia specialist at the Carnegie Endowment for International Peace, Martha Brill Olcott, probably understood more of the realities when she wrote that “the most grandiose oil and gas projects are still in their early stages, with their viability and pace of development uncertain. The reality of post-communist development has instead been an increase in corruption, and sharp drop in living standards once protected by a comprehensive welfare net.”

The experience of the 1990s has shown that the transition is a complex, demanding and lengthy process and that the new nations were poorly equipped to take

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3 “Petro-States—Predatory or Developmental.” *Econ and FNI*. October 2000.
advantage of the new opportunities. Azerbaijan has experienced a little more than 10 years of independence since the demise of the Soviet Union. It is therefore far too early to speak authoritatively of the long-term influence that hydrocarbon-derived revenue will have on state and society.

In the West, to date, most of the interest in the Caspian region has been focused on issues such as the geopolitical situation, pipeline routes and the oil and gas potential. The many conflicts in the Caucasus, especially in Karabakh, have also attracted international attention. However, the huge economic and social problems in the region are rarely mentioned. In Azerbaijan, the situation is all the more desperate since, in addition to a host of social and economic problems, it also has to cope with the many refugees and internally displaced people whose lives were shattered by regional conflicts.

Growth in the oil sector has contributed to strong growth in the GDP since 1995 but has not led to a reduction in income inequality. Moreover, more than half of the one million internally displaced persons do not have jobs and live on pitifully small government allowances. The socioeconomic challenges in Azerbaijan will undoubtedly gain importance. Social tension will rise further if the government fails to convert oil revenue into economic growth throughout the republic. Despite strong economic growth, poverty and inequality remain major concerns. There has been an increase in the unemployment rate, while health and education indicators show worrying downward trends. Poverty and inequality influence the rate and quality of economic growth.

In December 1999 President Aliyev issued a decree to establish an Azerbaijan oil fund to accumulate oil and gas revenues and manage the revenues efficiently. The main reason for the establishment of the oil fund was that the government had set itself a vast agenda of social and economic reforms. It also wanted to counteract macroeconomic distortions and excessive spending in an oil booming economy.

Setting up a fund is no guarantee that the resources will not be misused. It is a tool for making the use of oil revenue transparent. It is not, however, a substitute for sound fiscal management. Ultimately, the success of the Oil Fund will depend on the political will to manage the oil revenue wisely. The message from the Azeri Oil Fund management is that it will make every effort to be transparent, undergo regular audits, and publish regular reports and auditing findings.

For the first time in its history, Azerbaijan has indigenous control of its natural riches and the revenue linked to the development of the energy sector. International financial institutions, likewise the Azeri government, are fully aware of the historic evidence from other petrostates and the need to avoid a similar fate. But questions are still asked. A generation from now, will the resource-rich Caspian states look more like Norway, or more like Nigeria? Will the energy revenue bring a better life to the citizens of Azerbaijan? Will the revenue be spent wisely on such measures as improving infrastructure, health, education and agriculture, and creating new job opportunities? Will they be used to consolidate political and economic
independence? Will the oil wealth be wasted through corruption, frittered away on the construction of mega-projects for public show, on heavy subsidies for consumer goods and services, on programs to keep the incumbents in power, even on an arms race? Or will Azerbaijan follow other petrostates that did not have the state institutions capable of handling the large petroleum revenue? Again, the jury is still out.

**A Transparent Oil and Gas Industry**

The international oil and gas industry position on transparency is clear. The International Association of Oil and Gas Producers (OGP) has strongly emphasized that the industry is in favor of transparency and opposes corruption in any form.

“*The industry is committed to honest, legal and ethical behaviour in all its activities, wherever the industry operates,*” to quote a position document developed by OGP in 2002.⁶

The oil and gas industry also supports the principle of financial transparency of resource revenue streams. The industry organization is committed to working with multilateral institutions, regulatory bodies and other appropriate parties in their efforts to reduce corruption and maximize transparency.

The industry acknowledges that revenue generated by resource development can—if not properly managed—create distorted economic and social impacts. Good governance is crucial, and the industry supports the World Bank’s efforts to promote sound financial, legal, judicial, social, and physical management capacity, and infrastructures to deliver long-term economic development. The industry emphasizes that the discussion about transparency needs to involve a variety of stakeholders, including the oil and gas industry, governments, regulatory agencies, multilateral organizations, financial and lending institutions, and nongovernmental organizations.

In addressing transparency issues, we have to take into account the sovereign right of host governments to limit—or prohibit—disclosure of financial information. The industry can enter into a dialogue with governments to argue for a change, but companies will have to comply with the restrictions imposed by governments. A consistent approach to disclosure is necessary to avoid a situation in which some—but not all—companies suffer an unfair competitive disadvantage. The industry also emphasizes a need for a clear and consistent approach to the nature, and level of aggregation of the payments to be disclosed.

In recent years NGOs have focused on Angola regarding oil companies’ transparency in payment to the government. Statoil's response has been to point out that we apply the same standards of openness in Angola as we do everywhere else. The accounts

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⁶ OGP position paper developed before the World Bank workshop October 2002. OGP represents a variety of international oil companies worldwide.
covering our revenue and expenses in Angola are already in the public domain, lodged with the Norwegian Register of Company Accounts at Brønnøysund and available on enquiry.

Under Norwegian company law, Statoil is obliged to file details of all tax and signature bonus payments in each of our subsidiaries to the official Norwegian public registry. All documents are a matter of public record. Statoil’s payments to the Angolan government through our Angolan subsidiaries can therefore be found in the public records, and it is as easy to find data about payments to the Angolan governments as it is concerning payments to the government of Norway. Statoil is also supporting initiatives that can contribute to the establishment of a common international practice to avoid a situation where individual companies will suffer because of their approach to disclosure. We have, however, denied a request by Global Witness that we translate our Angolan accounts into Portuguese and distribute them in Luanda. We feel that it would be both wrong and counterproductive to sign on to a political campaign: wrong insofar as it falls outside what we would define as the scope of legitimate action by a commercial entity, and counterproductive because it could put our access or formal license to operate in jeopardy.

The management and spending of the oil and gas revenue flowing to the government is fundamentally a sovereign responsibility. Ultimately the ability of the oil companies to influence directly the spending plans of governments is limited. However, there are opportunities to influence indirectly the process through provision of information, economic and financial expertise, and advice.

*Delivering Projects of the Highest Standard*

Currently Statoil is involved as a partner in some of the largest oil and gas projects in the world, with BP as the operator. The projects involve oil and gas production in the Caspian Sea, and pipelines running through Azerbaijan, Georgia, and Turkey with total capital spent of around US$20 billion. The projects are the largest single foreign investment in Azerbaijan, Georgia, and Turkey. The operator’s and the partners’ ambitions are to deliver the projects according to the highest ethical and environmental standards, to ensure that the projects contribute to transparency and the struggle against corruption. The companies have a further role to play in that they must continue to be transparent in their relationships with the governments. The disclosure of the content of production sharing agreements with the host government on a website is a key part of this process. Further, revenue flows to the government will be reported on a regular basis.7

In 2002, BP initiated a regional review of the impact of the projects. *Economic, Social and Environmental Review of the Azeri-Chirag-Gunashli (ACG), Baku-Tbilisi-Ceyhan (BTC) and Shah Deniz Projects in the National and Regional Context* is referred to as the “regional review.” The report will set out to address a number of issues that are of

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7 [www.caspiandevelopmentandexport.com](http://www.caspiandevelopmentandexport.com)
interest to international financing institutions and local and international nongovernmental organizations (NGOs). It provides useful information on the projects and sets out the opportunities and benefits that the projects provide within a national and regional context. It also addresses issues of external interest and how the projects are managing these issues where they can. These issues include: oil and gas revenue, employment and procurement, social investment, domestic energy, ethical performance, human rights, conflict, biodiversity, oil spill response, and greenhouse gas emissions. It includes a forecast of revenue going to the governments.

The report was requested by EBRD and IFC in their capacity as potential lenders and, thus, together with the project specific environment and social impact assessments, supports ACG Phase 1 financing. It is also a key element to delivering the projects’ environmental and social strategies and protection of reputation. The regional review will be formatted professionally and made available on a publicly available website.

The projects are already, and will continue to be, major consumers of a wide range of goods and services. This expenditure will have an additional positive multiplier effect on the local economies.

The challenge for the oil companies is to ensure that these employment and procurement opportunities are optimized in a way that will contribute toward greater economic development within the region while at the same time managing unrealistically high expectations that are held by some people.

During construction, local employment targets will be set and overseen by the sponsor companies. Information centers and training programs have already been established for the ACG project and will be established for the other projects to give the people living in the local communities a better chance to get these jobs. Following construction, the projects’ operation phases will require people with a range of technical and business skills. One of the keys to maximizing local labor is to have a long-term view of future operations requirements and to implement a comprehensive training program starting as early as possible to ensure that when required, staff members with the right qualifications are available. A national technical training school is being set up in Baku.

The companies are committed to implementing the projects to the highest standards of business ethics. The business policies on health, safety, and the environment, ethical conduct, employees, relationships, and finance and control will continue to be integral to the way the project is conducted; this includes the prohibition on bribery, facilitation payments and corruption. Auditing by a number of internal and external groups will help ensure compliance and transfer of best practices. A 24-hour hotline has been set up so that any known or suspected breach can be reported confidentially and anonymously. Reported breaches will be investigated with integrity while respecting the law and individual human rights.

The companies have adopted the Voluntary Principles on Security and Human Rights by embedding these principles into the projects’ security management system. The
projects are playing a role in raising these principles with the governments. Governments, NGOs, and other experts already have and will continue to be consulted to ensure that potential issues are identified and risks are addressed; this is supplemented with a robust community relations program. BP has established an independent external commission as part of its intent to ensure that the Baku-Tbilisi-Ceyhan pipeline project sets new standards in responsible development. The commission, which has a three-year remit and will begin its work in early 2003, will provide objective advice to the company on the economic, social and environmental impact on Azerbaijan, Turkey, and Georgia generally, and on areas closest to the 1,760-kilometer pipeline in particular.\(^8\)

In 2000, a poll conducted in Azerbaijan on behalf of Statoil showed that 70 percent of the political leaders believed that investments by foreign oil companies would be beneficial and contribute to the development of the country. Among local non-governmental organisations, 73 percent of respondents were of the same opinion. They were not only enthusiastic about the prospects for economic growth, but saw the oil companies as important partners in the development of civil society. The expectations are still high.

**Taking on New Responsibilities**

Social or community investments are only a tiny part of the overall contribution of corporations to the societies in which they operate. By extension, corporate giving—whether disinterested or self interested—is only a tiny part of their involvement. Yet many people still tend to equate corporate social responsibility with a particular charitable contribution or a special community project. Statoil, for example, is commonly associated with a human rights capacity building project in Venezuela, a community development project in the Niger Delta, and support for the strengthening of democratic institutions in Azerbaijan.\(^9\)

What do these projects say about Statoil’s approach to community investments? We have moved beyond charity and aim to contribute to sustainable development. We seek to help build local capacity in the fields of education, human rights and self government. We prefer a model with trisector partnership. Statoil will work with and through local authorities and nongovernmental organizations to support activities that they have initiated on the basis of detailed knowledge of local needs. We do not envision establishing a foundation and running these projects ourselves. We do not look askance at projects if they also happen to build our reputation, enhance the morale of our employees, and promote our brand.

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\(^8\) BP commission established December 2002, chaired by Jan Leschly.

The experience with trisector partnerships in the field and stakeholder engagement through the UN Global Compact has spurred increased cooperation between Statoil and a select few Norwegian NGOs and international humanitarian and development organizations. Our civil society partners are all true champions of good causes. And there is no denying that we want to be seen as a supporter of these organizations and causes, in part because such an association can strengthen our reputation for social responsibility.

However, we also want to improve our risk management by tapping into the wealth of knowledge that these organizations possess. Through these partnerships we can gain access to information that may improve our understanding of a complex situation in a faraway land burdened by instability and conflict. We will also be able to draw on the rich experience of our partners when preparing Statoil personnel for assignments in locations that require special sensitivity to the challenges of health, safety and security, human rights, and bribery and corruption. In other words, our partners can help make us better corporate citizens and business people.

**Conclusions**

The keys to successful implementation—good corporate governance, risk management, and human resource management—are, of course, no different from the keys to business success in general. Success also hinges on our capability to listen to those who affect and/or are affected by our activities, to understand what is happening in society, and to argue our case with anyone at any time.

We have to begin with ourselves, and the way we treat our employees. If we cannot correctly manage our most precious assets, then we will be shirking our responsibility to both shareholders and society at large. Adherence to core ILO labor standards, as well as investments in the health, safety, education, and training of our own employees, lie at the heart of our corporate culture.

Freedom of association is not guaranteed in all the countries where Statoil is present. Neither is the right to collective bargaining. But all our employees have a voice in the workplace, be it through councils, committees, or general assemblies. We believe this helps instill a sense of trust and belonging throughout the organization. Three employee representatives also serve on the company’s nonexecutive board of directors. The workforce elects representatives among themselves.

With regard to health, safety, and environment (HSE) in the oil industry, the gap between global and local standards is closing. The leading international oil companies now apply the same standards wherever they do business. The cornerstone of Statoil’s HSE culture is the zero mindset with its objectives of zero harm to people and the environment, and zero accidents or losses.

Given the big money associated with the oil industry and the weak political/institutional basis of some of the countries in which we operate, international oil
companies must pay special attention to the risks of bribery and corruption. Three elements are key in the prevention of corruption in our activities and operations. We have a policy of zero tolerance, clearly communicated in both words and deeds by top management. We strengthen awareness and understanding through training programs and support mechanisms such as ethical audits. And we operate with strict financial and procurement controls.

Statoil finds the dialogue with the civil society useful, but it requires a certain level of mutual respect and trust. The parties involved must be ready to talk both to and with each other. They must be willing to listen and engage in debate. Only then can a stakeholder dialogue serve the purpose of revealing complexities in all directions. My feeling is that both the industry and civil society organizations are more ready for that kind of a relationship today than they were a decade or two ago. In Norway, Statoil has established a special environmental forum for engagement with the leading NGOs, and we are currently also building dialogue forums internationally.

But we also have to participate in the public debate and facilitate exchanges of ideas and lessons learned. An ongoing public debate around the use of the petroleum revenue is essential if petroleum revenue management is to succeed. Willingness to seek advice and learn from experience gained in other countries is important.

Oil companies can never assume the responsibility of political institutions or become substitutes for such institutions. But the industry can take part in the dialogue and can, also, apply its values and standards wherever it operates.

A successful development of oil and gas alone, however, is not enough to ensure the harmonious development of the country’s economy. In the early years of the oil era in Norway, Prime Minister Trygve Bratteli told Parliament: “We cannot live only on the oil revenue.”

But we also have to participate in the public debate and facilitate exchanges of ideas and lessons learned. An ongoing public debate around the use of the petroleum revenue is essential if petroleum revenue management is to succeed. Willingness to seek advice and learn from experience gained in other countries is important.

Oil companies can never assume the responsibility of political institutions or become substitutes for such institutions. But the industry can take part in the dialogue and can, also, apply its values and standards wherever it operates.

A successful development of oil and gas alone, however, is not enough to ensure the harmonious development of the country’s economy. In the early years of the oil era in Norway, Prime Minister Trygve Bratteli told Parliament: “We cannot live only on the oil revenue.” He gave a very sound advice to Norway then. It is still a very sound advice for Norway today. Maybe for other petrostates also?

**Civil Society: A Nongovernmental Organization Perspective**

*Arvind Ganesan, Director Business and Human Rights, Human Rights Watch*

Thank you very much for allowing me the opportunity to speak today on the important subject of petroleum revenue management. Before I begin, I’d like to give a brief introduction to Human Rights Watch generally and the Business and Human Rights Program in particular.

Human Rights Watch is currently the largest U.S.-based human rights nongovernmental organization. We currently conduct regular, systematic investigations of human

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rights abuses in some seventy countries around the world. We address the human rights practices of governments of all political stripes, of all geopolitical alignments, and of all ethnic and religious persuasions. Human Rights Watch defends freedom of thought and expression, due process, and equal protection of the law, and a vigorous civil society; we document and denounce murders, disappearances, torture, arbitrary imprisonment, discrimination, and other abuses of internationally recognized human rights. Our goal is to hold governments accountable if they transgress the rights of their people as well as to hold private actors accountable, such as insurgent groups, paramilitary organizations, corporations, illicit arms dealers, or other institutions. However, our role is not solely to condemn institutions, but also work with, and encourage, them to enhance respect for human rights.

The organization began in 1978 with the founding of its Europe and Central Asia division (then known as Helsinki Watch). Today, it also includes divisions covering Africa, the Americas, Asia, and the Middle East/North Africa. In addition, it includes three thematic divisions on arms, children's rights, and women's rights. We also have special programs on academic freedom, HIV/AIDS, and human rights, the United States, and the business and human rights programs. We maintain offices in New York, Washington, Los Angeles, London, Brussels, Moscow, Tbilisi, and Tashkent. Human Rights Watch is an independent, nongovernmental organization, supported by contributions from private individuals and foundations worldwide. It accepts no government funds, directly or indirectly.

Perhaps one of the most pressing issues in the area of business and human rights is that of revenue management. While many people speaking at and attending this seminar are far more expert on the fiscal and economic pitfalls of resource rich states and far more qualified to comment on that complex subject, I would like to talk about the human rights implications of revenue management and also discuss some of the possible steps that could lead to better human rights conditions.

The starting point for such a discussion is to understand the linkage between economic control and political accountability. In many cases, petroleum revenue creates the “enclave economy” where the government is the direct recipient of this economic activity and is not reliant on domestic taxation or diversified economic activity to function. The same is true from a political standpoint. An already undemocratic government that is not politically accountable to its population is only strengthened when it also exercises economic control. Such a consolidation of economic and political control is a disincentive for democratization and can generate hostility to transparency and accountability.

In this respect, energy wealth does not necessarily lead to better standards of living, increased democratic participation in government, or a better climate for human rights. Instead, economic, social, and political conditions may stagnate or even deteriorate. Stagnant or diminished development in countries that enjoy ample oil or energy revenue is frequently associated with a government's inability or unwillingness to adequately manage energy revenue in order to use its increased wealth as a means to foster constructive economic, political, and
social development. In some cases, the prospect of improving the overall situation with an increase in revenue—such as those created by energy development—can actually reinforce bad practices of an already abusive government by strengthening it financially and by providing the wherewithal to entrench and enrich itself without any corresponding accountability. This is not to say that energy development inevitably leads to poor economic performance, corruption, and political repression, but that a revenue stream of this sort is a major risk factor in assessing whether things will improve or deteriorate within a country.

Unfortunately, this does not appear to be the case. By most accounts, many energy exporters have not fared well economically or politically. The exceptions often highlighted are Norway and the U.S. state of Alaska. Many other resource dependent governments are often corrupt, undemocratic, and unable or unwilling to invest in the country or their citizens' welfare. Rather than building roads, schools, and hospitals, or diversifying the economy, money is wasted or stolen, and democratic participation in government is impeded.

An example of this phenomenon is the world's largest oil exporter, Saudi Arabia. The country is ruled by a monarchy that maintains control in no small part due to its access to immense natural wealth. Saudi Arabia has an estimated 264.2 billion barrels of proven oil reserves and may have as much as 1 trillion recoverable barrels of oil.\(^1\) It is a stunning amount of oil and is relatively inexpensive to extract.\(^2\) Saudi Arabia has only started to diversify its economy away from oil and has yet to make any meaningful political reforms. Oil revenue accounts for approximately 80 percent of the government's income and about 55 percent of GDP. Government spending on the national airline, power, water, telephone, education, and health services, and other activities accounts for 24 percent of GDP alone. Only about 40 percent of the economy is considered private. The monarchy does not allow any opposition political parties, and severely restricts freedom of both assembly and expression. Nor does it skimp on executing prisoners, torture, curtailing due process rights, or engaging in barbaric forms of punishment such as amputations and beheadings.\(^3\) The regime's corruption and opacity has generated public disaffection and contributed to the rise of religious extremism.\(^4\)

This is not unique to the world's largest oil exporter, but plagues all of the members of the Organization for Petroleum Exporting Countries (OPEC). Seven OPEC

\(^{11}\) United States Department of Energy, Energy Information Administration, "Saudi Arabia: Country Analysis Brief, January 2002. Proven oil reserves are those that have been reliably recorded, whereas recoverable reserves are an estimate of the total amount of oil that could be commercially extracted.

\(^{12}\) United States Department of Energy, Energy Information Administration, "World Crude Oil and Natural Gas Reserves," January 1, 2000. By comparison, the country with the second largest volume of proven reserves, Iraq, led by the dictator, Saddam Hussein, has an estimated 112.5 billion barrels of oil.

\(^{13}\) For example see: United States Department of State, Country Reports on Human Rights Practices 2001: Saudi Arabia.

member-states—Algeria, Iran, Iraq, Kuwait, Libya, Qatar, and the United Arab Emirates—are undemocratic with poor human rights records and limited economic diversification, while Indonesia, Nigeria, and Venezuela are nominally democratic but plagued with widespread corruption and poor human rights records. Non-OPEC energy exporters such as Angola, Azerbaijan, and Kazakhstan are quickly becoming models of corruption, mismanagement, and human rights violations. Sudan has set new standards in abuses related to oil development, and Burma is infamous for abuses that occurred when it developed its natural gas reserves. In some cases, economic and political problems related to energy revenue have exacerbated civil conflicts, such as the one in Indonesia's gas-rich province of Aceh. A low level civil war has been going on there for years, motivated in part by local resentment that the province has not benefited from the massive amounts revenue that Indonesia has derived from the province's sizable natural gas reserves. Nigeria may be the poster child of everything that can go wrong with a resource dependent state.

Nigeria

In the 42 years since the country became independent, Nigeria has been ruled by military dictatorships for 28 years. Democracy under President Olusegun Obasanjo (a former general) is still very weak. The oil sector contributes approximately US$20 billion a year or around 46 percent of the country's GDP and 85 percent of its foreign exchange earnings. However, the 127 million people of Nigeria have yet to enjoy widespread benefits from the country's wealth. For example, per capita GDP has declined since independence. By comparison, per capita GDP was US$370 in 1985 and fell to about US$260 in 2001. About 66 percent of the population lives below the poverty line as compared with 43 percent in 1985. According to the World Bank, "Economic mismanagement, corruption, and excessive dependence on oil have been the main reasons for the poor economic performance and rising poverty." Moreover, the situation in the oil-producing areas of the Niger Delta has deteriorated to a level of anarchy. The government has routinely ignored concerns by local communities that are not benefiting from oil wealth and bear the brunt of the industry's environmental damage. In some cases, the government has done the exact opposite and arrested, harassed, or attacked people protesting the impact of the industry. The most well-known case was when the government killed the messenger by executing Ken Saro-Wiwa and eight other Ogoni leaders on November 10, 1995. Things have become so bad that oil workers are routinely abducted and oil installations occupied by local communities in exchange for money or employment from oil companies, and state forces launch brutal retaliatory attacks against communities that may or may not have been involved in those acts.

So why does this happen? On the political side it has to do with the fact that many energy producing governments are not democratic and do not make the pretense that they represent their populations' interests. Corruption is a tool to sustain power and not just a means of self-enrichment. Since a dictator or group of oligarchs have no real political legitimacy, their rule can be sustained only through a combination of force (arrests, intimidation, killings) and inducements (money) to cement their power. On one level, it is common sense: if a leader does not have a popular mandate, power must be maintained by force or by appealing to peoples' greed, or both. But it has the pernicious effect of diverting public resources away from development and undermines the rule of law because the state engages in illegal activities and government officials must ignore or obstruct transparency and accountability (including legal accountability) in order to benefit from the system. It is a perverse example of the carrot and stick approach to governing. Oil, or other commodities, make their job comparatively easier because there is a constant and large stream of revenue that accrues directly to the government that can be used to sustain patronage networks as well as fund the coercive mechanisms of the state.\textsuperscript{17}

Corruption and misuse of revenue lies at the heart of the problems in energy producing states. In Nigeria corruption has been massive. Transparency International, the organization dedicated to fighting corruption worldwide, ranked Nigeria as the second most corrupt country among the 91 countries surveyed in its 2001 Corruption Perceptions Index.\textsuperscript{18} It is difficult to estimate how much money has been squandered or stolen in Nigeria, but recent revelations provide some idea of the level of corruption among government officials. On April 17, 2002 the Swiss Government announced that the Nigerian government had reached a settlement to repatriate approximately US$1 billion in government funds that was held in European banks after it was stolen by the family members and associates of General Sani Abacha, the deceased military dictator who ruled the country with an iron fist from 1993 until his death in 1998. Nigerian authorities estimated that Abacha and his associates may have taken US$2.2 billion during his five years as dictator—an average of US$440 million a year and quite a "salary" for the head of a state ranked among the 20 poorest countries in the world. In exchange for this settlement, the Abacha family was allowed to keep about US$100 million that they obtained prior to his coup and did not "demonstrably derive from criminal acts."\textsuperscript{19} Sadly, the Abacha family recently called off the deal and it is currently in limbo. Even the US$100 million should be considered suspect since Abacha's sole occupation was as a military officer


from 1963 until he took power in 1993. It is improbable that the Nigerian military paid its officers an average of US$3.3 million a year, or that Abacha was a world-class investor while in the army or while he was deposing various Nigerian governments. (He participated in coups in 1983, 1985, and finally when he took power in 1993.)

A key link between the misuse of revenue and human rights is the link between mismanagement or corruption and the government’s response to third-party scrutiny, whether it is the press, political parties, civil society, or other governments. Two good examples of this are Angola and Kazakhstan.

Angola

Angola has received a considerable amount of attention over the last few years because of its poor record of governance, its oil wealth, its crushing poverty, and the hardships the population has had to endure because of its recently ended decades long civil war.

The country is the second largest oil producer in sub-Saharan Africa, behind Nigeria. Oil revenue has been and remains the Angolan government’s principal source of income. On February 23, 2001, for example, the Angolan government announced that oil revenue would account for 90.5 percent of the 2001 budget, or approximately US$3.18 billion. Oil production could grow considerably as newer offshore oil blocks come on line. With a population of approximately 13 million people, Angola has the natural wealth to become a model of development. Yet the country ranks 146th out of 162 countries in the United Nations Development Programme’s latest Human Development Index.

Moreover, the opaqueness of the Angolan government’s budget and expenditures has generated concern among multilateral financial institutions, nongovernmental organizations, corporations, and governments, as well as within Angola itself that this revenue is being grossly mismanaged.

Some of the problems include the use of public funds, derived from oil revenue, to secretly finance arms purchases and the mortgaging of future oil revenue in return for immediate oil-backed loans to the government. In some cases in the recent past, oil revenue bypassed the Ministry of Finance and the Angolan central bank and instead went through the state-owned oil company, Sonangol, or through the Presidency, and was used secretly to procure weapons. This has also sparked allegations of official corruption. Recent scandals involving arms for oil deals with French and Czech companies have only highlighted these problems.

20 Floyd Norris, a financial columnist for the New York Times, had an interesting analysis of the Abacha fortune and noted that Abacha would have had to invest US$10,000 a year for thirty years in investments that generated a 21 percent rate of return up to 2002 in order to achieve a legal US$100 million fortune. See: Floyd Norris, "A Nigerian Miracle," New York Times, April 21, 2002.
When groups or individuals try to gain further information about the state of the
government’s finances, they have been met with arrests or other forms of harassment. For
example, on January 24, 2001, police beat and arrested eight members of the opposition Party
for Democracy and Progress in Angola (PADPA) who were staging a peaceful hunger-strike
outside the Luanda residence of President dos Santos, calling for him to resign on grounds of
economic mismanagement and corruption. The protestors also called for disclosure of the
details of the French arms for oil deal and criticized the government’s discontinuation of peace
negotiations with UNITA. Following this incident, the state Radio National de Angola
broadcast an official statement warning people not to demonstrate against the government. Two
of the eight demonstrators were quickly released but six others were charged with holding an
“illegal protest,” although the charges were dismissed when they appeared in court on January

Such actions were not limited to local civil society, however. Recently the
parliament passed two pieces of legislation that could effectively limit disclosure of important
information related to the government’s finances. The draft National Security Act, State Secrets
Act, and the Access to Administrative Documents Act reportedly regulate the sharing of
“confidential” information with foreign organizations and other parties. Some analysts interpreted
this as a way to prevent uncomfortable revelations about government activities. When such
information was disclosed, the government vigorously protested. For example, when the press
reported that Swiss authorities had frozen some US$700 million because of alleged links to
questionable Russian-Angolan business deals that may have involved government officials, the
government withdrew its ambassador in Switzerland, threatened legal action against the
investigating magistrate, and expressed outrage because an independent judiciary was
conducting an investigation.

To help address these problems and to embark on a program of economic
reform generally, the International Monetary Fund (IMF), World Bank, and the Angolan
government announced the beginning of a Staff Monitored Program (SMP) on April 3, 2000.
The program was an ambitious agreement to implement a wide range of economic and
institutional reforms in Angola that could have led to further lending and cooperation with the
IMF and World Bank. The program included a provision to monitor oil revenue known as the
"Oil Diagnostic." Human Rights Watch believed that if the Oil Diagnostic were to be properly
implemented, it could have marked a limited but positive first step toward promoting
transparency, accountability and, ultimately, greater respect for human rights.

However, the government’s implementation of this program has been dismal. In
particular, there has been no meaningful public disclosure of data regarding oil revenue, either in
terms of the Oil Diagnostic reports or in terms of accounting for its overall use of oil revenue and
related expenditures. Things became so bad that in August 2001, the IMF announced that the
SMP program had been allowed to expire because so many of the objectives outlined in the
SMP were not met. No data on the results of the Oil Diagnostic studies or other information
were made publicly available by the government. The government and IMF agreed that
“publishing data on oil and other government revenue and expenditures, as well as on external debt” and audits of the central bank would be some of the preconditions for further cooperation with the IMF. It is our belief that the IMF appropriately insisted on these steps before considering further cooperation with the government.

Unfortunately, the government did not comply with these basic measures. Following its mission to Angola in February 2002, the IMF announced that there was little progress on reforms and that the economic situation had actually worsened from the end of 2001 into early 2002. The IMF reiterated the need for the government to “publish data on oil and other government revenue and expenditures, as well as on external debt; and conduct independent financial audits of the 2001 accounts of Sonangol and of the central bank.” Most recently, the BBC reported that approximately US$900 million could not be accounted for this year, reportedly according to IMF documents.

Within this context, we believe that public disclosure of data regarding the amount and use of oil revenue is critical for bringing improvements in the human rights situation. Specifically, the government of Angola should take the following steps:

- Make publicly available existing and future Oil Diagnostic reports.
- Provide a detailed breakdown of its expenditures on a regular basis, particularly those involving oil and oil-backed debt. This should include the specific amount and use of the estimated US$500 million bonus payment made by oil companies that were awarded deepwater block 34.
- Conduct and publish audits of the Central Bank and Sonangol.

These basic measures could have a very positive effect on governance in Angola and could help lay the foundations for further improvements in human rights. But it is unclear whether the government will take the necessary steps to move forward.

**Kazakhstan**

In Kazakhstan, another country with immense oil wealth, President Nazarbayev continued to consolidate economic and financial power while severely curtailing public inquiry into the alleged misuse of government oil revenue. Government harassment of the independent media was partially attributed to revelations in late 2001 and early 2002 that the government secretly held approximately US$1.4 billion in a Swiss bank account under President Nazarbayev’s control. After repeated denials, the government confirmed the existence of the account on April 4, 2002 when Prime Minister Imangaly Tasmagambetov said that the money was derived from several oil deals that took place in 1996; that some US$900 million of those funds were used to offset budget deficits during the Russian and Asian economic crises of 1997 and 1998; and that the balance was deposited into the National Fund for Future Generations (NFFG), an oil revenue savings fund, in 2001. However, Tasmagambetov did not respond to parliamentary questions about the existence of personal Swiss accounts in the name of
Nazarbayev and his relatives. The Economist Intelligence Unit (EIU) reported that “the sudden revelation that a secret fund had been set up essentially as an oil windfall account was therefore seen by opposition parties as an attempt to distract attention from capital flight on an even larger scale.” The EIU estimated that capital flight amounted to approximately US$1.4 billion per year between 1995 and 2000.

A Manhattan federal judge ruled on September 9 that the Kazakh government could not prevent a federal grand jury from reviewing some 300,000 pages of documents related to a corruption investigation involving James Giffen and members of the government of Kazakhstan. The government made a request to suppress the documents on the grounds of sovereign immunity. However, the judge denied the request and noted “[t]he Republic’s interest in protecting governmental confidentiality is strong… a foreign government that is alleged to be a recipient of bribes from an American corporation cannot be permitted to bring a grand jury investigation to a halt.” The investigation stemmed from information that the United States Department of Justice (DOJ) received from Swiss authorities in 2000 regarding the "alleged use of U.S. banks to funnel funds belonging to certain oil companies through Swiss bank accounts and shell companies in Switzerland and the British Virgin Islands for ultimate transfer to present and former high-ranking officials of Kazakhstan," in order to determine whether these transactions U.S. laws.

According to U.S. Department of Justice documents, transactions totaling US$114,822,577 from March 1997 to September 1998 were allegedly transferred from several international oil companies to Giffen, a close associate of Nazarbayev and financial advisor to the Kazakh government. Giffen subsequently transferred US$55,869,000 of these funds to accounts allegedly belonging to Akezhan Kazhegeldin, a former prime minister of Kazakhstan, Nurlan Balgimbaiev, another former prime minister and former president of the powerful state-owned KazakhOil company, and President Nursultan Nazarbayev, or their families. At this writing, Giffen, as a U.S. citizen and the conduit for these transfers, was the primary focus of the Manhattan federal grand jury investigation.21

It might seem speculative, but in 1999, the International Monetary Fund published a working paper that detailed the nature between various forms of corruption and the nature of the governments involved, particularly dictatorships. The paper noted that "a dictator minimizes the probability of a palace revolution by creating a system of patronage and loyalty through a corrupt bureaucracy." It detailed two distinct forms of corruption: "competitive corruption" which is found in governments with weak dictators, and "monopolistic corruption" or patronage corruption under strong ones.22 Moreover, the strategic nature of such commodities means that consuming countries will readily mute their criticism of heavy-handed tactics in order

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to ensure a secure supply of resources. Once such a system becomes entrenched, it is very difficult to change, even after a democratic transition.

However, problems with energy should not be dismissed as the actions of a few corrupt rulers. Rather, corruption is a manifestation of deeper structural problems within energy exporting states. A developing country that has natural resources may be overwhelmed by the task of putting the country's newfound wealth to productive use, and may not be inclined to seek other sources of revenue since this one is so large and comparatively easy to obtain. Since energy development is not dependent on domestic development but mostly on foreign investment and prices set by the world markets, the industry develops independently, with few linkages to the country as a whole. It also creates a powerful lobby of companies, bureaucrats, and others that derive their wealth and power from energy and its gatekeeper, the government. It is also an industry that does not generate massive amounts of employment because after the initial construction stage of projects, labor is reduced to highly skilled technical workers, oftentimes from abroad. In a sense, revenue from energy "breaks" the link between government and citizens because the government does not rely on its population for support. This is why the oil industry is sometimes called the "enclave economy." The government’s role becomes skewed as both the engine of economic activity within a country as well as the engine of politics and governance. Moral hazard permeates such a system since so much political and economic power is at stake and concentrated within the government.

**What Can Be Done?**

Clearly, the principal responsibility for ensuring good governance and respect for human rights lies with governments themselves. But when governments are unwilling or unable to do so independently, there is an important role that other institutions can play. In this case, civil society, multilateral institutions, the private sector, and other governments are critical.

**Private Sector**

Companies can be transparent when they deal with governments. They should disclose all payments to a government so that the public will have some of the necessary information to assess revenue that accrues to the public treasury. The recently launched “Publish What You Pay” campaign seeks regulatory measures that would require such disclosures, but in the meantime companies could undertake such measures voluntarily. Another step is to consistently work with multilateral institutions to help governments become more transparent while encouraging home governments to make transparency and accountability a cornerstone of bilateral relations. These are responsible steps companies can take to ensure that the potential benefits from resource wealth are realized.

**Multilateral Institutions**

Perhaps the most important role to be played is by multilateral institutions. They play a unique role since they work with both the private and public sectors. Since 1997, the
IMF has undertaken a considerable amount of research into the pitfalls of resource-rich economies and has adopted a strong stance in support of transparency throughout its dealings with several governments. Most notably, it insisted that the government of Angola publish accurate data regarding its oil revenue and government expenditures before any formal program with the Fund can be negotiated. To a lesser extent, it has called for such transparency in Gabon, the Republic of Congo (Congo-Brazzaville), and has informally indicated such measures would be part of any Staff Monitored Program with Equatorial Guinea. As at the World Bank, however, there does not appear to be an explicit and consistent approach to transparency in resource rich states. For example, similar requirements seem to be lacking in Central Asia and the South Caucasus. In every case, the IMF could assess governments’ compliance with the Code of Good Practices for Fiscal Transparency on a regular basis in order to determine progress.

Were the IMF to apply such a strategy consistently, it could be a starting point for a World Bank approach to these issues because it would explicitly tie broader reforms to good governance. At a minimum, such requirements could be accompanied with World Bank assistance to governments for auditing, and capacity building so that government agencies can manage resources, strong anticorruption efforts, creating transparent and effective “stabilization” or “future generations funds,” and legal and judicial reforms in order to strengthen institutions that could hold officials accountable for corruption and human rights violations and help to create a more stable legal environment for development. This approach requires explicit recognition of these problems and close coordination between the World Bank and IMF, but it should be part of any strategy in dealing with resource rich countries.

Independent of the IMF, the World Bank group has opportunities to address these issues independently. At the outset, Country Assistance Strategies (CAS) should make transparency, good governance, and responsible revenue management a consistent cornerstone of the country strategies. Since it is already well known which countries have natural resources and which countries have problems with governance, the CAS can be proactive. By placing an emphasis on these issues, even before projects are contemplated in the extractive sector, the probability of mitigating or correcting problems increases.

IFC, for example, should consider auditing a mandatory requirement when companies receive funding. In the case of U.S. companies or companies with a substantial U.S. presence, IFC should also assess compliance with the U.S. Foreign Corrupt Practices Act, a law that prohibits bribery of foreign government officials. A relatively new and somewhat controversial approach is to have companies declare all taxes, duties, royalties, and other payments made to host governments. This proposal should be implemented so that revenue is disclosed but structured in a manner that does not publicly reveal commercially sensitive information. Ideally, stringent auditing and disclosure by the government of its revenue and expenditures would detail these types of revenue, but corporate disclosure could only complement such an effort and would build public confidence that both companies and the IFC
were acting in a transparent and socially responsible manner. IFC’s support of this effort during the most recent annual meetings is a very positive first step.

Governments

As noted earlier, other governments should make this a cornerstone of their activities. Too often, more narrow political or strategic considerations outweigh the need to insist on greater accountability, transparency, and respect for human rights. But governments should insist that these measures be taken. As noted earlier, they should also implement measures to ensure that companies adequately disclose their payments to governments.

Civil Society

While broadly, civil society does not regulate, lend, or have other available tools, it can play an important role in scrutinizing, investigating, and reporting on those institutions, which can increase transparency. Without such scrutiny, it is less likely that governments will change. More important, civil society within countries can mobilize the population and educate it so that greater public control over finances may be possible. Many of the major disclosures about revenue misuse have been the result of the press or NGOs. This cannot be underestimated, as information is one of the best tools in solving this problem.

Conclusion

There is no one panacea for this complicated problem. However, the more institutions can recognize the nature of this problem and develop coordinated and comprehensive responses to it, the greater the odds of success. With such widespread recognition of the problems, now is the time to look at solutions.

Comments at the Open Discussion of Session 1: Revenue Collection

Michael Engelschalk, Senior Public Sector Policy Specialist, the World Bank Group

Effective and efficient petroleum revenue collection has two dimensions: a policy and an administrative dimension. As experience with tax reform in many developing and transition countries has shown, tax policy reform can be achieved in a much shorter timeframe. It also generally is easier to manage and requires fewer resources than reform of revenue administration. This is the reason why donor organizations tend to focus more on the design of a modern tax policy system than on its implementation, which requires the comprehensive reform of tax administration. Kazakhstan, one of the countries mentioned in this session’s presentations, is such an example: in 1995, Kazakhstan was the first CIS country to adopt a comprehensive tax code, which subsequently became a model code for other countries in the region. Seven years later, the country still is struggling with the task of establishing an efficient tax administration.
What applies to tax policy and tax administration in general is equally true in the special case of petroleum revenue collection: the design of the tax policy framework is only one element in the process of reforming petroleum revenue collection. Guaranteeing the fair and efficient application of the system through appropriate administrative arrangements appears to be the more difficult task in practice. Weak implementation capacity calls for simplicity in the design of the system. Simple structure of a petroleum tax system and use of generally established tax and commercial accounting concepts in the petroleum tax legislation are prerequisite conditions for the proper implementation of the system.

The problem of weak administrative capacity to implement tax legislation can influence the design and subsequent modification of tax policy in various ways. Transfer pricing is a good example here. The presentation on *Transfer Pricing in the Oil Industry* mentions that Kazakhstan has designed one of the most aggressive transfer pricing systems in the world. It then recommends applying universally the OECD Transfer Pricing Guidelines.

There are three issues that arise from this approach: the first one is an issue of representation. Undoubtedly the OECD Guidelines have become the key reference document for the design and interpretation of transfer pricing rules worldwide. There are no real competing approaches or initiatives. Ideally, they should also be applied by oil-producing countries. Nevertheless, it should not be overlooked that the OECD has a limited membership of developed countries, and that the universal application of the Guidelines therefore requires increased dialogue with developing countries on the extent to which these countries can agree to the Guidelines and where they see problems. The OECD has launched an extensive outreach dialogue now, and it can be hoped that this dialogue will lead to greater acceptance of the Guidelines in oil-producing countries worldwide.

The second issue is that general experience with tax compliance of businesses indicates that smaller businesses tend to engage in tax evasion to reduce their tax burden, while large businesses, with access to highly sophisticated tax advice, use tax avoidance schemes, of which transfer pricing is a key element. The fact that in the oil business the tax burden at the upstream level is considerably higher than downstream makes upstream transfer pricing even more attractive. Inexperienced tax administrations, such as in Kazakhstan, see little chances to win the battle they have to fight with the tax departments of large oil companies to detect transfer pricing practices. In such a situation aggressive transfer pricing legislation, combined with ample discretion given to tax officials, becomes a way to guarantee that collection targets are met. What this means is that a pre-condition for applying the OECD Transfer Pricing Guidelines in developing countries is capacity building in tax administration, especially in large taxpayer departments, so that a core group of transfer pricing experts, with sufficient understanding of the oil industry business, is available.

A third issue is the exchange of information: applying transfer pricing legislation may require additional information not only from the oil company but also from the tax administrations of other countries. International practice unfortunately shows that developing
countries are not always able to get easy access to such information; developed countries frequently share tax information among themselves for the application of domestic tax legislation; however, they are reluctant to share information with developing countries, except information needed directly for the application of a tax treaty. A greater openness to international information exchange thus becomes another requirement for a full move to an OECD-type transfer pricing regime for the oil industry.

A number of countries have set up special oil revenue offices to increase the efficiency of revenue collection from large oil companies. This can be a highly appropriate step to guarantee the necessary professional knowledge of the oil industry in the tax administration. But there are some concerns associated with this approach as well. The presentation by Arvind Ganesan highlights the problem of corruption and misuse of revenue in energy producing states. Corruption surveys in many developing countries consistently have identified tax and customs administrations as being among the most corrupt institutions in the country. If this is the case, the oil revenue office, which is responsible for the collection of a major share of the total tax revenue of the country, can easily become the most lucrative place for a corrupt tax official to work. The consequences for revenue collection and harassment of oil companies are obvious. Anti-corruption strategies for revenue administration therefore need to focus specifically on the oil revenue office. However, even with a strong anti-corruption focus on the oil revenue office, it will be impossible to create an island of integrity within a generally highly corrupt environment.

A core element of efficient tax administration is the analysis and processing of information. OECD countries are moving more and more to a flexible, ongoing industry-wide exchange of information to better understand specific economic sectors. According to the definition in the 2000 update of OECD Model Tax Convention, industry-wide exchange of information is the exchange of tax information especially concerning a whole economic sector (for example, the oil industry) and not taxpayers in particular. The IRS in the U.S., for example, has conducted industry-wide studies with a number of countries, including France, Germany, the United Kingdom, Australia, and Canada. The industries covered included oil, banking, electronics, and shipping. It would be useful if, at some stage, tax administrations in oil-rich countries could be involved in such an exchange of information.

Practical experience in a number of countries has highlighted the degree of weakness of tax administration capacity in oil-producing countries. I remember the case of one country where new, inexperienced auditors, after three month of training on the job, were assigned to audit an oil company. The results for revenue collection, and also the problems this created for the oil company, can be easily imagined. Such a situation is not unusual, however.

A recent IMF report on the tax administration of one of the main oil producing states says: “Staff posted to the Petroleum Tax Office (PTO) receive no formal training either on the oil industry and its accounting methods or on the peculiarities of oil taxation. They are left to pick up what they can from reading the legislation, looking at files and working with more experienced officers—though in times of high staff turnover these may be hard to find. There is
virtually no written guidance or training material suitable for newcomers to oil taxation, either on
the oil industry or the PTO procedures or the interpretation and application of the law.”

The fundamental deficiencies of tax administration in developing countries thus extend equally to the parts of the administration dealing with oil taxation. Capacity building in tax administration has to become a clear priority for the improvement of petroleum revenue collection, the reduction of compliance costs, and the move to a more predictable and equitable tax system for oil companies. The problem of hostile audits of oil companies having the effect of crypto-taxes, which was mentioned by one of the presenters, is a direct consequence of weak administrative capacity and a tax administration focused exclusively on meeting revenue targets. The lack of a comprehensive audit strategy and of an annual audit plan, weak field audit capacity and the concentration on desk audits, combined with the necessity to meet high revenue targets, results in a high risk of harassment of businesses subject to audit. In addition to the mere training of tax inspectors and computerization of processes, an improvement of petroleum revenue collection requires institutional improvements as well as fundamental changes in the tax administration’s management strategies. One institutional option for capacity building and for increasing accountability for petroleum revenue collection could be the creation of a semi-autonomous revenue authority.

A final comment is that a discussion on petroleum revenue collection should not be limited to analyzing the design of tax laws and production sharing agreements (PSAs), but should be broader and include also the legal framework for the operation of the tax system. One critical issue, which from my point of view should at least be mentioned in the context of this session, is the availability of a well functioning dispute resolution system. This is not always sufficiently possible in petroleum revenue countries, as a culture to accept appeals against tax administration decisions is lacking in the tax administration, and a weak and corrupt judiciary provides no guarantee for a fair and timely court decision.

*Thomas Baunsgaard, Economist, International Monetary Fund*

The presentations this morning have covered extensive ground in discussing the multiple challenges policymakers are faced with not only in designing a good petroleum revenue regime, but also in administering this. In my comments, I would like to make a few points regarding tax design and the administrative constraints, and then raise three issues for further discussion.

*Design of the revenue regime*

When looking at the myriad of tax and nontax systems used to collect the state’s share of petroleum rent, the apparently widely differing approaches to revenue collection are striking (Table 2.4). In contrast to other areas of tax policy, it seems very difficult to come up with one revenue regime that is inherently superior to others. Rather, there is a menu of regimes for policymakers to choose from: tax/royalty, production sharing (with or without
royalties), state participation (equity holdings), risk service contracts, and so forth. Some countries operate within a tax-based system; other countries prefer alternative regimes, perhaps using a production sharing contract to provide a greater sense of fiscal stability or even project specific terms.
### Table 2.4: Key Characteristics of Fiscal Petroleum Regimes
Selected Developing Countries

<table>
<thead>
<tr>
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<td></td>
</tr>
<tr>
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<td>...</td>
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<td>50%</td>
<td>None</td>
<td>...</td>
<td>Yes (E)</td>
<td>25%</td>
</tr>
<tr>
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<td>48.65%</td>
<td>None</td>
<td>25%</td>
<td>Yes (O)</td>
<td>50% (C)</td>
</tr>
<tr>
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<td>50%</td>
<td>None</td>
<td>20%</td>
<td>None</td>
<td>10%</td>
</tr>
<tr>
<td>Gabon</td>
<td>10-20%</td>
<td>Gov. share</td>
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<td>...</td>
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</tr>
<tr>
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<td>...</td>
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<td>45%</td>
<td>None</td>
<td>18%</td>
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<td>...</td>
</tr>
<tr>
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<td>20-65%</td>
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<td>10%</td>
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<td>Variable</td>
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<td>None</td>
<td>None</td>
<td>...</td>
<td>None</td>
</tr>
<tr>
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<td></td>
</tr>
<tr>
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<td>65-80% (V)</td>
<td>None</td>
<td>None</td>
<td>...</td>
<td>Yes (I)</td>
<td>None</td>
</tr>
<tr>
<td>Brunei</td>
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<td>55%</td>
<td>None</td>
<td>Yes (A)</td>
<td>50%</td>
<td></td>
</tr>
<tr>
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<td>40-65% (V)</td>
<td>20%</td>
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<tr>
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<td>38%</td>
<td>70% (Pr.)</td>
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<td>25%</td>
</tr>
<tr>
<td>P.N.G.</td>
<td>2%</td>
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<td>45%</td>
<td>20-25% (V)</td>
<td>None</td>
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<td>32%</td>
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<td>15-32%</td>
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<td>None</td>
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<td>10%</td>
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<td>None</td>
</tr>
<tr>
<td>Vietnam</td>
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<td>65-80% (V)</td>
<td>Gov. share</td>
<td>Formula</td>
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<td>Yes (H)</td>
<td>15%</td>
</tr>
<tr>
<td>Middle East:</td>
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<td></td>
<td></td>
<td></td>
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<tr>
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<td>20%</td>
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<td>30% (C)</td>
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<tr>
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<td>...</td>
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<td>Yes (U)</td>
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<td>25%</td>
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<td>None</td>
<td>7%</td>
<td>None</td>
<td>50% (C)</td>
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<td>Formula</td>
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<td>30%</td>
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<td>None</td>
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<td>None</td>
</tr>
<tr>
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<td>None</td>
<td>10%</td>
<td>Yes (E)</td>
<td>None</td>
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<tr>
<td>Mexico</td>
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<td>None</td>
<td>7.7%</td>
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<tr>
<td>Trinidad &amp; Tob.</td>
<td>12.5%</td>
<td>Variable</td>
<td>50%</td>
<td>0-36% Pr</td>
<td>...</td>
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<td>None</td>
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<td>Yes (E, Cr)</td>
<td>0-35%</td>
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<td></td>
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<td></td>
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<tr>
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<td>15%</td>
<td>Yes (E, O, U)</td>
<td>7.5-20%</td>
</tr>
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<td>15%</td>
<td>Yes (H)</td>
<td>None</td>
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<td>15%</td>
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<tr>
<td>Uzbekistan</td>
<td>5%</td>
<td>75%</td>
<td>25%</td>
<td>None</td>
<td>15%</td>
<td>...</td>
<td>50% (C)</td>
</tr>
</tbody>
</table>

Sources: Barrows (1997), Petrocash (online), Coopers & Lybrand (1998), PricewaterhouseCoopers (1999), and International Bureau of Fiscal Documentation (various).

1/ Production sharing linked to physical volume of production (V), years of production (T), or realized profitability (P)

2/ Investment incentives: tax holiday (H), accelerated depreciation (A), tax credit (Cr), current expensing of exploration and/or development cost (E), duty exemption for imports of equipment and capital goods (I), unlimited loss-carry forward (U) and other (O).

3/ The maximum equity share that the state can select to take, often on a carried basis (C).
Underpinning this flexibility is the main policy insight regarding the design of petroleum regimes: different regimes can be designed to provide broadly the same sharing of risk and reward between the government and the investor/operator, a point well made by both Philip Daniel and Daniel Johnston. Let me illustrate this with a simple numerical example by comparing the taxation of an illustrative petroleum project under three common types of revenue regimes: (i) a tax/royalty regime (with a progressive resource rent tax); (ii) a production sharing regime with a progressive government share of production; and (iii) a carried interest equity holding. We will see that the similar sharing of risk and reward can be achieved through these so apparently different regimes.

Table 2.5 shows that a tax/royalty regime (with a 25 percent income tax, a 25 percent rate of return based resource rent tax, and a 2 percent royalty) will provide the same government take in net present value terms as a production sharing regime (with a 25 percent government share in profit oil, a 25 percent progressive profit oil share linked to the rate of return, and a 2 percent royalty).²³ Figure 2.12 shows that the revenue flow over the life of the project is also quite similar under the two regimes. In contrast, a carried equity interest will require a very high government share (about 50 percent) before providing a similar government share in net present value terms. This reflects the backloaded revenue stream as the carry is initially repaid. In this stylized example, it is also apparent that the overall regime is slightly regressive; when the tax burden is reduced the project profitability is higher.

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²³ A cap on cost oil could be equivalent to the royalty as long as the cap is binding. Once costs have been recovered, there is no longer an implicit royalty.
Table 2.5: Stylized Project: Comparison of Revenue Regimes, NPV Terms

<table>
<thead>
<tr>
<th></th>
<th>Tax/royalty regime</th>
<th>Production-sharing regime</th>
<th>Carried-equity interest</th>
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<td><strong>Base-case scenario</strong></td>
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<tr>
<td>Cash-flow, NPV terms</td>
<td>222</td>
<td>222</td>
<td>222</td>
</tr>
<tr>
<td>Total investor/operator take</td>
<td>50</td>
<td>51</td>
<td>56</td>
</tr>
<tr>
<td>Total government take</td>
<td>173</td>
<td>171</td>
<td>166</td>
</tr>
<tr>
<td>Cash-flow, in percent</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>Total investor/operator take</td>
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<td>23</td>
<td>25</td>
</tr>
<tr>
<td>Total government take</td>
<td>78</td>
<td>77</td>
<td>75</td>
</tr>
<tr>
<td><strong>High-case scenario</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash-flow, NPV terms</td>
<td>382</td>
<td>382</td>
<td>382</td>
</tr>
<tr>
<td>Total investor/operator take</td>
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<td>138</td>
<td>114</td>
</tr>
<tr>
<td>Total government take</td>
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<td>244</td>
<td>268</td>
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<tr>
<td>Cash-flow, in percent</td>
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<td>100</td>
<td>100</td>
</tr>
<tr>
<td>Total investor/operator take</td>
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<td>36</td>
<td>30</td>
</tr>
<tr>
<td>Total government take</td>
<td>64</td>
<td>64</td>
<td>70</td>
</tr>
</tbody>
</table>

Revenue assumptions (in percent):
- Royalty rate: 2, 2, 2
- Company income tax: 25, ..., 25
- Resource-rent tax 1/: 25, ..., ...
- Profit-oil (base): ..., 25, ...
- Profit-oil (high) 1/: ..., 25, ...
- Equity share: ..., ..., 50

1/ Rate of return-based
Figure 2.12: Stylized Project: Government Share in Cash Flow

Base-case scenario

High-case scenario
I would opine that there may be benefits from relying on a tax/royalty or a production sharing based system, rather than on more direct state involvement in petroleum extraction. Arguably some countries—from Norway to the Middle East, as illustrated by Willy Olsen—have successfully applied more direct state participation in upstream production. However, this can have high upfront costs and may imprudently increase the risk carried by the government. Many countries have also found it very difficult in a scarce resource environment to appropriate sufficient resources in the budget to meet the ongoing cash call obligations that follow with equity holdings. There may also be conflicts of interest between the role of the state as a regulator and as a joint venture partner.

Daniel Johnston argued that fiscal regimes are becoming unduly tough for the petroleum firms. I would be more guarded, as it is quite difficult to assess this, but undoubtedly many countries feel an increasing pressure from investors to offer more competitive fiscal terms to attract scarce investment dollars.

As regards the effectiveness of fiscal incentives, though, two points are worth keeping in mind. First, fiscal incentives can make some difference, but usually taxation is not the major deterrent for an investor. Rather, various country specific factors have an impact on the investment climate in the petroleum sector, including macroeconomic instability, political and social unrest, insufficient infrastructure in remote areas, law and order problems, weak enforcement of contractual and property rights, and landowner disputes. By addressing this long list of problems head on, a country may be able to reduce the risk premium the investor demands rather than compensate for an excessively high premium through fiscal incentives.

Second, for investors located in countries taxing global income (for example, the United States), tax incentives in host countries may simply result in lower tax credits in the home country. At the extreme, rather than benefiting the investor, lower taxes may simply constitute a transfer from the host country to the U.S. Treasury—hardly the best way for a developing country to use its scarce resources.

But should a country decide to give tax incentives, they have to be designed carefully. For example, whereas a lower tax rate or a tax holiday may simply be offset by a reduction in the investor’s home country tax credit, providing relief from taxes such as royalties that may not be creditable in the home country clearly would target the tax relief at the investor much better.

Have fiscal regimes become too tough? Ultimately there is a market test for each country’s fiscal regime—can the country attract foreign investment in the petroleum sector or not? This also highlights the difficulty in comparing fiscal regimes across countries. What may be too tough in one country can be competitive in another depending on country specific extraction costs, size and quality of the petroleum reserves, and in general differences in the risk premium.
Administrative capacity

Under all revenue regimes, a binding constraint will be the administrative capacity. Though at first glance a production-sharing regime may appear to be less administratively demanding, at a closer look this reasoning does not seem so convincing. A tax administration faces the same problems in determining whether claimed tax deductions are genuine as it does in deciding whether claims for cost oil submitted by an operator are legitimate. If the government trusts the operator, a production-sharing contract is a wonderful environment to operate within. But would not the same argument apply to a tax regime, if the government has full confidence in the taxpayer’s return?

The bottom line is that there are no magic solutions here. Collecting revenue from the petroleum sector is an administratively high-intensive pursuit with a somewhat uneven playing field. Very often, the tax skills and abilities that can be tapped into by the major oil companies far outweigh the capacity that is available to the local tax administration, petroleum department, or national oil company.

Clearly support from donors, including the World Bank and IFC, could play a role by strengthening technical skills in the local administrations. Good examples of this are two projects in Papua New Guinea aimed at strengthening the technical capacity in both the mining and the petroleum departments as well as in the tax office. However, the benefits from capacity building may be difficult to sustain, as it is particularly difficult to retain skilled staff after that staff has been trained. They simply become too attractive to the oil companies who can offer conditions of employment that many governments cannot match.

Some countries have set up a kind of “large taxpayer unit” that specializes in petroleum taxation. This is a way to concentrate scarce administrative resources on a group of very important taxpayers. It is easier to build up specialized knowledge and capacity in the tax department to deal with the challenging sector-specific issues. For taxpayers in the petroleum sector, there are clear benefits from dealing with a more specialized group of tax officers, perhaps even by developing a one-stop-shop concept. That said, as always, sufficient safeguards must be instituted to prevent the buildup of a too cozy relationship between the poacher and the gamekeeper. There are also benefits from seeking close cooperation with tax offices in the home countries of the major oil companies, though this at times has not proven straightforward.

Transfer pricing is a particularly pressing challenge, although this is not an issue solely for the petroleum sector, but rather an administrative challenge for all tax administrations. While in general the oil price determination is relatively transparent, it is possible for hedging instruments to be manipulated and used for tax savings purposes. Moreover, some revenue pricing arrangements, particularly if these involve netback mechanisms (for example, of pipeline charges or other costs), can be manipulated. But typically, transfer pricing is more of an issue on the expenditure side. There are many ways in which expenditure deductions can be inflated.
including the creative application of debt financing, management fees, headquarter cost sharing, and leasing arrangements.

A common recommendation is that the tax legislation should include at a minimum a requirement that transactions between related parties should be assessed on an arm’s length basis. While it is sound legislative advice, in practice it is often difficult to enforce the arms length requirement. For many goods and services used in the petroleum industry, it may even be difficult to find a true arm’s length price given the specialized nature of many of these transactions.

The final administrative question is whether or not to apply a ring fence around either the petroleum sector or a particular project. In the latter, ring fencing disallows consolidation for tax purposes of a taxpayer’s share in different projects. There is no doubt that the industry in general strongly dislikes ring fencing and sees this as an unnecessary deterrent to investment. But let me try to make a case, though perhaps not spirited, for why one would consider a ring fence.

Ringfencing can level the playing field among investors. At the most extreme, this will ensure that there are no firstcomer advantages in terms of offsetting new development costs against ongoing operations for existing investors. This in some sense is an incentive for new investors, by not favoring established investors unduly.

Ringfencing is important if fiscal terms for upstream and downstream operations are very far apart. Otherwise, this difference in the tax burden would provide incentives for the taxpayer to shift profits to the lightly taxed sector and deductions to the highly taxed sector through transfer pricing.

Ring fencing may be more important for a resource rent tax than for the regular corporate tax.

However, one must weigh the benefits in terms of saved revenue against the deterrent effect that a too excessive ring fence may have on new developments. Some countries have applied a halfway house by allowing a limited deduction of exploration and development costs, say at 10–20 percent, against ongoing projects. As always, a sensible balance will need to be found, but for many countries at least some modest element of ring fencing would seem justifiable.

Three “new” issues

Let me put some additional issues on the table, more as questions for further discussion and research in the policy area.

Environmental Rehabilitation

Is there a role for taxation to encourage the set aside of funds for environmental rehabilitation as a project is coming to an end? This may particularly be an issue for hard rock mining where the environmental damage left behind usually is more challenging to deal with. But
for petroleum projects, there are also likely to be environmental considerations and a need for funds to rehabilitate the environment during or after completion of production. Tax deductions (or a credit) could play a role to encourage operators to contribute to project specific environmental funds. However, if a company gets a tax deduction for contributions to a reserve, it is important to ensure that the funds are available only for their intended purpose.

Community Development

Is there a role for taxation to bring benefits to local communities affected by petroleum extraction? Clearly dealing with disgruntled landowners and local community groups is an issue of growing importance, and many companies have responded by carrying out community development programs (and learning the same lesson that many donors have learned the hard way: sustainable development is difficult to achieve). But what role, if any, could tax policy play?

One possibility is direct revenue sharing with the affected communities. As Philip Daniel mentioned, some countries from Nigeria to Papua New Guinea share revenue with the local communities or governments in the regions where the oil is found. However, there are limitations to how much can be achieved in this way, and most would agree that petroleum revenue really is best treated as a national source of tax revenue.

However, the growing pressure on companies to provide social services and infrastructure in the vicinity of the project areas is likely to lead to increased demands on governments to accommodate this within the tax regime. A well established example of how this can be addressed is the tax credit scheme for community development projects carried out by oil and mining companies in Papua New Guinea. There are some clear advantages from this scheme, for example that it may be the most cost effective mechanism to bring development to remote areas with very little government presence. However, there are risks, particularly that this can be abused by taxpayers hiding commercial investment as community projects, highlighting the monitoring problem the governments face. Going this route may also confuse the role of companies vis-à-vis the role of government in regard to the responsibility for providing public services.

The Transparency Question: How Can One Strengthen Accountability for Revenue Flows?

I will not say much about this hot topic, as it will be intensively debated later during the workshop, except to make one point (that may be obvious): accounting for revenue, at an appropriate aggregation, is a necessary but not a sufficient first step. The ultimate question is how well oil money is spent, and answering that question requires an overall assessment of priorities and effectiveness of the budget. Pressure is building up on countries and oil companies to become more transparent and accountable about their revenue flows. However, to have an impact, an equally sustained effort must focus on encouraging better use of oil revenue to achieve development and progress. Peter Macnab and David Reading nicely illustrated how the
transparent accounting for revenue flows is linked to the proper reporting and modeling of financial flows of often great complexity.
Keynote Address: “The Publish What You Pay” Initiative

The Honorable Karin Lissakers

It is a sad and perverse paradox of today’s global economy that some of the very wealthiest developing countries are also the very poorest. Countries that possess an abundance of diamonds, gold, oil, gas, and exotic minerals can barely feed, clothe, let alone educate, the bulk of their populations, which suffer among the highest infant mortality rates and shortest average life spans in the world. War and civil strife, not peace, are the norm in many of these resource rich but troubled areas.

Poor governance is the explanation we give for this condition—a catchall term for misguided public policies, lack of capacity, and corruption. It is clear that many of the governance problems stem from the sheer complexity of navigating the web of tax, petroleum fiscal regimes, selected developing countries regimes, contracts, market fluctuations and uncertainties of exploration and development that characterize the extractive resources industry. The newly rich countries can feel as overwhelmed as the plumber who wakes up one morning to learn he won US$15 million at the lottery. But as Peter Woicke noted, there is also evidence that resource wealth may erode governance. In the resource rich countries, money and its misappropriation often loom large in the governance picture.

The link between governance and prosperity is now widely recognized, but it is worth noting that only recently has the international official community treated bad governance and corruption as an economic issue and an obstacle to development and poverty reduction. For example, when I joined the IMF executive board in late 1993, these topics were not on the table at all. Bilateral donors and multilateral lenders now take a very proactive approach to rooting out governance problems rather than turning a blind eye or, worse, aiding and abetting.

The ethos of good governance and transparency has also taken hold in developing countries. The New Economic Partnership for African Development emphasizes honest and transparent government, and there is genuine progress in many countries. But countries highly dependent on petroleum and other resource exports continue to present a special challenge.
This two-day conference signals that the IFIs are trying to systematically address the “linked complex” of issues that must be addressed to ensure proper management of resources and revenue.

The governance problem in these countries is not primarily corrupt payments, but corrupt use of legitimate payments of fees, royalties, and taxes and profit-sharing by the companies extracting the resources. The question is how to stop these flows from being misappropriated by the recipient governments.

The multilateral institutions can help these governments to structure the revenue flows and design budget systems to encourage proper management, as is being discussed at this conference. But good design can take you only so far. The will to spend the money properly must also be there.

Experience tells us that reforms take hold only when driven by domestic forces. In the end, good government comes from within. The challenge for the outside world is to offer not just good systems design, but also strong incentives for internal reform. Financing and conditionality work up to a point, but in the resource rich developing countries their impact is blunted. The private flows trump official aid.

We must use other tools. We know that transparency works, that public disclosure, be it of human right abuses or a president’s Swiss bank accounts, can change political dynamics. Full transparency of the revenue flows from petroleum production and similar activities could have a salutary effect on governance in the resource rich countries. If everyone knows the revenue flow, then the expenditure flow can be tracked more easily, and mismanagement or diversion for illicit purposes will be much harder.

A campaign led by Global Witness, George Soros, and a host of NGOs from around the world has launched an appeal to the oil, gas and mining companies to Publish What You Pay (PWYP, that is to disclose publicly all the fees, royalties, taxes, loans, profit-sharing and other payments to governments for extracting resources on their territories.

Clearly, oil and mining companies do not control how their payments are spent or misspent, but it is in their enlightened self interest to help ensure that the money they invest benefits the broad populace and not just a corrupt few. Civil strife that swirls around corrupt regimes increases the cost of doing business. When government services fail, companies may be asked to step into the breach. Fair or not, oil and mining companies are beginning to be blamed for the conditions of deprivation in many countries where they are the dominant industry and primary source of revenue. The sentiment is growing that if they are good corporate citizens in this age of globalization, the resource companies that play such a central role in these economies must do more to improve conditions.

In theory, publication could be done voluntarily, on an individual company or industrywide basis. Newmont Mining has done so in Indonesia, taking out an ad in newspapers, with positive effect. Its relationship with the local community changed for the better. Local
activists stopped demanding that the company substitute for the public sector in providing social
services and turned their attention to the local government and what they were doing with the
money they were getting from Newmont. On the other hand, when BP-Amoco announced its
intention to go public in Angola, the state oil company threatened to terminate its concessions.
The voluntary approach is also problematic because coverage could be uneven, leaving large
payment flows undisclosed.

The Publish What You Pay campaign therefore calls for a regulatory approach. We want the G8 countries, which are not only home to many of the world’s major oil, gas and mining companies, but also to the most important stock exchanges in the world, to require extractive industries to publish what they pay as a condition for listing on their exchanges. This would ensure maximum coverage of payments, a level playing field for all the major companies so no one would enjoy a competitive advantage, and protection for the companies against retaliation by the resource-rich countries.

I should like to stress that this is not an antibusiness initiative. If implemented, this measure would be an important advance in the fight against corruption in the developing world, particularly in Africa and Central Asia, where state revenue from oil production is set to rise dramatically over the coming decade. It would empower citizens of the countries most impacted to hold their governments accountable for the use of that revenue. It would contribute to political stability by reducing civil conflict motivated by desire to control state assets for power and personal gain. It would be good for business and shareholders since it will create an environment in which business can prosper. And it would be neither cumbersome nor expensive for companies to comply.

Among the potential users of the information are local and international watchdog organizations that can help civil society hold governments accountable, for instance Caspian Revenue Watch, an organization that monitors revenue from the expected increase in oil production in the region and will press governments in Central Asia to use the fund appropriately.

There are some positive signs that the PWYP campaign is making headway. Transparency, including for corporate payments, was an important topic at the Johannesburg Summit for Sustainable Development. The UK government has taken a strong lead on this issue. Gordon Brown told the Commonwealth finance ministers meeting last month: “The recent proposal from George Soros and Global Witness to increase transparency in extractive industries is an excellent example of how private sector companies can positively contribute to development and poverty reduction…” Prime Minister Blair promised at Johannesburg to work with governments, businesses and NGOs to ensure that all payments by companies are published openly. The UNDP and IFC have added their voices. The G8 have taken a positive step in their Africa partnership, declaring that they will be working “to ensure better accountability and greater transparency with respect to those involved in the import or export of Africa’s natural resources from areas of conflict.” We hope the U.S. government, which is what
regulates the most important capital market in the world, will also endorse Publish What You Pay. This would be consistent with its policy of linking aid to reform and the campaigns against money laundering and for financial transparency in the fight against terrorism. The commitment of leading countries to transparency must take concrete forms to be meaningful.

The attitudes of industry will be critical. There have been signs of support from the mining sector. At Johannesburg, the chairmen and CEOs of Rio Tinto plc, BHP Billiton plc, and Anglo American plc issued a joint statement saying they welcomed the British Prime Minister’s initiative on transparency of payments and promised to work for a satisfactory framework for reporting “in the interests of integrity and sustainable development.” Internationally, there has been some support from the petroleum industry, with some companies showing a real commitment to transparency. The U.S. industry has not yet sent a clear signal that they believe private corporations have a role to play alongside governments in advancing transparency in this way. We hope the private sector will come to strongly support this important initiative.

Publish What You Pay is no panacea, but it would be a strong complement to the other approaches being discussed here today. Over time, proper management of the vast wealth of the resource rich poor countries will contribute to peace and security, social justice, a better business climate and a better life for the people living in those countries. I urge all of you and the organizations you represent to support Publish What You Pay.

Thank you.
Revenue Management

Issues in Oil Revenue Management

*Michael Lewin, Senior Economist, Development Economics, the WBG, co-author
Julia Devlin, Senior Private Sector Development Specialist, the WBG*

Thank you. It is a little intimidating to have to take up an issue that was described this morning as being extremely controversial: management of revenue and revenue funds. Phillip Daniel said that a lot of people either take a vigorous stand in favor of the special funds or a vigorous stand against the special funds. I do not think I fit very well into either of those categories. However, I am also reminded of the comment made by Milton Friedman: “The problem of being in the middle of the road is that you get hit by traffic going in both directions.” But anyway, I will turn to that controversial issue later on.

What is the problem? A lot of speakers this morning spoke about it. Mr. Woicke in particular spoke a lot about the poor performance of mineral based economies, particularly oil economies. I think that this has been immortalized in Alan Gelb’s very fine book on the subject, *Oil Windfalls: Blessing or Curse?* I recommend that you read the book, but even if you do not read it, I hope you have read the title. There is a lot of debate, of course, about whether well-endowed countries like oil economies actually perform relatively more poorly than other economies. I think there is a lot of evidence that they do, and it has been well documented. Even if that case is not completely watertight, the case that these countries certainly do not do as well as they should is unassailable. Nigeria is not the only example. Many economies that have very large oil, gas or mineral endowments still have very large poverty levels. Some of the economies in the world that should have had enough income to provide a comfortable living for their entire populations for many years find themselves in dire economic straits and squander their resources. That is really the reason why we are all here today. As Paul Stevens said, what the countries do with the funds is really what determines the well being of their people.
Among the things over which we have control, fiscal policy is clearly the key. There may be many things affecting natural resource endowed economies over which we do not have control, but fiscal policy is something that at least we should be able to determine. That is really at the heart of the matter. One of the characteristics of resource-endowed economies is that the oil sector is usually an enclave and that the fiscal authority is really that body that links the rest of the economy and the oil sector.

The types of problems that are associated with these countries were also spoken about earlier this morning. The fiscal policy will determine the real exchange rate fluctuations, rent seeking, corruption, and of course the general overexpansion of the public sector. It may also favor the development of a rent-seeking behavior and facilitate corruption. There seems to be something about oil-based economies. Oil revenue is a relatively painless way for governments to expand, and this determines their overexpansion. I guess the key element of revenue management is really a necessary implication of expenditure management. The ills that I have spoken about earlier depend on how a government spends the money or what it does with the money. We heard from other speakers that a sensible policy would be for the government to put money in the bank and withdraw it only when a sensible expenditure project materializes. But money cannot sit idle in a bank account, and before setting the money aside a government needs to have a plan to invest such money, that is, some form of asset or revenue management. A government needs also to decide how to use those funds. So while we can all agree that expenditure management is the key to avoiding the kind of ills that we associate with the resource curse, the implication is that there have to be some rules for managing the assets.

There are two determinants, or two characteristics, that have to be addressed in any kind of revenue management or expenditure management scheme. First, the resource is exhaustible, and, second, the value of the resource may be volatile. These are two characteristics of oil revenues. The issue of exhaustibility may be less relevant in some cases: there may be some countries, in particular gas-exporting countries, where the issue of demand is far more important than the supply. But for other countries, and at a global level, exhaustibility of the resource may be very important. However, volatility seems to affect all oil exporters.

I think there is an analytical similarity between the two. In cases where exhaustibility is an issue, when not all the current revenue may be spent now because of intergenerational equality considerations, the challenge is to spend only what can be spent in perpetuity or, even if the future is discounted, to transfer some of the resources to future generations. The same problem to some extent affects volatility. If the government is saying that it is not going to spend all current revenue, what it is really saying is that it is going to save some of it for a rainy day. In one case, it is saving for a certainty or relative certainty, which is the exhaustibility of the resource. In the other case, it is saving for an uncertain rainy day, but in both cases the government has to distinguish between “permanent” and “transitory” revenue. So to sum up the key challenge for fiscal policy is to delink current expenditure from the current oil revenue.
Smoothing the revenue will not necessarily smooth expenditure, and the key is to smooth expenditure. Let us consider a hypothetical case, which will help us highlight the importance of the need to smooth expenditure. This hypothetical case is completely unrealistic and not in line with economics’s traditional doctrine. It is based on the assumption that the government can sell all the oil on discovery and that it is forced to purchase an asset with the proceeds. What would this asset do? This asset would give the government a certain stream of income in perpetuity. In this way the government would acquire a stable source of revenue unrelated to the volatile oil prices. This gives the government a more solid foundation for budgeting decisions: its permanent or expected income (at least from this source) is also its current income.

The point I am trying to make is that revenue management is necessary if one assumes that expenditure smoothing is a desirable goal of fiscal policy. Choosing the mechanism to achieve and implement that goal is the issue that was described as being so controversial. However, we must understand that a sound fiscal policy does not logically arise prior to the question of whether or not one should establish a special fund. A fund is neither a sufficient nor a necessary condition for the implementation of a sound fiscal policy. The question we have to answer is whether it can be an important catalyst in the process.

Some economies have adopted at least some of the fiscal goals that I spoke about without the adoption of a formal fund. Russia has recognized, having been stung by oil price volatility, the importance of calculating its likely, permanent, or expected revenue according to the best available information via a special account. Botswana, I believe, has also based its government expenditures not just on current revenue but on future expected revenue, as well, and has achieved more successful fiscal results. And neither of these countries has formally established a fund. Russians are actually considering an establishment of a more formal fund to help in the process, but that remains to be seen. The appropriate mechanism will depend on the particular country’s circumstances, and in saying this I find myself in the middle of the road, which I referred to at the beginning of my presentation.

What is the important question to ask about the establishment of a fund and whether or not a fund is the appropriate mechanism? The real question is whether the fund can help in increasing transparency in the economy, in improving accountability, and in promoting good governance. These are really the crucial questions. There are many cases in which we might also want to know whether the formal establishment of a fund can increase the government’s capacity to handle some of the difficult issues involved in asset management and also enhance a system of checks and balances that is necessary for good fiscal management. These are issues that all economies encounter at some point, and are also relevant in discussing the independence of central banks. In some circumstances, a formal fund will be able to achieve all these goals. However, I think that finding the institutional mechanisms that can best achieve these goals is still a challenging exercise.
Now I wish to discuss with you a few fairly controversial issues. The fund should not undermine the fiscal process, and earmarking of expenditures by the fund has a tendency to do that. In our work in developing countries as macroeconomists we are very much concerned with strengthening the fiscal process and strengthening the transparency of the fiscal process, and we should not really be advocating something that undermines that process. Yet we live in the world of second, and sometimes third, best, so there may be cases in which earmarking is justified. Chad may be an example of that. But as a general principle, I believe that a fund should not be a substitute for expenditure decisions from the overall fiscal authority.

I should also mentioned a practical difficulty that a fund may face, that is the ability to distinguish between permanent and transitory changes in revenue, particularly when these are linked to fluctuations in the oil price. Having an appropriate reference price is an important practical problem. I think that oil prices show some form of predictability. There is some form of mean reversion (although very slow) that in principle should allow fund managers to develop a rule for distinguishing transitory and permanent changes in revenue.

Different funds have different goals. Some funds emphasize savings. We can call them heritage funds, to borrow from the environmentalists. This type of fund aims to obtain intergenerational equality. Other funds emphasize stabilization over a shorter period. I think that there is an analytical similarity between the two. Both types of funds face the same problems. With regard to the heritage savings fund, a fund manager still has to decide on whether a permanent change translates into an increase in permanent wealth. In other words, if a price rise is permanent, then the amount that can be transferred and spendable by the government increases. This is quite similar to a stabilization fund whose manager also has to determine how much the fund can afford to transfer to the government in response to changes in prices, or when to make a painful adjustment, if necessary in a downturn. So the two are not that dissimilar in the way in which they operate, but they do place a different emphasis over the type of goals they plan to achieve.

How effective are funds? I think that there is still a lot of work to be done on the empirical side. The IMF has made valuable contributions on this subject, and Julia Devlin is doing some valuable work on this as well, but there is still a long way to go. The key thing is to be able to see whether a fund can help in the delinking process, that is, delinking current expenditure from volatile current income. I am not sure that we have reached a final conclusion on this point. The findings from sample data show that there is some sort of negative correlation between government spending as a percentage of GDP and the existence of a fund. This tends to decrease with the size of the fund, which is actually not totally illogical. One does not want the fund to overaccumulate, and a larger fund could be the sign of an increase in permanent income, and therefore it is not unreasonable that the government should spend more. There is also some evidence from time series that funds can lower fiscal volatility and government spending.

Before concluding my presentation, I would like to repeat that I think a reasonable conclusion is neither just to dismiss funds out of hand nor to adopt them...
dogmatically, but rather to look for the correct institutional mechanism, to enhance a transparent system and support the fiscal policy rules. And the key to this mechanism is to base expenditure on permanent or sustainable revenue rather than volatile or transitory current revenue.

Oil Funds and Revenue Management in Transition Economies: The Cases of Azerbaijan and Kazakhstan

John Wakeman-Linn, Paul Mathieu, and Bert van Selm

Introduction

Managing oil wealth has proven a daunting challenge for many countries. Numerous studies (see, for example, Sachs and Warner [1995]) have shown that resource rich—particularly oil rich—countries have experienced slower economic growth over time than have resource poor countries. Countries confronted with the added challenge of transforming their economies to a free market, while simultaneously managing an oil boom, face a more complex task, as noted by Rosenberg and Saavalainen (1998).

This paper assesses the approach taken by two such countries—Azerbaijan and Kazakhstan—as they try to address these common challenges while confronting very different futures for their oil booms. Azerbaijan, on the basis of proven and probable reserves, will see a short but sharp spike in its oil production and revenue, while Kazakhstan is expected to see a long, sustained peak in revenue. How they manage their differing revenue streams will be critical to their economic futures.

This paper assesses the revenue management strategies chosen by these two countries and their chances for success. We begin by describing the prospects for oil and gas exports in these countries. We then assess the reasons both countries have recently introduced oil funds, as well as how the differences in the way the funds are designed reflect the different revenue prospects facing these countries. Finally, we attempt to predict how well these funds will help Azerbaijan and Kazakhstan manage their oil revenue while completing their economic transition, and we make some suggestions for improvements in these funds.

Oil and Gas Sector Prospects in Azerbaijan and Kazakhstan

In both Azerbaijan and Kazakhstan, important new oil and gas discoveries have been made in recent years, and there has been considerable progress in the construction of

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24 This paper builds on a previous paper presented at a conference sponsored by the IMF Fiscal Affairs Department on “Fiscal Policy Formulation and Implementation in Oil-Producing Countries,” held on June 5–6, 2002, which will be included in a forthcoming volume to be published by the IMF in mid-2003.

25 A more detailed discussion of the energy sector prospects for these countries is contained in Wakeman-Linn, Mathieu and van Selm (forthcoming).
pipelines to bypass the existing monopolies linking these countries to world energy markets. 

Assessing the prospects for the energy sector in these countries—coming up with a reasonable forecast of energy exports on which to base policy decisions—has been a major challenge for the authorities in both countries. According to current best estimates, proven reserves will allow Azerbaijan to increase oil production to about 1.2 million barrels per day (bpd) by 2010, while Kazakhstan’s production could exceed 3 million bpd by about 2015.

**Azerbaijan**

Oil and gas production in Azerbaijan decreased sharply in the final years of the Soviet Union and the first years after its break-up. Gas production has continued to decrease, but oil output has now surpassed the 1990 level. In 1995, Azerbaijan International Operating Company (AIOC)—a consortium of international oil firms—was formed to operate Azerbaijan’s most promising oil field, Azeri-Chirag-Guneshli (ACG). AIOC’s oil production is projected to reach 1 million bpd by 2010 (Figure 4.1). To make this surge in energy exports a reality, huge oil and gas sector investments—more than twice the annual GDP—are planned in the coming years. However, this peak will be short lived, with production and exports expected to begin declining in 2013, and to fall by almost half by 2020.

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26 Dodsworth, and others. (2002) and Mathieu and Shiells (2002) provide more details on the pipeline issue in the region.
Kazakhstan

In the Soviet era, Kazakhstan’s considerable petroleum endowment was underexploited. Exploration and development have accelerated since independence, as international firms have been attracted by the favorable prospects in the Caspian basin. Three large projects dominate the petroleum sector: the onshore Tengiz oil field, the Karachaganak gas and gas condensate field, and the Kashagan offshore field. Oil and gas producers are investing heavily to expand production from 800,000 bpd in 2001 to around 3.1 million bpd in 15 years, which would put Kazakhstan among the top ten oil producers in the world (Figure 4.2). Unlike Azerbaijan, these volumes appear to be sustainable through at least 2020. Gas production of about 12 bcm per year, largely oil associated gas, is also expected to rise strongly over the medium-term, stabilizing at around 50 bcm per year.
Large oil and gas revenue, and the prospect of much more to come, have confronted Azerbaijan and Kazakhstan with the challenge of appropriately managing these potentially destabilizing flows. In both countries, fiscal receipts from the petroleum sector have surged with rising output and the recovery in prices since 1998. In Azerbaijan, government oil receipts represent more than one third of total revenue; this is projected to rise to more than 50 percent in the medium term, begin declining starting in 2013, and be below one third of revenue by 2020 (Figure 4.3). In Kazakhstan, the increase in petroleum sector revenue has been even more pronounced—from close to zero to about one quarter of revenue, reflecting the more recent development of the sector. The share of oil and gas revenue is expected to continue to increase in the foreseeable future, reaching 40 percent by 2020.
Clearly, despite both experiencing surges in oil and gas revenue in recent years, and expecting further surges in the coming years, Kazakhstan and Azerbaijan face very different challenges in managing this revenue: Azerbaijan needs to determine how to manage a large but temporary revenue stream, while Kazakhstan has to determine how to best respond in the face of prospects for a long term surge in energy revenue.

The Institutional and Transformation Challenges

All CIS countries confronted a wide range of economic and political challenges following the collapse of the Soviet Union, but for Azerbaijan and Kazakhstan their potential oil wealth complicated two of these challenges: the need to create the institutions of economic policy in a market economy, and the need to foster the development of new industries and services to replace inefficient Soviet era enterprises, which were not viable in a market economy.

The Institutional Challenge

Like other countries that had once been part of the former Soviet Union, at independence Azerbaijan and Kazakhstan lacked the institutions vital to the conduct of economic policy in a market economy. In particular, they lacked the tools for effective fiscal policy—a market-based tax policy and administration, a treasury system, and institutions for budget preparation and execution. All CIS countries have struggled since independence to create a modern tax policy and a tax administration capable of shifting from collecting taxes
from state-owned and controlled enterprises, to "the more challenging compliance activities of the emerging private sector and increasingly autonomous state owned firms," (Ebrill and Havrylyshyn, 1999).

For Azerbaijan and Kazakhstan, an easily available alternative source of money—oil revenue—has made this more difficult. When faced with the need for additional revenue, it is both administratively and politically easier to use oil money than to struggle to strengthen tax administration and enforcement or to revise tax policy. Thus, if they were to be successful in developing a sound tax policy and administration, these countries needed to find a way to insulate tax-related decisions from the easy availability of oil money. This is particularly important for Azerbaijan, where the surge in oil revenue looks to be short lived.

Similarly, all CIS countries faced the need to develop market-oriented systems for budget preparation and execution (Potter and Diamond, 2000). Carefully prioritizing and controlling expenditures in an environment of rapidly falling revenue was a high priority, as was redirecting expenditures from commercial activities and toward those activities more consistent with government expenditures in a market economy. Again, this has proven difficult for CIS countries, as evidenced in part by the frequent occurrence of budgetary expenditure arrears in CIS countries.

As with tax policy and administration, the availability of oil money has made the challenge of expenditure prioritization and control even more difficult in Azerbaijan and Kazakhstan. Political pressures to increase spending to unsustainable levels—in Azerbaijan, to levels that would be unsustainable after the peak of oil revenue—or to levels both beyond the absorptive capacity of the economy and beyond those that the governments could efficiently and effectively control, needed to be resisted. Again, this called for some way of delinking surging petroleum fiscal receipts from the political debate over expenditures.

The Transformation Challenge

A second major challenge facing the CIS countries has been the need to foster new business development to replace large, inefficient, and failing Soviet era enterprises. While all CIS countries face this challenge, the task is potentially more complex for Azerbaijan and Kazakhstan. On one hand, the easing of the financial constraint on the budget has eased the pressure for domestic financing, thereby reducing fiscal crowding out and potentially facilitating structural transformation. On the other hand, this availability of revenue has made it easier for these governments to subsidize inefficient, uncompetitive industries, thereby delaying necessary restructuring. In addition, over the longer term, rapid increases in expenditures could lead to substantial real appreciation, with a potentially damaging impact on the nonoil sector.

Oil revenue has eased the problem of revenue availability, as declining tax revenue was offset by rising oil revenue. To this extent, the existence of oil revenue eased the transition process for Azerbaijan and Kazakhstan. But that did not eliminate the need to develop a modern tax system, or reduce the importance of containing expenditures to sustainable and manageable levels.
A successful macro sterilization policy, to avoid inefficiencies and “Dutch Disease” type phenomena, requires controlling the rate of revenue expenditures from the booming sector, targeting those expenditures primarily toward investments that would enhance productivity of nonoil sectors, and ensuring that unspent funds are effectively sterilized. In the view of the Azeri and Kazakh authorities, this required special treatment of petroleum revenue—some mechanism for isolating these funds from the normal budget debates.

The different situations the two countries face, have impacts on the nature of this challenge. In Azerbaijan, with a projected transitory spike in oil revenue, the need to contain the real appreciation and ensure the development of the nonoil sector is critical. In Kazakhstan, where substantial oil revenue is potentially more durable, it will eventually be impossible to prevent significant real appreciation. A larger level of spending from oil revenue would thus appear justified, but it is nonetheless important to target expenditures on enhancing productivity in the nonoil sectors.

The Political Economy Rationale for Oil Funds

The nature of the challenges faced by Azerbaijan and Kazakhstan led them to create natural resource funds to manage surging petroleum revenue. Oil funds in general, and those in Azerbaijan and Kazakhstan in particular, can be thought of as having two primary objectives and two secondary, and related, objectives. The primary objectives are stabilization—insulating fiscal and monetary policy, and the economy, from swings in oil and gas revenue—and savings for future generations. Given the different time profiles of prospective energy revenue, it is appropriate that Azerbaijan's oil fund places relatively more emphasis on savings, while Kazakhstan's places more emphasis on stabilizing the flow of oil revenue to the budget, as will be seen below.

The secondary objectives of oil funds are maintaining fiscal discipline—which requires procedures to ensure that oil and gas revenue cannot be used to offset budget shortfalls stemming from poor non oil revenue collections or excessive expenditure growth—and avoiding monetary expansion and pressures for excessive appreciation of the exchange rate, which can be addressed through saving oil and gas revenue outside the country. In principle, both oil funds emphasize fiscal discipline by precluding the use of extra oil revenue to pay for poor non oil budget performance, and both funds save unspent revenue outside the country.

From the perspective of economic theory, it is difficult to make a case for an oil fund. As argued by Davis, and others. (2001), any fiscal policy decision that can be made in the context of an oil fund—any particular decision about the use of oil revenue over time—can also be made without an oil fund. Similarly, an oil fund is not required for a government to save oil-related revenue abroad, thereby preventing exchange rate pressures from this revenue and easing the task of the monetary authorities. The rationale for the creation of an oil fund must thus be based on political economy arguments rather than on purely economic arguments.
Annual budget debates are short-run exercises, typically focused on political and economic pressures over the next year (Schick, 2002, p.79). However, planning for sound use of oil and gas revenue requires a longer horizon. A long-term political compact, detailing how oil and gas revenue is to be used not just this year, but for years to come—which is one definition of an oil fund—can protect some portion of oil revenue, thereby allowing larger fiscal surpluses in the short run, and a more desirable path of expenditures over the medium to long run, than would otherwise be politically feasible.\(^{28}\) By allowing larger surpluses, oil funds also improve coordination between monetary and fiscal policy, since this fiscal sterilization of oil revenue means that the monetary authority has less of a sterilization task confronting it (and its often very limited intervention tools). Finally, use of an oil fund can improve the transparency of revenue management.

These political economy arguments were clearly thought by the authorities to apply in Azerbaijan and Kazakhstan. In both countries, the government was worried about political pressure to spend oil wealth rapidly and inefficiently. As a result, Azerbaijan and Kazakhstan created oil funds subject only to presidential control, bypassing parliament. By taking control over oil revenue—except for revenue from Soviet-era oil fields in Azerbaijan, and a baseline level of oil revenue in Kazakhstan—away from parliament, they sought to insulate this revenue from short-term pressures.

In Azerbaijan, the creation of an oil fund has had a positive impact on fiscal discipline and transparency in revenue management. Prior to the establishment of the oil fund, oil related receipts were used to close gaps in the state budget, undermining expenditure and tax discipline, while the funds and their expenditures were often not accounted for in a transparent manner.\(^ {29}\) In Kazakhstan, prior to the creation of the National Fund for the Republic of Kazakhstan (NFRK), significant oil revenue was kept off budget and held in undisclosed offshore accounts, beyond the purview of both Parliament and the Chamber of Accounts.\(^ {30}\) Keeping these funds in such accounts was viewed as necessary for maintaining discipline. The creation of the NFRK thus led to improved transparency in the management of petroleum revenue, and the oil fund mechanism is designed to serve the disciplining role previously served by undisclosed offshore accounts.

\(^{28}\) The Norwegian Petroleum Fund, for example, is designed as a “tool for coping with the financial challenges connected to an aging population and the eventual decline in oil revenues, by transferring wealth to future generations,” (Norwegian Ministry of Finance).

\(^{29}\) In 1998 and 1999, oil bonus financing of the state budget amounted to 1.8 and 3.7 percent of GDP respectively. Off-budget use of oil revenue included payments related to the purchase of one Tupolev 154 and two Boeing 757 aircraft in 1998.

\(^{30}\) In 1996 the authorities sold a 25 percent stake in the Tengiz field to Mobil for about US$1.1 billion, with an upfront payment of about US$500 million and performance based tranches through 2000. On April 4, 2002, the Prime Minister revealed that a significant portion of these funds had been kept in undisclosed offshore accounts. About US$300 million was transferred to the NFRK in mid-2002.
Revenue Management and the Oil Funds

The declared objectives of the oil funds of both Azerbaijan and Kazakhstan include the primary savings and stabilization objectives. However, differences in the long-term oil and gas outlook are reflected in the relative emphasis placed on these objectives in the two funds. The inflow and outflow rules of Azerbaijan’s oil fund have clearly been designed to save a large part of the government revenue related to the projected short spike in production. All revenue from post-Soviet field oil and gas production—responsible for the spike—flow into the oil fund, while revenue from older fields continues to flow into the state budget. Oil fund inflows are not related to an oil price level or a budgetary position, thus limiting the fund’s potential for stabilization. On the outflow side, the rules pertaining to Azerbaijan’s oil fund stipulate that in any given year, outflows cannot exceed inflows. This rule—if applied—guarantees that savings in the fund will grow steadily. However, ruling out a net drawing down on oil fund resources in a year of low oil revenues again restrains the contribution that the fund can make to the stabilization of budget revenue.

Conversely, in Kazakhstan the oil fund makes an important contribution to stabilizing budget revenue, with only a small portion (10 percent) of oil revenue formally earmarked for savings. Accumulation in the oil fund is contingent on the oil price, effectively delinking the flow of oil-related revenue to the budget from actual prices. The inflow rule that specifies that all oil and gas sector revenue in surplus of a baseline projection are accumulated in the NFRK has clearly been designed with the NFRK’s stabilization function in mind.31

Prospects and Policy Agenda

It seems likely that these oil funds—if operated according to existing rules—will improve the management of oil and gas revenue. Inflow and outflow rules of the funds are consistent with Azerbaijan’s greater need for savings and Kazakhstan’s relatively greater concern for stabilization, which in turn is consistent with the different revenue streams they face. In both cases, the limitations on expenditures and the requirements for investment abroad should help avoid excessive real appreciation, and both sets of rules should ensure substantial savings for future generations. Finally, both sets of oil fund rules should support fiscal discipline.

Preliminary evidence suggests that both funds have contributed to improved transparency and accountability in oil revenue management, although, as we will discuss later, there are some causes for concern. In Azerbaijan, prior to the creation of the oil fund, no regular reporting took place on the use of oil revenue. With the creation of the oil fund, quarterly reporting of oil fund revenue and expenditures and annual external audits have been put in place. Similarly, in Kazakhstan, before the establishment of the NFRK oil revenue was administered in an ad hoc, nontransparent manner. Now, any future expenditures of the oil fund transit through

31 The President can propose additional spending from the fund. However, the authorities have indicated they do not intend to use this option in the near future.
the state budget, all inflows pass through the treasury, and its portfolio balance is published monthly.

However, these oil funds are works in progress, and there are some causes for concern. In Azerbaijan, the accumulation rule—which requires all gross earnings from new oil and gas fields to go to the oil fund—has already created problems in financing new oil field development (since the oil fund rules rightly prohibit it from financing commercial activities). This problem has led Azerbaijan to ignore its own asset management rules, undermining the credibility of those rules.

In Kazakhstan, it is important to ensure that all transactions of the NFRK are controlled by the central treasury, including the recording of investment returns, and that the government follow international best practices in publishing the audits of the oil fund. Without these changes—without full transparency—public confidence in the fund will not last and its legitimacy will be challenged.

In both countries there is a need to develop a coherent long term spending and public investment strategy in order to address short term pressures for potentially unwise expenditures, avoid excessive buildup of oil fund assets, and ensure that the funds are spent efficiently. As part of this strategy, both countries will also need to enhance their capacity to assess potential investment projects. In addition, it is important that these strategies do not call for the use of oil funds as development banks, or otherwise as instruments of industrial policy.

**Conclusion**

While Azerbaijan’s and Kazakhstan’s long-term perspectives differ, government oil and gas revenue is set to surge over the medium term in both countries. Now is the time to firmly establish the institutions needed to deal with the expected boom, and the authorities of Azerbaijan and Kazakhstan have taken encouraging steps to do so. If well managed, Azerbaijan’s and Kazakhstan’s natural resource wealth can play an important role in facilitating the transition from plan to market. The oil and gas sector brings in foreign capital, expertise, and supplies these countries with the means to improve the non oil business climate in the form of better infrastructure, education, and public health.

However, many countries have found themselves “cursed” by the availability of oil and gas riches. Azerbaijan must carefully manage a huge but temporary revenue surge, while Kazakhstan must manage the transition to a long-term situation with substantial oil and gas revenue. Mismanagement of this revenue can easily turn it into a liability. While the oil funds in Azerbaijan and Kazakhstan have the potential for contributing to improved macroeconomic management in those countries, for that potential to be realized, a further strengthening of these oil funds, along the lines discussed, is urgently needed.

**References**


Governance Framework of Oil Funds: The Case of Azerbaijan and Kazakhstan

Christian E. Petersen and Nina Budina

Both Azerbaijan and Kazakhstan are rich in natural resources. Azerbaijan has crude oil reserves estimated at 7 billion barrels, Kazakhstan at 30 billion barrels, or 0.5 and 2.5 percent of the total proven world reserves. As shown in Table 4.1, the share of oil in total exports and in total government revenue is significant for both economies, similar to that of other leading energy-based economies already. Both countries are on a steeply increasing curve of their production profile as new fields, such as Azeri-Chirag-Gunashli in Azerbaijan and Tengiz and Kashegan in Kazakhstan, are expanding capacities with foreign direct investments from major international oil consortia. As most of the increase in the oil production would be directed for exports, extraction rates are strongly driven by the fast developments of transport routes.

32 Kazakhstan’s endowment with oil and gas resources is discussed in more detail by Paul Mathieu (2002). EBRD (2001) gives an overview of the Caspian region endowment with natural resources.

33 Prior to 1997, exporters of Caspian region oil had only one major pipeline option available to them—the 240,000-bbl/day Atyrau-Samara pipeline from Kazakhstan to Russia. Smaller amounts of oil were exported by barge and by rail through Russia, as well as by a second, smaller pipeline from Kazakhstan to Russia. In the decade since the collapse of the Soviet Union, several new oil export pipelines, such as the Baku-Novorossiisk, the Tengiz-Novorossiisk, and the Baku-Supsa pipelines, have been constructed, and the Atyrau-Samara pipeline recently was upgraded to increase its capacity to 300,000 bbl/day. Nevertheless, the Caspian region’s relative isolation from world markets, as well as the relative lack of export options, continues to hinder exports outside the former Soviet republics. Of the 920,000 bbl/day exported from the region in 2001, only about 400,000 were exported to consumers outside the former Soviet Union. The planned Baku-Ceyhan Main Export Pipeline to transport oil from Azerbaijan to Turkey and then to European consumers might change this situation considerably with the planned one million bbl/day capacity. Construction on the Turkish section of the pipeline began in June 2002. The entire pipeline is expected to be finished in late 2004, with the first tanker leaving Ceyhan with Azeri oil in January 2005 (Energy Information Administration: http://www.eia.com).
With production and exports expected to grow rapidly over the next decade, the need for proper mechanisms to manage petroleum revenue is pressing. In Azerbaijan in particular, the outlook over the next decade is substantially affected by the unusually steep pattern of the projected oil output. Despite the country’s rich endowment of oil and gas resources, technical estimates suggest that without a major new oil discovery and, given the current schedule of the four major oil and gas projects, oil production will peak at about 65 million tons in 2011 followed by a relatively short plateau starting to decline in 2013. This decline will be quite rapid—dropping to less than half its peak level in about six years in 2018 and to about a quarter of its peak level in 2024 when oil resources are depleted. This hump shaped profile obviously has important ramifications for designing long-term public expenditure strategies. In Kazakhstan, known resources are more substantial and also the expected time profile of the extraction is smoother. Oil production is projected to peak at 150 million tons in 2017, followed by a more extended plateau, with a decline accelerating only after 2027, so that by 2033 oil production will amount to half of its peak level. Oil is expected to be fully depleted only in 2049.\(^\text{34}\)

Given this hump shaped profile of oil production, prudent oil windfall management in Azerbaijan and Kazakhstan requires the accumulation of large savings in the form of financial assets abroad, in order to avoid excessively rapid growth in government expenditures and deterioration of competitiveness of nonoil sectors. The governments and political parties in both countries are aware of the difficulties and risks associated with managing the oil windfall. Many countries have attempted to use the natural resource windfall to the benefit of their citizens, to fight poverty, to increase the productivity of their economies and to diversify away from the resource based industry. Yet the empirical evidence points to the

\(^{34}\) These technical assessments are drawn from the participating oil companies’ own estimates.
“natural resource curse:” small oil rich economies grow more slowly, have low saving rates and low physical and human capital accumulation, as well as stagnating or declining total factor productivity. Perhaps an important factor explaining this disappointing performance is the abundance of “easy money” during the oil windfall, which creates mounting political pressures to spend inefficiently and creates incentives for corruption. To this end, both Azerbaijan and Kazakhstan are facing the following tradeoff: high public expenditures today will most likely lead to low standards of living in the future. This is the lesson that many small oil-exporting countries have painfully learned in past decades.

What can be done to create political constituencies for prudent policies? It is essential to encourage discussions of the long-term tradeoffs in the political debate, to increase public awareness about the consequences of too expansionary policies, especially the lessons from other oil rich countries. Furthermore, creating good institutions, increasing fiscal transparency, establishing good budgetary systems and eliminating soft budget constraints are also essential for successful macroeconomic management. To generate political support for the accumulation of large savings in the form of financial assets abroad, Azerbaijan and Kazakhstan have set up oil funds. The oil funds provide the necessary financial mechanism to separate commercial decisions on oil extraction from public spending decisions, allowing Azerbaijan and Kazakhstan to save part of oil revenue, to prevent adverse effects from excessively rapid transfers of oil revenue into their economies, to reinforce sound fiscal policy, and to provide for fiscal stabilization.

There is no strong empirical evidence (see Davis and others, 2001) supporting the idea of the necessity to establish natural reserve funds to address issues such as short run stabilization and long run saving challenges posed by nonrenewable resource revenue. The oil funds can help generate political support for the principle of accumulation of large savings, rather than repeatedly building political consensus for a sound long run social and economic trajectory through the annual budget deliberations. To this end, the time horizon of the government, the overall soundness of the fiscal policy, fiscal transparency and good governance are essential in shaping up the governments’ behavior and consequently determining whether the oil windfall be seen as a blessing or a curse.

The main objective of this paper is to describe and analyze the governance arrangements of the oil funds in Azerbaijan and Kazakhstan and to compare those with the best practices in the management of natural resource funds (NRFs). Section II briefly outlines the main types of nonrenewable resource funds and the main differences between them. Section III discusses the main governance features of best practice in the management of natural resource funds and the most essential requirements that the funds have to adhere to. Section IV describes

the governance arrangements for the oil funds in Azerbaijan and Kazakhstan, and the last section contains our concluding remarks.

**Types of Nonrenewable Resource Funds**

The general characteristics of nonrenewable resource funds are that they are public sector institutions, separate from the budget, that receive inflows related to the exploitation of a nonrenewable resource. Some countries possess large reserves of finite natural resources and their governments have established special extra budgetary funds built upon revenue from the sale of those resources. Other countries have preferred to handle the natural resource revenue within the framework of a unified budget. These funds share a common element in that they operate as savings and/or stabilization funds.

*Stabilization (Contingency) Funds.* (Kazakhstan) Stabilization funds firstly shield the economy from the negative effects of volatility due to variation in government tax revenue. Secondly, the stabilization fund reduces uncertainty emanating from fluctuations in revenue from natural resources. By transferring revenue to the stabilization fund, the government is able to improve overall fiscal discipline. Stabilization funds usually use preannounced accumulation and withdrawal rules that are contingent on the natural resource price or revenue levels. The fund accumulates a portion of natural resource revenue when prices exceed a preannounced threshold level; it releases assets to finance government expenditures when prices are below a threshold level. The thresholds may be defined in a number of ways, including arbitrarily setting the value of natural resource price or revenue or as a formula calculated on historical natural resource prices or revenue, sometimes including price/revenue projections.

*Savings Funds.* (Azerbaijan) NRFs that operate as savings funds deposit a share of income resulting from the sale of finite natural resources into a fund by which future generations may expect to benefit once the natural resources are depleted. Kuwait (Reserve Fund for Future Generations), Alberta (Heritage Savings Trust Fund), and Alaska (Alaska Permanent Fund) have set up NRFs of this kind. Savings funds accumulate assets, and withdrawal rules are not conditional on the natural resource revenue’s/price’s exceeding or falling below a preset threshold level. Deposits to savings funds may be fixed as a percentage of the revenue from natural resources, a percentage of total government revenue, or a predetermined monetary contribution. It is anticipated that investments in the savings fund will earn revenue that allow future generations to enjoy consumption levels comparable to the present generations after the resources have been depleted.

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36 Significant portions of this section have been adapted from the paper prepared by Andriy Storozhuk, “Rationalizing Turkmenistan’s Foreign Exchange Reserve Fund” unpublished manuscript (Washington: The World Bank, 2001) and from Davis, J. and others, Stabilization and Savings Funds for Nonrenewable Resources: Experience and Fiscal Policy Implications. IMF Occasional Paper 205. 2001.

37 This may in effect increase the volatility of other revenue accruing to the government.
Virtual Funds. Many governments integrate the NRF into the state budget for both savings and stabilization. The revenue accruing to such “virtual funds” is not earmarked to special types of expenditures. Decisions on expenditures are a part of the regular budget preparation process and spending is funneled via the Ministry of Finance rather than specially set up structures. Changes in assets in the NRF accounts, just like changes in balances of other government accounts, are reflected in the state budget below the line as deficit financing. Examples of these virtual funds include the Alberta Heritage Savings Trust Fund and Norway’s Government Petroleum Fund. In Norway, revenue from oil is transferred to the Norges Bank (Norway’s central bank), which credits the equivalent in national currency to the government’s deposit accounts. The government uses the deposit accounts to finance the state budget. With adequate accounting, reporting, and auditing, a virtual fund is the closest thing to the integration of a NRF into the unified state budget.

Best Practices in the Management of Natural Resource Funds

In the best practice NRFs (the case of Alberta, Alaska, and Norway), authorities have integrated to a maximum extent the fund’s operations into the state budget and maintained good governance practices. Integration into the budget has facilitated the management and supervision of revenue while keeping in mind the NRF’s objectives of increasing assets by setting benchmarks to monitor and improve performance. Good governance practices that build a strong ethic of transparency and clear accountability have been as critical as the NRF’s integration into the state budget and an appropriate organizational form, including transparency in the NRF’s transactions and accountability of its management. Rules governing the management of NRF need to include provisions for accountability through appropriate representative bodies and other state agencies that interweave lines of supervision.

Lessons from the three best practice NRFs suggest that transparency of operations in the form of accessible public reports, regular audits available in published form (on both the Internet and paper), and meritocratic human resource practices constitute essential components for the good governance of a fund. What distinguishes the experiences in Alberta, Alaska, and Norway is that the oil funds operate under conditions of simultaneous vertical and horizontal accountability (Heilbrunn, 2002). Vertical accountability is present in the reporting responsibilities of management in the fund itself that continues up a hierarchy until it reaches a minister. Horizontal accountability operates through two mechanisms: (i) elected officials independent of the government receive regular reports on portfolio performance; and (ii) readily available information is published through press releases, publications of reports and audits on the Internet. The presence of nongovernmental watchdog agencies enforces horizontal accountability. An effect of the linked axes of accountability is to limit the discretion of any single actor in the government to decide on the uses of the fund.

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38 This section is drawn from Heilbrunn, J. “Governance and Oil Funds,” World Bank (mimeo). 2002.
The development of an appropriate asset management strategy has been a crucial part of the successful administration of oil revenue in Norway, Alberta, and Alaska. These governments have an elaborate strategy by which they manage the NRF: first, they set benchmarks to attain the desired risk-return profile, liquidity, and macroeconomic effects consistent with the fund’s objectives. Second, they publish and disseminate reports and audits on the NRF to maintain transparency of all operations. Finally, each government has unambiguously assigned operational positions in the NRF to the most qualified people, who are directly accountable for performance of the fund’s assets. Hence, a large part of their success has been the establishment of a hierarchic organization that has included in its operational mandate the transparent dissemination of information on the size of the fund, assets accumulated, and regular reports on the management of those assets. Citizens are aware of the NRF and its performance and have a sense of any policy directions on which the fund might embark.

In sum, the NRF’s best management practices, although varying in their institutional arrangements, are subject to certain common principles:

- **Strong governance**, with prudent oversight provided by an independent public supervisory body or multiple players, interlocked by a system of mutual accountability.

- **Clearly defined goals and transparency** with public disclosure of operations and audit reports, regular dissemination of information through the media and the Internet; enhancing transparency of the NRF and/or citizen’s understanding is often set as an explicit or implicit objective of the fund.

- **Integration with the state budget**, which facilitates management and supervision of the oil revenue while purposes of establishment are kept in mind (for example, in case of assets accumulation a good practice would be to monitor performance through benchmarks).

- **Sound assets management strategy**, namely, setting benchmarks for the desired return, liquidity, and macroeconomic effects.

**Governance Arrangements**

**State Oil Fund of Azerbaijan Republic**

The State Oil Fund of Azerbaijan Republic was established in December 1999 by presidential decree as an extrabudgetary institution, accountable and responsible to the president. It is deemed to combine both savings and stabilization principles, since its main objective is to ensure “collection and effective management of foreign currency and other assets generated from the activities in oil and gas exploration and development as well as from the Oil Fund’s own activities in the interests of citizens of the Azerbaijan Republic and their future...
In addition, the Oil Fund’s expenditure rules also indicate the necessity to increase the competitiveness of the non-oil sector and macroeconomic stability.

**Supervision and Control.** The ultimate authority over all the aspects of the Oil Fund’s activities rests with the president, who is empowered to liquidate and reestablish the fund, approve the Fund’s regulations, and identify its management structure. Internal supervision functions are entrusted to the supervisory board established in December 2001. The supervisory board implements general oversight of the composition of the Oil Fund’s assets and compliance to the expenditure rules. It represents a structure of a very formal nature, as ultimate supervision and decisionmaking prerogative rests only with the president, and the first meeting of the supervisory board held in July 2002 was chaired by the president. Members of the board are also appointed by the president. The supervisory board consists of 10 members, two of whom are members of the national parliament (Milli Mejlis) nominated by the speaker. The rest represent key governmental officials (such as the prime minister, key economic ministers, and the national bank governor) as well as academia. Members of the supervisory board meet at least once every quarter, but any member of the supervisory board or the executive director can call for an ad hoc meeting when necessary.

**Investment Strategy and Operational Management of Assets.** Operational management of the Oil Fund is delegated to the executive director who, although he should consult with the supervisory board on asset management decisions, is accountable directly to the president, who annually approves investment strategy for the Oil Fund’s portfolio. The fund has so far managed its investments independently, but to increase the efficiency of the asset management, services of external managers of high credit rating as assigned by the world’s leading rating agencies can also be contracted for a certain portion of the fund’s assets. The fund’s investment policy follows “prudent investment” rules and is confined to highly secure investment instruments, such as government bonds or deposits.

The Oil Fund’s assets are first accumulated in a special account at the National Bank and then deposited at highly reputable financial institutions (such as central banks, commercial banks, and other financial institutions). Current regulations stipulate the investment portfolio profile and define both type of investment assets and their currency composition. The fund should maintain a certain level of liquidity and diversification of its assets: only up to 60 percent of its investments can be long term, and no more than 15–20 percent of its assets can be invested in one bank. The preference is given to fixed income instruments, while equity income instruments (corporate securities and stakes) are banned unless a highly reputable professional investment manager is hired to handle them.

**Transparency, Accountability, and External Oversight.** The reporting system at the fund makes the executive director responsible for information preparation on the size of the fund and regular reports on its asset management, which, after accounting for the

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39 Charter of the State Oil Fund of Azerbaijan Republic, Section 2.
supervisory board’s comments, are submitted for the president’s consideration. The Oil Fund currently produces quarterly reports, which are made readily available to the public, on revenue, expenditures, and assets. An internationally reputable accounting firm audits the Oil Fund accounts annually. Its accounts as of end-2001 have been audited, and the results were made public through the publication of the auditor’s report in July 2002. The fund has achieved good progress on ensuring transparency of its operations and dissemination of its principles and guidelines to the public.

Governance of Revenue and Expenditure Rules. Assets of the fund are generated from the following sources: the government’s profit share of, as agreed under the PSAs; rental fees under the contracts with foreign companies; bonus payments starting from year 2000 onward; acreage fees, and income earned on the Oil Fund’s assets. An annual budget will be drafted and submitted to the parliament as part of a consolidated annual budget procedure ensuring public scrutiny of the use of the Oil Fund. Consolidation with the state budget is ensured by close coordination with the Ministry of Finance through the joint Budget Coordination Committee co-chaired by the executive director of the Oil Fund and the Minister of Finance, and based on a memorandum of understanding signed between the fund and the ministry. The Oil Fund’s spending is carried out through the state’s treasury system, and the use of funds is subject to the State Procurement Law (SPL) and the provisions therein, which govern other budgetary expenditures. Finally, the Oil Fund’s spending should be consistent with the government’s Medium-Term Expenditure Framework (MTEF), Poverty Reduction Strategy (PRS), and Public Investment Program (PIP).

Under Presidential Decree No. 592 of October, 2001, a draw down of eligible funds totaling AZM 16.7 billion manats (or about US$3.6 million) was authorized for 2001 to construct housing and other infrastructure requirements necessary to improve the living conditions of internally displaced persons (IDPs) and refugees, who hitherto have been living in makeshift accommodations without basic utility services. Expenditures for the same purposes are also envisaged in the Oil Fund budget for the year 2002: initially they were planned at the level of AZM150.3 billion, but after the first meeting of the Oil Fund’s supervisory board, the president authorized the withdrawal of an additional AZM182.6 billion, which brought the total amount to be spent out of the Oil Fund (together with the operational expenditures) by the end of 2002 to AZM336.1 billion (US$69 million). This expenditure program will occur during 2002 and is consistent with the poverty alleviation principles documented in the Interim Poverty Reduction Strategy Paper (I-PRSP) and the evolving PRS.

Issues with the Governance Framework. The governance framework for the Oil Fund could be further strengthened by giving the asset management and budget regulations the force of law. Concrete proposals for an Oil Fund law, or amendments to the Budget

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Systems Law, address the following issues. First, the role of the Oil Fund should be clarified as solely a vehicle for managing part of the liquidity generated by the exploitation of oil and gas resources, until the government decides to spend a portion of those resources. Second, the legal framework should maintain a unified control of fiscal policy and should facilitate expenditure coordination. The MoF should be put in charge of preparing and executing the consolidated budget consisting of the state and Oil Fund budgets. The annual Budget Law should approve the consolidated budget deficit (without Oil Fund revenue) and consolidated expenditure limit. To help alleviate poverty and to support the government’s medium term development objectives, this consolidated budget should be consistent with the PRS, the MTEF, and the PIP, with the latter two discussed formally in parliament every year. Third, the investment of the Oil Fund’s assets (prior to their expenditure) should be limited to investment grade assets, as defined by internationally reputable rating companies. To that end, the fund should not be permitted to invest in domestic purely commercial projects under the new law, with a view to protecting its assets from undue exposure to risk. These proposals would bring the governance framework close to a Norwegian type virtual fund, often considered the best practice example.

**National Fund of the Republic of Kazakhstan**

The National Fund of the Republic of Kazakhstan (NFRK) was established as an extrabudgetary institution by a presidential decree in January 2001. The main goals of the NFRK are to accumulate part of the oil revenue (a savings function), and to reduce the dependence on oil to meet budgetary needs (a stabilization function). Furthermore, the overall objective of the fund is to ensure efficient oil revenue management and transparency, in order to increase the welfare of current and future generations.

*Supervision and Control.* The NFRK has been modeled to some extent on the Norwegian Government Petroleum Fund. Management is provided by the National Bank of the Republic of Kazakhstan (NBRK). A management council oversees the operation of the NBRK and vets all reports. The president of Kazakhstan decides the composition of the management council. The overall functioning of the council is at the president’s discretion. The president chairs the management council, which includes the prime minister, chairman of the senate of parliament, chairman of the majlis of parliament, head of the administration, chairman of the NBRK, deputy prime minister, minister of finance, and chairman of the accounting committee for controlling execution of the republican budget. No representatives from trade unions, professional associations, or civil society sit on the council. Since the president is the chairman of the council with powers to appoint and dismiss other members at his discretion, his decisions are binding.

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Transparency, Accountability, and External Oversight. The fund makes daily, monthly, and annual reports that it submits to the council. On February 1 of each year, the council prepares an annual report with the collaboration of the NBRK. This report is submitted to the president along with a report from an independent external auditor selected by the president. Information about the report and the audit is to be released to the national (state-owned) media. All reports go to the president, who decides the contents of their release.

Investment Strategy and Operational Asset Management. As stipulated in the regulations, the fund’s assets maybe invested in reliable and liquid financial instruments abroad. There is an additional provision that management of assets may be transferred to management by an external administrator. Although the NBRK is responsible for the fiduciary management of the fund decisions for asset allocation may be made by a simple majority of council members and are then implemented by the president. If votes are evenly split on uses of funds, the president as chairman casts the deciding vote. In effect the president has ultimate decisionmaking control over the activities involving management of the fund, investment decisions, and the procedures for arriving at those decisions.

Revenue and Expenditure Rules

For the purpose of the execution of its stabilization function, assets of the fund are generated from receipts of the raw materials sector in excess of the following types of taxes approved by the state and local budgets: income tax on juridical persons, windfall profits tax, bonuses, royalties, and the profit share of the government established according to the PSAs. For the purpose of the execution of its savings function, assets of the fund are generated by: (i) the accumulation of 10 percent of state and local budgets receipts from the raw-materials sector, as specified above; (ii) investment income from the management of assets; and (iii) other receipts. Statutory limitations on the uses of revenue are defined by the president and include the following uses: (i) the execution of its stabilization function; (ii) transfers of the fund earmarked for republican and local budgets, for purposes to be defined by the president; (iii) operational expenditure of the fund and the conduct of the annual external audit; and (iv) reliable and liquid investments abroad. The fund may be used neither to provide credits to private or state organizations nor to provide security for other obligations. Statutory definitions of the procedures for the use of revenue from the fund have been passed recently, but have not yet come into operation. Formally, expenditures occur when the Ministry of Finance submits a

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43 Sec 17 of Presidential Decree No. 543
44 The approved amounts of these taxes are based on conservatively projected constant world average oil prices.
45 Production sharing agreements between the Republic of Kazakhstan and foreign oil companies.
certificate of notification of fund expenditure, which should take into account results of the reporting quarter and statement of the NBRK. Approval for all budgetary decisions comes from the president.

Conclusion

As Section III points out, best practices in the management of oil funds operate under the conditions of simultaneous vertical and horizontal accountability. This means that besides vertical accountability, there is a significant presence of horizontal accountability, which limits the discretion of any single actor in the government to decide on the uses of the fund.

Is this the case for Azerbaijan and Kazakhstan? Strong vertical accountability is a typical feature of fund management in both countries (the ultimate decisionmaking power and accountability rests with the president). When the chief executive presides over the hierarchy, decisions over uses of the fund’s revenue become political. Developing horizontal accountability, however, is essential to create constituency for long-term vision and enforcement of prudent and sustainable fiscal policies. Although the Oil Funds in Azerbaijan and Kazakhstan have some provisions that allow for horizontal accountability, it does not restrain actions as the chief executive may impose sanctions on criticism.

In the case of Azerbaijan, internal supervision functions are entrusted to the supervisory board implementing general oversight over the composition of the oil fund assets and compliance with expenditure rules. Despite provisions for independent audit and public transparency, horizontal accountability features less prominently in the oil fund management, as the oil fund’s budget has to be approved by the president. There have been recent discussions about designing an oil fund law to further strengthen the checks and balances, as this is expected to maintain a unified control of fiscal policy and should facilitate expenditure coordination, with the MoF in charge of the consolidated budget. Furthermore, this consolidated budget should be consistent with the PRS. The MTEF and PIP for the consolidated budget would be approved by the parliament every year together with the Annual Budget Law.

In the case of Kazakhstan, vertical accountability is very strong: even though the management council of the NBRK is formally entrusted with the management of the fund, in practice the president has ultimate decisionmaking control over the activities involving fund decisions for asset allocation and can also decide on the uses of the fund’s assets. Some degree of horizontal accountability is present through transparency and independent audit provisions. The main drawback, however, is that the president can decide on the uses of the fund’s assets without having any medium term fiscal framework approved by the parliament.

An essential feature of the best practices of NRFs is the degree of integration with the state budget. Indeed, creating a virtual fund (Norwegian fund) seems to be the best arrangement, because it allows for maximum integration with the state budget. However, a recent article by Peter Westin puts into question the success of the virtual stabilization fund adopted a year ago by Russia. In an effort to ensure smooth debt repayments and to enforce
budget discipline, Russia established a virtual stabilization fund to accumulate excess oil revenue from high oil prices. However, using overly optimistic oil prices did not allow for accumulation of oil windfall revenue and for reducing the volatility of the budget. Furthermore, there are no effective checks and balances on the management of the financial reserves, due to lack of transparency and independent oversight, and the unclear legal status. Apparently, there are no regular statements on the size of the fund or on the uses of its assets.

Russia’s experience points to the fact that if there is aggregate fiscal discipline, it doesn’t really matter much whether the fund is virtual or outside the budget. The general flaw with oil funds is that they do not necessarily constrain aggregate fiscal expenditure as money is fungible and the government can borrow instead of running down its oil fund assets. Nevertheless, NRF rules, including the revenue rules of the oil funds in Azerbaijan and Kazakhstan, can contribute to improved transparency and better management of oil wealth as they establish a public political awareness for long-term fiscal sustainability and diversified economic growth. But even the best oil fund governance framework can be only one element in a much more comprehensive compact of effective government expenditure management.

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Russia: Revenue Management without an Oil Fund

David Owen

Overview

This presentation will consider how Russia has managed its oil revenue and its macroeconomic policy in recent years, without having an oil fund.\(^{47}\) It will focus on the period since the financial crisis in August 1998; but will begin by summarizing briefly the run up to the crisis. It will then consider what policy challenges the authorities have faced since the crisis and how the role of oil in the economy has impacted on those challenges. Next, it will look at how macroeconomic policy has actually been conducted, and at the macroeconomic results. Finally, it will address two questions:

- Could Russia have done better with an oil fund?
- Would an oil fund help in the future?

Pre-crisis background

Before the crisis in 1998, the nominal ruble exchange rate was essentially pegged to the U.S. dollar—in practice, it was a crawling peg. Policies had been successful in reducing inflation to a moderate rate, but Russian inflation remained higher than that of competitors, so the real exchange rate had steadily appreciated. Partly as a result, but more importantly because structural reforms had not yet taken root, GDP growth had been persistently weak. In the fiscal area, policy was much too loose, and this was reflected in high and rising public debt.

Pressure on the exchange rate built up steadily through the first half of 1998, reflecting contagion from the Asian crisis, low oil prices and, most importantly, the failure of the government and parliament to address the persistent fiscal problem. International reserves

\(^{47}\) The views presented in this presentation are those of the IMF staff and do not necessarily reflect the views of the Executive Board.
declined sharply. Confidence snapped in August 1998, leading to a large nominal depreciation and a default on domestic debt. As a result of the depreciation, the external debt burden rose very sharply, to around 100 percent of GDP by 1999. Inflation also rose sharply, peaking at over 120 percent during 1999.

Post-crisis policy challenges

Following the crisis, the authorities’ macroeconomic policy goals were to:

??  Restore growth by preserving, for as long as possible, the competitiveness gain arising from the crisis—that is, to the extent possible, slow the pace of real exchange rate appreciation that, they accepted, would inevitably occur.

??  Get inflation back down to moderate levels—subsequent experience suggests they were content initially to get inflation down to the range 15–25 percent.

??  Restore fiscal and external debt sustainability.

Role of oil and gas

The importance of oil and gas in the Russian economy has both helped and complicated efforts to achieve these goals. Oil and gas accounts for about 15 percent of GDP, 50 percent of exports, and 25 percent of government revenue. This means that Russia is somewhat less dependent on oil and gas than Kazakhstan, and much less so than Azerbaijan, but natural resources still play a very significant role in the economy.

The doubling of the oil price from around US$12 per barrel in 1998 to US$24 per barrel on average in 2000/01 led to:

??  A dramatic strengthening of the balance of payments—the current account surplus rose to over 17 percent of GDP in 2000.

??  A surge in general government oil and gas revenue, from 5.5 percent of GDP in 1998 to 10 percent in 2001. Nonoil revenue was relatively stable over this period (Figure 4.4).

??  A substantial positive contribution to growth, as enterprises in the oil and gas sectors used their windfall to invest, first in their own sectors and, more recently, in other sectors.
However, strong balance of payments inflows presented serious problems for monetary management, as the central bank (CBR) lacked adequate monetary instruments to fully sterilize these inflows. This hampered efforts to reduce inflation.

Post-Crisis Macroeconomic Management

In the period since the crisis, monetary policy has focused on resisting pressures for nominal exchange rate appreciation resulting from the strong balance of payments—with the aim of slowing real exchange rate appreciation. For much of the post-crisis period, the CBR has intervened heavily, leading to a huge rise in the reserves, from US$11 billion (2.5 months of imports) at end-1998 to around US$47 billion (more than six months of imports) now.

Rapid reserves accumulation would have been inflationary if it had not been at least partly sterilized. In the absence of active monetary policy instruments, sterilization could come only from a marked tightening of fiscal policy. A large fiscal adjustment was also needed to restore debt sustainability.

The fiscal adjustment actually achieved since 1998 has indeed been remarkable. Comparing 2001 with the pre-crisis period (1995-97):

The general government balance improved substantially, from a large deficit before 1998, to surpluses of 3–4 percent in 2000/2001 (Figures 4.5–4.6).
Of the overall adjustment—more than 8 percent of GDP in the primary balance—about 2.5 percentage points reflects higher oil and gas revenue.

The remaining fiscal adjustment reflects compression of expenditures, with only a partial rebound following the sharp cut from 1997 to 2000.
There has, however, been some loosening of the fiscal stance since 2000, which reflects almost entirely a rise in the nonoil deficit (Figure 4.7).

**Figure 4.7: Measures of the Real Exchange Rate**

![Graph showing measures of the real exchange rate](image)

*Macroeconomic results*

Turning next to the macroeconomic results of these policies:

The real exchange rate has appreciated, but relatively slowly. On average, the three measures of the real exchange rate shown in Figure 2.7 remain about 20 percent below the pre-crisis peak, so Russia has managed to maintain a significant competitiveness gain relative to before the crisis.

Output growth has been very strong, averaging 6.5 percent during 1999–2001 (Figure 4.8).
Inflows were only partially sterilized, primarily through the improved fiscal position, so inflation has fallen slowly since 2000 and is still around 15 percent.

But debt sustainability has been restored fairly quickly, with total public debt down from around 100 percent of GDP in 1999 to around 40 percent now (Figure 4.9).
Could Russia Have Done Better with an Oil Fund?

It is often argued that an oil fund could help to address several problems arising from a large natural resource endowment. So how has Russia done without a fund?

How has it done in terms of resisting the “Dutch disease?” By running a substantial fiscal surplus during a period of high oil prices and accumulating foreign currency reserves, policy has arguably slowed the pace of real appreciation and so supported growth in the nonoil sector. There are limits to what can be achieved in this area, however, with or without a fund. The real exchange rate will eventually adjust to a durable change in the terms of trade, and an attempt to resist this will eventually mean that adjustment occurs through inflation rather than nominal appreciation. This process is underway in Russia, as shown by the relatively slow decline in inflation since 2000, which has left Russia with higher inflation than most CIS countries.

What about stabilization of budgetary spending? So far, the authorities have shown considerable restraint in resisting the temptation to spend the windfall oil revenue—expenditures have been relatively stable, as a percentage of GDP, since 1999, while most of the volatility in revenue has been reflected in changes in the fiscal balance.
What about long-run saving of the revenue? As we have seen, higher savings have been reflected in reserves accumulation and a rapid reduction in the debt burden, which have reduced Russia’s vulnerability to future shocks. It could be argued that, beyond debt reduction, saving for future generations is not a high priority for Russia—given the prospect that oil revenue will continue for many decades and the many potential uses for resources today—for example, the urgent need for high-quality public investment in infrastructure, and for structural reforms, such as restructuring the public administration, that could have high short-run costs. In the absence of such spending now, there is a case for saving some of the oil windfall until the authorities are ready to undertake such spending.

What about governance aspects of the management of oil revenue? The identification and monitoring of oil and gas related revenue in Russia’s fiscal accounts is by no means straightforward, and the establishment of a fund into which all such revenue would be transferred could help to increase transparency in this area. However, the governance benefits of a fund are not clear cut. Keeping these resources on budget—as Russia has done—has allowed greater oversight by parliament and greater coherence in budgetary planning than would exist under some oil fund arrangements.

Our conclusion is that Russia has done well so far without a fund. There is, in any case, no guarantee that a fund would stabilize public finances or raise public savings—that depends on the overall stance of fiscal policy. Clearly, an oil fund alone could never have delivered the very large fiscal adjustment that Russia needed and achieved. That required very strong political will to establish a sensible medium term fiscal policy.

Would an Oil Fund Help in the Future?

The key question, then, is whether this strong macroeconomic policy can be sustained, and whether a fund could be helpful in the future in sustaining such a policy.

A number of factors contributed to creating a particularly favorable policy environment over the past few years:

- Post-crisis shock—which helped to convince many politicians of the need for a major fiscal adjustment.
- An unusually calm political environment, with a strong and popular president and a largely supportive parliament.
- The sustained high oil price itself, which contributed to strong growth.

There are signs now that the benefits from these factors are diminishing. As elections for the parliament (end 2003) and the presidency (early 2004) approach, pressures for higher spending are clearly emerging.
Real expenditures have risen strongly since 1999, and only rapid GDP growth has prevented that being reflected in a marked rise in the expenditure to GDP ratio.

As noted above, the fiscal surplus has been declining since 2000.

The parliament is becoming increasingly aware of budgetary devices—such as cautious assumptions for inflation and the oil price—that bias downward projected revenue relative to the outcome.

The outcome of the elections is of course uncertain, and it is therefore by no means certain that the current political calm will be sustained.

These changing political economy factors suggest that in the future a more formal defense against excessive spending could be helpful. A fund is not the only option: another approach would be a fiscal rule to ensure windfall revenue is not spent. As an alternative, the two approaches could be combined. Those in Russia who support the introduction of a fund believe that it could—by removing windfall oil and gas revenue from general budgetary revenues—provide additional political support for a sound fiscal policy with stable public expenditure. If appropriately designed, we would support such a fund.

It was not the aim of this presentation to discuss the details of what such a fund might look like. Briefly, however, if there is to be a fund, these are some of the characteristics we think it should have:

- The fund should be fully integrated with the budgetary process.
- It should be transparent and fully accountable.
- It should have clearly defined objectives (for example, stabilization, long-run savings, or both) and appropriate operational rules.
- It should have an explicit and sound asset management strategy.

In conclusion, however, the key for Russia is to find a way to sustain political support for a sound and prudent fiscal policy. In our view, an oil fund is relevant to the extent that it can strengthen that support.

### Revenue Management Scorecard

**Paul Stevens, Professor of Petroleum Economy, University of Dundee**

Let me outline what I am going to talk about. I would like to show you some preliminary results of a study that I am in the process of undertaking. The study comes out of work I have been doing with BP’s Economics Unit in London, headed by Professor Peter Davis. For the last three years the unit has been looking at such issues as resource curse and resource impact, and I have been involved in that process. During the course of looking at these
issues what has emerged out of the academic literature and, indeed, the nonacademic literature, is that countries with large natural resource revenues make a mess out of the revenues, but of course there are exceptions to this. This list of exceptions, which I have come to call “the usual suspects,” consist of about five or six countries that in different sources were sited as having avoided the resource curse and instead received a blessing.

While many of my academic colleagues are working away trying to explain why it is that many countries get the resource curse, being a contrary type of person I thought it would be interesting to ask the opposite question and try to establish why some countries did not get the resource curse. In other words, what did they do that was somehow right and worked compared with the others? This is the basis of the study.

The study is basically looking at three questions. The first obvious point is, how is it determined whether a country got or did not get the curse. In other words, what are the criteria that we are going to use to discuss this? Second, once we have established the criteria we can then simply empirically determine which of the countries got the curse and which did not get it. Finally, I suppose the most interesting question, and what I am going to say least about this afternoon, is why some countries were blessed. The reason I will say little about it is because this is still an ongoing work, but I will throw out a few tidbits for you to take away and think about.

How do we know if a country got or did not get the curse? The first thing to do is to establish what I think of as the target group of countries. In other words, who was vulnerable, who might be expected to get it or not get it? After fiddling around with the numbers I came up with the following definition: “Any country that between 1965 and 1995 at any point had oil, gas or mineral exports as 30 percent or more of merchandise exports will go into the pot.” This is essentially my target group.

I started initially with 20 percent as a cutoff point and ended up with 66 countries. I decided fairly arbitrarily to move it up to 30 percent and also to take out the re-exports. On the basis of these assumptions I ended up with 55 countries. Interestingly enough, the Netherlands does not come in under the 30 percent, so we have to rethink the name for Dutch disease and call it something else.

The usual suspects among these 55 are the countries that in the literature are usually cited as having done rather well out of natural resources rather than badly. What criteria are used? Two criteria apply. First of all, what happened to nonoil, nongas or nonmineral traded GDP? In my view a deep flaw in a lot of the academic work on this subject is that they have looked at standard overall GDP. Frankly, with regard to the overall GDP in oil exporting countries starting with 1973 and 1980 and then 1990, one need have only a passing knowledge of the history of oil prices to realize that the results out of this are going to be very strange. One has to look at traded GDP, which excludes oil, gas, or minerals exports. That was the first criterion.
Let me share with you the result first of all for nonoil and nongas traded GDP. I was simply looking at the total percentage change of nonoil, nongas, or nonmineral traded GDP over a certain period. For 1965–2000 there are only about 17 countries that have data for that period. During that period the usual suspects do seem to have done rather well. Indeed Botswana outperformed the so-called Asian tigers in the period. If, to overcome the data limitations, the period is narrowed from 1980–1995 in order to include more countries, then the results give significant empirical support to the fact that the list of usual suspects remains the same. The only suspect that is out of line is Norway. But I guess this is really the benefit or the disadvantage of being a fairly mature economy. In addition, the Norwegian data had to come from Norwegian sources, while the rest of it came from the World Bank’s World Development Indicators. Incidentally, the OECD data is horrible. If we use that criterion of non oil/gas/mineral traded GDP, then clearly a number of countries did avoid the curse and in fact benefited from the abundance of resource revenue.

The second criterion is what happened to poverty. The difficulty with poverty is how to measure it, and even more important, how to measure changes in it. After fiddling around with this for some time, I came up with the concept of benchmarking. I took the data I could get on all of the countries in the world, about 180 of them, and did a simple log regression with infant mortality on the left hand side of the equation and GDP per capita on the right-hand side. This gave me an estimate of what things should be. If you then plug into that the actual GDP and you come up with an estimated infant mortality rate you can then say whether people did better than they should have done given GDP or whether they did worse. If this approach is applied to all of the countries, as you would expect the result is fairly symmetrical, with the group of countries that did better than they should have done, and the other group that did worse.

If I apply this methodology to my 55 target countries, the result is quite interesting in the sense that it does give support to the notion of resource curse. In other words, some countries out of this target group did significantly better than they should have done given their level of GDP, and the others did worse. So what you have is a cursed tail. Again the usual suspects have done much better. The one sad exception is Botswana, but the reason for that has to do with the HIV/AIDS problem. The rest of the usual suspects did reasonably well.

I have done a similar thing for the other components of the Physical Quality of Life Index (PQLI). I have done it for literacy and for life expectancy. The results there are not quite as convincing as with infant mortality, which is why I have left them out. When I come to write up the whole thing I promise I will come clean and show all of the results, warts and all. If you simply take the Human Development Index (HDI) and look up its ranking in 1999, it does give some support to the idea that my usual suspects actually did rather well.

The implication of this exercise is that it might be interesting to stop talking about resource curse and start talking about resource impact and asking the question whether that
Impact was a curse or a blessing. It is true that probably the majority of countries with large oil, gas, or mineral exports were cursed, but a significant number were not.

This brings me of course to the most interesting question, which is why? What did Botswana, Chile, Indonesia, and Norway have in common? The first point to make is that there is nothing that is going to leap out and bite you on the leg. Democracy? In Chile? Forget it. Transparency? Then what about Indonesia and Malaysia? Obviously there has to be some other source of explanation.

The only conclusions I have made so far are basically two. One of the keys was certainly sound macroeconomic policies for much of the time. I have deliberately added “much of the time” because they did not always get it right all the time. The second one, which is a fascinating commonality, is the key role of the senior civil servants. In Chile they were called the Chicago boys, in Indonesia it was the Berkley Mafia, in Malaysia they were called the Backroom boys, and Botswana is famous for the quality of its senior civil servants.

Two interesting questions arise. First of all, why are there such high quality civil servants, but more interestingly, why did the politicians let them get on with their job of whatever they were supposed to do. Here we are getting into issues of developmental state and a whole set of issues but at that point I will stop. I wanted to share with you some of these empirical results. It is not telling you anything you did not know already, but I sometimes think it is nice to get some empirical support for one’s prejudices.

Thank you very much.

Comments at the Open Discussion of Session 2: Revenue Management

Rolando Ossowski, Division Chief, Fiscal Affairs Department, IMF

Thank you very much. It is a great pleasure to be here and I am grateful to Mr. McPherson for inviting me. I think that there were a number of interesting and thought provoking presentations here this afternoon. In the first presentation, and I do not want to elaborate much on this issue, we were reminded of the problems that oil revenue poses to oil producing countries. We all know in this workshop what that means: the volatility, the uncertainty, the fact that oil is exhaustible, and also that oil revenue largely originates abroad, and that also raises issues. These characteristics of oil revenue complicate fiscal management, macroeconomic management. Exhaustibility raises complex issues of sustainability and intergenerational equity. The fact that revenue originates abroad raises the issue of competitiveness, of the absorption capacity of the economy. Clearly, as we saw in the last presentation, many oil-producing countries have had difficulties in addressing these challenges. We have been reminded of the disappointing growth performance of many of these countries. Despite their enormous natural wealth, poverty is still a big issue, as is vulnerability to downturns in oil prices that lead to fiscal and to foreign exchange crises.
I would like to draw your attention to one particular point that was made in several of the presentations, and that is the question of volatility and short-run policies. If the government is procyclical in the upswing, chances are it will be forced to be procyclical in the downswing. This is an obvious point, but is often not kept in mind in practice. We often see a fiscal policy that follows oil market developments and has a stop-go pattern of expenditures. This transmits oil price volatility and uncertainty to the economy with negative results for nonoil growth. Such policy has significant macro and fiscal costs. All of this is well understood but, as I said, it is often forgotten. Some oil producing countries have turned to oil funds in an attempt to help them frame and conduct fiscal policy in a sensible way. The preceding presentations have highlighted many issues related to the oil funds, and I would just like to comment on a few of them.

The first point is that oil funds are not fiscal rules. This is a point that was made in several of the presentations. An oil fund, except under very exceptional circumstances, does not constrain either expenditure or the nonoil deficit.

The second point is that oil funds come in various flavors and varieties. There are contingent funds, as in Kazakhstan and Venezuela. There are savings funds, as in Kuwait. There is the Norwegian fund. You can also give a different classification concerning some oil funds that can spend outside of the budget, as in Azerbaijan. Other funds are just systems of transfers between the budget and the fund, as in Kazakhstan. Some funds are separate institutions, as in Azerbaijan or Iran. Others are little more than an account at the Central Bank, as in Norway.

Michael Lewin made an important point that an oil fund cannot guarantee an appropriate fiscal stance. On this the empirical evidence as far as we can see is decidedly mixed. Michael told us that he may not be able to see much impact of oil funds on government spending. Our own research in the occasional paper also suggests that the existence of an oil fund does not substantially alter the relationship between oil export earnings and government expenditure. Let me give you just one piece of casual empiricism and observation for what it is worth. We looked at the latest oil price upswing 1999–2001 and at ten countries with oil funds and sixteen countries without oil funds. Real expenditure (deflated by CPI) rose on average by 20 percent to 21 percent in both groups. We could not find a difference between two groups of countries. Of course one can use a counter factual argument: what would have happened in these countries with funds had there not been a fund? But this is what we observed.

I also want to make a couple of comments on Mr. Lewin’s presentation in respect to Chile and Norway. In Chile, copper accounts for a much smaller share of total government revenue than oil in many oil-producing countries. It is less than 10 percent of government revenue. Moreover, copper is less volatile than oil, so the importance of volatility and its consequences for the Chilean economy are less significant.

In Norway the oil fund, as you know, does not restrict or constrain fiscal policy in any way. It is just an account. If there is a budget surplus, it is put into the oil fund. If the
Norwegian government runs a budget deficit, it can draw from the fund. That is the Norwegian oil fund, with very stringent transparency governance, auditing and reporting standards.

As John Wakeman-Linn said, it is difficult to make a case for oil funds on theoretical grounds. Whatever you can do with a fund, you can do without. So Mr. Wakeman-Linn stresses the political economy argument. He may even be ready to admit that there may be some technical problems with oil funds but on balance these problems are outweighed, and they are outweighed by the political economy advantages. How does it work when the government puts money away in a fund? The government tries to protect this money. From whom? It may try to protect it from politicians who have a short term planning horizon from irresponsible spending prone legislators. Indeed Christian Petersen noted that in the case of Azerbaijan the ultimate authority for oil fund issues does rest with the president.

In my view, one of the problems with the political economy argument is that it sounds plausible, but first of all as discussed before there is little empirical evidence to suggest that it works, and there is reasonable evidence that there are problems. The strength of the argument that access to easy money is prevented by setting up an oil fund will depend on the circumstances and in many cases will not be convincing. The reason is that, as was noted before, money is fungible. The government can put as much money in the fund as it wants and it can finance budget deficits all the same. What has it gained? What is important is the government’s net financial position, and not a particular pot of money held somewhere in a separate account.

Another issue is that the government tries to protect this fund from being raided. So what does it do? It puts a tough rule: it says that this money cannot be accessed. But does it have a rule not to raid this fund indirectly? It can raid the fund by just increasing the budget deficit. The question at issue is the overall stance of fiscal policy and not what is happening in the fund. Would shortfalls in the budget be compensated by either raising nonoil revenue or reducing expenditure? They may or may not be. Or they may be financed. If you think that these are just theoretical considerations, I draw your attention to the recent experience of Venezuela, where a very tough oil fund rule combined with an expansionary fiscal policy led to acute policy dilemmas for the Venezuelan government.

Of course if money is not fungible, if the government is liquidity constrained or cannot borrow abroad, then obviously what it puts in the fund cannot be spent. In that particular circumstance the fund will help. But surely if the government is liquidity constrained or it cannot borrow, one of its main policy objectives should be to regain access to capital markets to be able to finance.

On the other hand, tough oil fund rules may have costs. What happens, for example, if a country has one of these contingent rules that says to put money in the fund if the oil price is above US$19 or whatever the trigger is, but its fiscal policy is not aligned to that arbitrary oil fund rule and, at the same time, it decides to run a budget deficit and must finance it? Then asset management begins to be hampered, begins to be fragmented, because the
government has to put money into the fund and at the same time it has to borrow probably at higher rates. So this rule has fiscal costs. Recent examples in Venezuela and Colombia can be examined.

In fact, there is also quite a bit of international evidence to suggest that if the country adopts tough oil fund rules there is going to be a temptation to change them (Venezuela has already gone through two changes and it is looking at the third one), that they are going to be bypassed, that they are going to be “interpreted,” or that they are going to be suspended (again, Venezuela is an example).

An important point was made this afternoon on transparency, and I think in this area progress is being made in a number of countries. In both John Wakeman-Linn’s and Christian Petersen’s presentations it was important to see the progress that both Azerbaijan and Kazakhstan are making in making the funds more transparent. These developments are encouraging. I think that transparency is absolutely critical because international experience suggests that the combination of a nontransparent fund and the ability to spend in an extrabudgetary manner is really lethal. That is a bad combination and it should be avoided.

Michael Lewin and David Owen also stressed the importance of avoiding a dual budget and I fully agree with that. If the oil fund has a spending program that is separate from the budget, this can result in fiscal management problems. Who finances what? Who carries what expenditure? It can reduce transparency. Expenditure should be prioritized as a whole in the budgetary process. The government should keep a unified control of fiscal policy and avoid expenditure coordination problems. And again, it is encouraging that reforms being considered in Azerbaijan are going in that direction.

Finally, I would like to comment on the question of an oil fund in Russia, which was raised by David Owen. He mentioned a more formal defense against excessive spending, and this could be helpful given the political economy factors and the spending pressures that may be arising. The question here is whether an oil fund would constitute a more formal defense. Well, only if Russia were liquidity constrained or there were some friction in issuing debt. It is not clear whether the oil fund would constrain Russian expenditure per se. By contrast, a fund with inflexible rules or with very rigid rules could lead to some of the problems that we discussed before.

The question here really boils down to what kind of an oil fund one would consider for Russia. Russia could go for a Norwegian oil fund, but it would have to have budget surpluses at least in the first few years of operation to build the fund unless it borrowed to finance the fund. Also, there is some expensive debt out there, so Russia has to take into account the question of risk, liquidity, and return.

Spending would not be constrained under a Norwegian fund, and Mr. Owen mentioned the possibility of a statutory fiscal rule. We all know that fiscal rules have pros and cons. They have been extensively debated in literature, seminars, and so on. They can lead to
some problems like creative accounting and efforts to bypass them. In general, though there
could be a good discussion on this, my feeling is that they are not stronger than the political will
to abide by them. Second, if a fiscal rule is considered for an oil-producing country, great care
has to be taken in designing that fiscal rule to avoid procyclicality. What I am saying is that rules
that work for nonoil-producing countries may not work for oil-producing countries, because the
design would lead to the procyclicality of the nonoil deficit or of expenditure, and care needs to
be taken.

To sum up, I think that the international experience with funds is mixed at best. It is not clear to what extent the funds have restrained expenditure, and a number of countries
have had operational difficulties in implementing policies with them for uncertain gain. Yet
prudent fiscal policy is crucial for economic performance. So what are the suggestions that one
could make? To pursue fiscal strategies that aim to break the procyclicality between expenditure
and oil prices; to establish good budgetary systems; to use medium term budget frameworks
that can help design stable expenditure policies to allow a better appreciation of the future
implications of the government’s expenditure decisions today; to target prudent and relatively
stable non oil fiscal deficits—not to have them vary too much; to create fiscal room, as Mr.
Owen suggested for Russia, that can then be used in case the country is hit by a rainy day; to
have a long term horizon: the government has to transform oil wealth into nonoil wealth and
financial assets, and this should always be high on the political agenda.

Finally, how can such a fiscal policy be supported? I would like to draw on a
paper that was recently produced by Alan Gelb and his colleagues for a conference the IMF
held in June 2002. He mentioned that it is important to build good institutions, to increase fiscal
transparency, so that everybody can see how the oil revenue is used or misused; to raise public
awareness of the issues that concern the good use of oil revenue; to develop constituencies in
support of prudent policies, and also, and critically, to get the political debate span a longer time
horizon—a very long term horizon rather than just next year’s budget.

Thank you very much.

Joel Hellman, Lead Specialist on Poverty Reduction & Economic Management, the
World Bank Group

I am a political scientist, a very rare breed at the World Bank, one of maybe
five or ten. Normally I feel like a lone voice in the wilderness. Yet when we talk about the
governance of oil funds I feel like a fox in the chicken coop, because the political issues are
really the most interesting ones here and, frankly, I think we have not given them enough
attention.

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I would like to open up my presentation with a question. I think that John Wakeman-Linn said it best when he described the oil funds as long term-compacts and political deals. I think that is exactly right, that is what they are. Therefore their credibility rests in the extent to which the political deal is believable.

The first question I have is, especially given the examples we discussed—Azerbaijan and Kazakhstan: Are these political compacts between whom? As far as I can see, in these and many other cases these are not political compacts the way we normally see them. Normally these are compacts between competing institutions with somewhat different interests who agree to a set of arrangements to bind the institutions, because they realize they will be better off constraining the other guy. Often this is the case with presidents and parliaments. Parliaments need to be constrained because of their excessive tendency to spend, and presidents need to be constrained because of their extended capacity to use these oil funds. So they come to an agreement—a compact, a long-term compact—whose credibility is based on the nature of the political agreement they have.

As I see it, many of these oil funds now do not seem to be political compacts between institutions. They really seem to be much more like the case of the king’s binding his own hands by his own rules. If you have the king binding his hands by his own rule—namely, he creates the fund, appoints the management of the fund, reviews the performance of the fund, and determines what is going to be published or not—then you have to ask yourself how credible is that, especially as a long-term pact? As a long-term political deal, what does it mean for the king simply to be tying his own hands?

The thing that concerns me is that the more you look into these institutions, the more it seems almost as if they are the opposite of a political compact in the sense that they are efforts by politicians to prevent the compact they would have to make with the parliament in order to come to a spending agreement on the nature of the oil fund. Often they take institutions out of the picture rather than creating compacts between institutions. I think in that case another point John Wakeman-Linn made is critical. It is that in transition economies, when you are essentially creating the institutions that are going to govern the economy and the policy over the long term, excluding key political actors from this compact, even if those political actors may be more inclined to spend than we like, sets a dangerous precedent for the way these political institutions are going to develop over time. Any time you are creating an oil fund, you have to ask yourself what is the nature of the political compact and among whom will the compact be created. If it is not a compact, if it is just the king binding his own hands, then how credible is it over the long term, and what are the risks associated with the king’s tying his own hands?

We know what some of the risks are. The key risk, of course, is that although we may be fairly comfortable that this king has benevolent interests, we certainly are not sure that the next king will have benevolent interests, and in some of the countries we have mentioned here the people who are waiting in the on deck circle are not the kind of people I want to trust with management of oil revenue. I think that this is a critical issue.
What happens when the system itself changes? I think this is a very important point in developing countries. We are assuming that the political systems in Kazakhstan, Azerbaijan, or other developing countries are stable, that they are not themselves in transition and going to change. If we create an arrangement and the political system itself changes, what is the likelihood, given that these rules themselves are incredible, that this arrangement is going to stay put, that people are going to have confidence in this?

The final point that concerns me is that many leaders have understood how to play this game and therefore they have begun to develop the apparatus of transparency and accountability. Yet ultimately, when you pierce the bubble you see that it is essentially just an apparatus, that the underlining power relations are not different from those of the king essentially tying his own hands. The question I have therefore is: what does that say about the credibility of transparency and accountability we are selling to the society, to the public in a sense? We are saying that when we have created these funds we have created accountability mechanisms; and yet, given the high risk that these mechanisms themselves would be in some way undermined by the extensive concentration of political power over these funds, how credible is it to say to the public that these institutions of accountability, which have a long history of development in the West and in other countries, are credible over the long term? Are we not undermining the notion of some of these apparatuses of transparency and accountability that we are putting on these systems before the underlying compact, which John talked about, is actually there in terms of the distribution and the balance of power?

I just want to leave you with that thought. Thanks very much.
In this short piece, I will provide a brief overview of the core dimensions of effective public expenditure management. I will then discuss recent findings on the most common problems poorer countries face in spending public money effectively and some of the governance issues that underlie those problems. Based on this overview of public expenditure management, I will raise what I hope are some provocative questions relating to the creation and operation of special funds for petroleum revenues. The fundamental question that I believe need to be posed is why would establishing a petroleum revenue fund increase the impact of public spending?

A useful conceptual framework exists that helps structure thinking about public expenditure management. In this framework, public spending can be thought of as having three primary components or levels. The first component is that spending cannot exceed a level that is sustainable for the nation. This dimension of public expenditure management, termed aggregate fiscal discipline, is the first or foundational level since significant fiscal imbalances imperil all public spending programs. The second component is that money needs to be allocated across the government in ways that reflect societal priorities and add to social well-being. This dimension is termed allocative efficiency and relates primarily to the manner in which the executive determines funding priorities. The final dimension is that ministries and agencies use the money that is provided to them efficiently to achieve their objectives. This concern is termed

operational efficiency, and is primarily determined by the ability to define and implement programs that efficiently achieve ministerial objectives.

A set of work has developed around each of these core dimensions of public expenditure management to assist countries to adopt good practices. Efforts to assist countries establish effective public expenditure management systems share two common features – an emphasis on enhancing organizational coherence and increasing transparency of decision-making and implementation. In the area of aggregate fiscal discipline, great efforts have been taken to establish greater controls over spending within each year as well as more realistic planning. Concerns about over-spending have led advisors to stress the importance of ensuring that the system captures the receipt and commitments of all public money. This has been translated into a push to ensure that all public funds (such as donor support, etc) come into the budget as well as expanding the definition of commitment of funds to include government guarantees for loans (termed contingent liabilities).

Assisting countries to enhance their allocative effectiveness has also received a great deal of attention, including work on broadening participation in allocative decision-making (through decentralization and participatory exercises such as the poverty-reduction strategy process). Within the national government, improving effectiveness has centered around organizational simplification and enhanced clarity of decision-making. Countries have been advised to unite investment and recurrent spending in one common budget and to approach spending decisions taking a multi-year perspective. International experience points to the benefits that can be achieved by integrating all spending decisions into a single budget and creating great clarity in the cost of different expenditure choices.

The final level of public expenditure management, operational efficiency, has recently moved to the forefront of debates about public spending in both developed and developing countries. The core question here is how does a country get good value for money? Achieving value for money has directed attention towards steps to orient the public sector towards performance and the satisfaction of client demands. The current emphasis on setting performance targets and monitoring performance is directly linked to efficiency concerns and the perceived need to increase the transparency of governmental outputs and outcomes.

Public expenditure systems in all countries have mechanisms for managing each of the three budget dimensions that I have discussed above. Recent evidence from a study of 24 countries in Africa involved in the HIPC-debt relief program suggests that managerial problems are not spread evenly across the public expenditure spectrum. The joint WB-IMF study indicated that the greatest weakness in public expenditure management in many of the poorest

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50 For a broad range of materials on the World Bank’s work on public expenditure management, see the website of the Public expenditure Group in the World Bank – www1.worldbank.org/publicsector/pe
countries is found in their execution of the budget. Over 80% of the surveyed countries do not have internal audit units and a roughly equal proportion have problems in accounting, reporting, and oversight. It a large extent, it appears that problems with the effectiveness of public spending are due not so much to choices being made within the budget but how money is actually spent.

Some insight into how public money gets used has been provided by studies that track funds from when they are released from the central authority to when they get used. One such expenditure tracking exercise examined non-wage payments made in the education sector in one African country in the mid-1990’s. The study found that only 12% of the money that was allocated to schools actually reached its intended destination while 88% was diverted along the way. Studies in other countries have found similar levels of re-allocation. Given the magnitude of divergence between how money is budgeted and how money is spent, is not surprising that there appears to be little relation between budgeting spending and social outcomes in weak governance environments.

The detrimental impact of corruption on a host of social outcomes has been well documented in recent years. Recent work has also made strong advances in distinguishing among types of corruption and clarifying the consequences of these corruption forms. The primary distinction that has been drawn is between administrative corruption and state capture. Administrative corruption refers to the soliciting and taking of bribes by officials. This is sometimes also referred to as petty corruption although this term fails to appreciate the cost to societies that comes with shoddy public works and public services and an untrustworthy government. The second type of corruption refers to situations in which an elite captures the government and public authority is used to benefit that particular group. The nature of the elites can differ, from economic elites to military ones, but the commonality is that governments are made to work for the enrichment of a single group. In these cases, corruption stops becoming transaction related and becomes enmeshed in the day-to-day working of the government. The harmful consequences of state capture can be felt across government policy. One small example


of this is the recent work that has traced a strong association between high state capture countries and poor performance of the World Bank portfolio. There exists a strong overlap between high state capture environments and countries with rich natural resource endowments.

The overview I have just provided on governance and public expenditure management is very crude and refinements would need to be added to every point that I make in order to get an accurate understanding of these areas. However, the broad structure that I have laid out provides a sufficient basis upon which to raise a set of questions about petroleum revenue funds and public expenditure management. It is clear from my comments that creating a distinct fund based on one source of revenue goes against the current of organizational simplification. Establishing separate rules for use of the fund would violate the simplification and transparency principles to an even greater extent. The only justification for such a move would be that separating out revenues derived from petroleum revenues would increase the effectiveness of their use. The locus of the problem in public expenditure around budget execution would seem to call into question the impact that would be derived from a distinct petroleum fund. Presumably, the advantage of the petroleum fund would be associated with its independence from the government and normal bureaucratic processes but the concept of state capture raises questions about the nature of independence. While establishing organizational separation from the government may be possible, greater problems would appear to exist in creating independence from the environment of authority that exists in a nation. I believe that these issues need to be addressed by those individuals and groups who advocate the creation of petroleum revenue funds as a means to improving the impact of public spending.

Negotiating a Petroleum Revenue Management Program in Chad

Philippe-Charles Benoit, Director, Project Finance, Oil & Gas, Société Générale, Former Country Manager for Chad at the World Bank

First, I would like to introduce myself. My name is Philippe Benoit, and I currently work at the bank Société Générale in the project finance department. I previously worked at the World Bank, where I was the project manager on the Chad-Cameroon petroleum project. I worked on the project from its inception in 1993 through the presentation to the World Bank Board in 2000. In that capacity, I helped design and negotiate the revenue management program. I should add that I am not an economist and so some of the language that I use will be different from that used by some of the earlier speakers. But the concepts are the same, and there were a lot of economists working in the World Bank project team.

I will talk about the development and negotiation of the Chad petroleum revenue management program. It was a five-year process. This revenue management program is not about setting up and managing an oil fund, which was the subject of several of the earlier discussions on managing petroleum revenue. Rather, the Chad revenue management program was about mobilizing petroleum revenue to reduce poverty.
I would like to start the first part of my presentation by placing the development of the revenue management program in the overall context. At its base, the Chad project involved an oil project. But for the Bank, the objective was to develop a program that was designed to meet Chad’s stated objective and the World Bank’s stated reason for participating in this oil project—that is, to develop oil in order to promote development and reduce poverty.

In the second part of my presentation, I would like to discuss the key elements of the program, and in the third part I would like to discuss some of the keys to success and how one goes around measuring success of this program. Finally, I would like to discuss what faces Chad as well as the World Bank at the moment as we move into the critical phase of implementation.

In terms of the overall context, I think that it is important to travel back to the early 1990s. This project started in 1993 and at that time, and unfortunately it is still the case today, Chad was one of the poorest countries in Sub-Saharan Africa. It has a lot of geographic disadvantages. It is a landlocked country. You have to travel all the way across Sudan, Libya, Cameroon, or Nigeria to get to Chad. It faces a lot of climatic challenges, and it also has a history that has been marked by extensive periods of civil strife. Chad has an extremely low annual income per capita—US$200–250—and a very limited natural resource base except that, as it turns out, Chad has some oil. This was something that had always been part of the Chadian people’s view of their country. They heard that they had oil, but it had never been developed.

In that context, the World Bank was approached by a consortium of private oil companies led by Exxon Mobil to develop a project that had two components: the development of the oil field in Chad and the construction of a 1,000 kilometer pipeline from Southern Chad to the Atlantic Coast traversing Cameroon. Project preparation began in the early 1990s. From the Bank’s perspective, a critical aspect of this project was that it was expected to generate significant amounts of revenue for Chad, with the values depending upon where the price of oil was. The price of oil during project preparation fluctuated from about US$12 a barrel to US$30 a barrel, but under any price scenario the project would generate revenue that could potentially double or triple Chad’s fiscal revenue.

When the project started, ExxonMobil’s two partners in the consortium were Shell and Elf. This changed over time, and I will come back to that, but what is relevant is that ExxonMobil was the lead sponsor and it had a certain perception of the political risk in the region. This perception was probably different from Elf’s. The consortium approached the World Bank because it viewed the Bank as a critical element in mitigating the political risks that it perceived as affecting this US$3 billion dollar investment.

The commitment of the sponsors to the project varied over the seven-year period. Ultimately, Shell and Elf pulled out of the project almost at the end of the process, and they were replaced by Petronas and Chevron. Another fact of the oil project worth mentioning
is that the World Bank was called upon to provide loans to the project within an overall project finance context. I will come back to the significance of this point later on.

In 1993, Chad was emerging from a period of civil war and various coups that had characterized the 1980s and early 1990s. The Bank’s view on the development challenge in Chad was that there were three major constraints facing Chad. The first constraint was a limited financial base, very limited fiscal resources, and a small economy. The second was a limited institutional capacity. The third constraint was an overall situation marked by insecurity. This characterized the situation in Chad in 1993.

The World Bank evaluated the proposed oil project from its own perspective. In particular, we were looking at the link between oil projects generally and our development mandate. There had been very few successful precedents in transforming oil into sound development, in particular in developing countries. There was equally a great deal of skepticism in the international NGO community about the ability to transform oil into development. There was also a lot of skepticism within Chadian society itself about its government’s ability to handle this project.

The final point that I would like to make is that there were no strong geopolitical considerations supporting the project. The Chadian situation was different from projects in other parts of the world, such as Central Asia, where there has been strong G7 geopolitical support. This was something that was not present in the Chadian case, and it had an impact on our dealings with many of our key shareholders.

In terms of the oil project, one of the challenges we faced was meshing the different objectives of the key players. The Chadian government’s interest was to develop its oil resources as quickly as possible. At the same time it wanted to protect and promote a variety of interests. Development was its stated objective, but clearly oil would provide an opportunity to enrich the country. The oil companies wanted to develop the oil resources quickly and wanted to mitigate political risks, but they also wanted to do this within a context in which they were optimizing their global strategy. The reason I mention this point is because while the project evolved, Elf, for example, merged with Total Fina and at the end was perhaps not as interested in the project as it had been at the beginning. Shell also seemed less interested as time passed, perhaps because Nigeria reopened as an opportunity. Having said that, ExxonMobil, the lead sponsor, remained committed to the project.

As for the World Bank we always said that our objective was not to get oil out of the ground, not to generate money, but rather to transform oil revenue into poverty reduction and development and, at the same time, to ensure sound environmental and social management. We also wanted to do this in a way that responded to the project’s communications dimension—communication with the World Bank’s external partners, whether countries, shareholders, or NGOs, as well as the communication and the social interrelationships within Chad itself.
From the sponsors’ perspective, the World Bank was a key political risk mitigator, and its participation was stated by the sponsors as a precondition for their willingness to invest US$3 billion dollars in this project. This provided a key source of leverage for the World Bank in its discussions about the need for a revenue management program. The Bank stated clearly to the oil companies and the Chadians that, given that development was the Bank’s key objective, the revenue management program was a precondition for its involvement. In addition, another Bank precondition was that there had to be satisfactory macroeconomic frameworks in both Chad and Cameroon.

When it came to the development of the revenue management program itself, the set of players was different from those for the oil project. The key players were the Chadian government, including its president, the ministers, as well as opposition parties within Chad, and the parliament. The second key player was obviously the World Bank team, which comprised experts specializing in a variety of different disciplines, all of whom had an impact on the way this process was carried out. The team included macroeconomists, political economists, lawyers, project finance experts, and experts who were focused on social aspects, civil society, and institutional development. At the same time, the Bank team was working very closely with colleagues in the IMF who had a major impact as well on the development of the program and how it played out. The third critical parties were NGOs and civil society, in particular NGOs and civil society within Chad, but also international NGOs and international civil society.

I would like to briefly go over the process that was actually followed in the development of the program. As I said, it stretched out over a five-year period. The first key step was raising an awareness within Chad and within the Bank, learning the lessons from other countries’ experiences and the hurdles faced in transforming oil into sustainable development. In the very beginning, the Bank stressed to the Chadian government that its interest in doing this project was to reduce poverty. The Chadian government said that this was its interest as well. Chad’s representatives repeatedly conveyed the message that theirs was a very poor country and they wanted to spend the money on education, health and social issues. But the Bank team would caution that its experience demonstrated that in practice it was not so easy. So part of the issue was to increase awareness within Chad that it wasn’t simply a question of taking a lot of money and spending it in a poor country, and all of a sudden poverty would be alleviated. With this goal in mind the Bank organized a seminar at its headquarters in early 1996 to discuss these issues with the Chadian authorities.

But at the same time, to be frank, we at the World Bank also had to raise our awareness and analyze and internalize the lessons. As I said, we are talking about 1993, 1994, 1995, and at this point there was an attempt to see what was happening in other countries and what lessons we could draw upon. For example, we looked at what was going on in some of the countries neighboring Chad. We saw that it was critical that local populations felt they were being treated equitably. In another country a parallel fund had been set up ostensibly to protect the oil revenue from misuse, but a definite lack of transparency undermined the effort. In other parts of the world, as well, the lessons pointed to caution. One country, which seemed to have
successively limited corruption, had not succeeded in getting the development push it had anticipated. We also looked at large revenue projects outside the oil sector, including water. In one case the government established a fund that was managed by a parallel but smaller parliamentary type institution designed to run the fund in an efficient manner. However, in practice this created a situation where there were two parallel parliamentary systems for budget allocation, and the management of the fund ended up being even more politicized than under the traditional parliamentary structure.

There was a whole period of shaping our objectives, and this stretched out for several years within the Bank. We were trying to figure out exactly what it was we were looking for in terms of the revenue management program. From my own perspective the basic objective was to have the bulk of the revenue used to finance effective expenditures in the poverty sectors.

Another issue the Bank had to look at was overall macroeconomic stability. Oil is always interesting because it is always viewed very much as a national resource belonging to everybody and it generates a lot of emotions. The expectation within the Chadian society about how their oil was going to be used—whether there was going to be private capture of the national resource or not—was one of the aspects the Chadians and the Bank had to deal with. That was a critical element, as was putting in place a system that would provide for safeguards to ensure that the money was spent properly but also in a way that did not destabilize the economy by overspending. We worked with our Chadian partners to develop a system in which there would be safeguards.

Then we went into a phase of trying to develop the actual principles. The World Bank’s approach changed over time. The Chadians had become more aware that it was not simply a question of stating that they wanted to spend the money on education and health; but it was the question of spending it well, protecting the rest of the economy. There were very difficult moments in our dialogue with the Chadian authorities partly because, as the World Bank team was thinking through what it wanted to do, I think, the Chadians viewed us as vacillating in some sense as to what we wanted to do, and that perception was probably fair. At the same time, there were difficult discussions between the Chadian government and civil society, but the discussions were also constructive. One thing that the project and the program helped to do was to encourage a greater deal of discussion within Chad. In some ways that was part of our objective, as I think the World Bank in this period started to recognize the importance of dialogue and the importance of greater stakeholder participation. Then the last aspect was the discussions between the World Bank and the NGO community.

In about 1997, after about three years of thinking about the issue, the Bank finally had a proposal that it was ready to submit to the Chadians, which it did. The sides then entered into a relatively short period of negotiations. The key elements of the revenue management program were really worked out over a short period thanks to the extensive preparation and discussion that had preceded this point in the process.
One thing that I want to come back to is the modeling issue, which was discussed yesterday. Modeling was a critical part of the negotiation process. We had to understand how much of the revenue would be royalties, how much would be dividends, and how much would be taxes. The Chadian government had a different view on how taxes should be treated. It viewed them as traditional government revenue as opposed to royalties and dividends, which it viewed as the product of the oil project itself. Understanding the modeled revenue components facilitated these discussions.

Following the successful negotiations of the revenue management program in 1998, the Bank came to an agreement with the Chadian government on the elements of the revenue management program. I will come back to the key elements in a second. Following that, the Chadian government prepared a law that was adopted by the parliament in December 1998 to reflect some of the key elements. After that, we had to work through a lot of the implementation details.

At the same time, we were working with the Chadian government on the development of complementary capacity building projects. It was clearly recognized that, if the objective was to get poverty reduction from oil, it was a question not only of having an agreement on how those resources would be allocated but also of ensuring that those resources were in fact used in productive activities—thus the importance of the capacity building projects.

In terms of the guiding principles of the program, the first is the allocation of the bulk of the petroleum revenue to six specified poverty sectors: education, health, rural development, infrastructure, environment, and water. Transparency was a critical element. The funds would come in through segregated accounts, so that it would be possible to identify how much oil money was coming into the system; a variety of monitoring and auditing mechanisms were also to be set up. The third point was the integration of the programming of these funds within the overall budget context. The idea was that the Chadian government and the parliament would adopt a single unified budget with part of the resources coming from the oil revenue and part of the resources coming from other traditional fiscal sources. This was something that was very much emphasized by the economists within the Bank as well as within the IMF. It was critical that Chad would not end up with a parallel expenditure decisionmaking processes or the like. This is a point that was touched upon earlier today as well as yesterday by other speakers.

The last thing was really an effort to balance a variety of needs and different priorities. As much as there was earmarking for critical poverty sectors, a minority of funds could also be used in other activities. The desire of the local population to see tangible benefits from the oil production activities in their backyard had to be balanced with the needs of the entire country. The balance had to be found between uses by the existing generation and uses by future generations. It was also important to ensure that Chadian civil society could play its role in the revenue distribution process; this was done in part by civil society involvement in an oversight committee. In addition, expenditures would need to be approved by Chad’s parliament as part of the traditional budgetary process. Provisions were made to also ensure
that there was an extensive dissemination of information. In that regard, it was very striking that before the revenue management law and the concessions were approved by Chad’s parliament, the Chadian government informed the population about the level of revenue that was expected. Another guiding principle was Chad’s repeatedly stated desire to ensure that it maintained sovereignty over its revenue. The government was very sensitive on this point. The last guiding principle was the World Bank’s involvement in the programming and monitoring of these funds.

Finally, I would like to give a quick overview of the terms of revenue allocation: 70 percent was allocated to specified poverty sectors, 15 percent to general recurrent expenditures in civil sector ministries, 10 percent to a future generations account, and 5 percent as a special supplementary allocation to the producing region. All these funds were to be allocated through the standard budgeting process, with auditing of the segregated accounts and civil society involvement at a variety of levels. But here, I think, it is important to note that the central piece of the program is not the fund but rather a system by which certain stated objectives are reflected in a structure that is designed so that the bulk of revenue is used to finance activities in the poverty sectors.

It is important to note that there are two components to the revenue management program. The first is the domestic component, namely the revenue management law and the regulation of the relationships among and between Chadian stakeholders. The second is what could be described as an external component, which is basically an understanding between Chad and the World Bank as an external party. Ultimately these are two interrelated and interacting components that can reinforce each other in a positive sense.

What are the keys to success? First, it is the government’s commitment to using the funds wisely or, at the minimum, its willingness to do so. In that regard, the quality of the dialogue amongst the Chadian stakeholders is a key, as is the equitable treatment of the variety of Chadian stakeholders. Strengthening capacity within Chad, in particular in macroeconomic management, is very important. The World Bank also has an important role to play. The quality of the guidance that the World Bank provides, as well as the quality of the dialogue between the World Bank and the Chadian NGOs, is very important. Ultimately, the main objective is to produce tangible benefits for Chad’s poor and move to a cycle that builds on success.

In terms of measuring success, some of the indexes of program success include the allocation of revenue as proposed—transparency; involvement of civil society; and effective and efficient use—which builds on the two points that the previous speaker discussed, reducing poverty and improving the social context. There is also an unstated political dimension here. Indices of failure are the misuse, misappropriation, and inefficient or inequitable use of revenue; a breakdown in dialogue amongst the Chadian stakeholders; and increased social tensions. If oil money is used badly, then the downside can be significant.

Looking forward, we are about to enter a critical period under the program. The oil pipeline and the field facilities are near completion. They should be finished by the middle of 2003. At that point, revenue will start to flow. They will be used, and we will enter a phase of
actual operation of the revenue management program. It is about to be tested. Significant stakes for Chad, its development and its social fiber are involved, but the stakes are also significant for the World Bank. Many of our external partners were extremely skeptical about whether this project made sense, whether Chad’s poor would benefit from this, and so the World Bank staked its reputation to some extent on success in this project and at this point is making every effort to ensure that there is a relatively happy ending. One of the key elements in that will be how the Bank manages the Chadian program, and on that note I am turning over the microphone to the country director for Chad, Mr. Ali Khadr.

Preparation for Implementation of the Petroleum Revenue Management Program in Chad

Ali Khadr, Country Director for Chad, Cameroon, and Equatorial Guinea, the World Bank

Thank you very much. It is a pleasure to be here today. I do have the pleasure of being the country director for Chad, Cameroon, and some of the other Central African countries. I should add very quickly that I am relatively new in my job. I have been on the job for only about two months. Nevertheless, as Philippe Benoit said, the implementation of the revenue management program for Chad is one of the key challenges that my World Bank colleagues and I are going to be facing over the next year or two, and it is clearly an issue of critical concern to us.

I would like to point out that I have changed the title slightly. I have realized that the title should more appropriately be called “Preparing for Implementation of the Petroleum Revenue Management Program in Chad,” because first oil and petroleum revenue have not started to flow yet, but they will soon.

I would like to start off by saying that two key messages will be the undercurrent of this presentation. The first message is that the issue of preparing for adequate petroleum revenue mobilization and for efficient and effective use of petroleum revenue is much broader than one might think. It really is a much broader issue than simply having in place financial controls and accountability mechanisms. It speaks to governments more broadly. It speaks to having adequate knowledge about poverty reduction, the causes of poverty, and what can be done about it. It speaks to outreach and participation issues, some of which I will touch upon. It is very important, I think, to get a sense that this is about much more than just training and putting accountants and financial managers in place.

The second message is that it is fair to say that the preparation efforts generally, and the capacity building efforts more specifically, have gone much more slowly and with much more difficulty than any of us had anticipated. The World Bank is staying on top of this and making sure that quick corrective measures are put in place. However, one lesson that I can
draw already at this stage is that one can never underestimate how difficult it is to create capacity for adequate petroleum revenue management in a developing country.

Let me just speak briefly about some of the starting parameters. I will not dwell on these, because Philippe has already sketched the Chadian context very well. In terms of timing, first oil is now expected to flow roughly speaking between June and August of 2003, and first oil revenue will start accruing to Chad approximately four to five months later. In other words, at the end of 2003 or beginning of 2004, Chad is going to begin receiving its first petroleum revenue. It is just a little over a year away.

As for the macroeconomic, setting the country has a program in place with the IMF under the poverty reduction growth facility. The country has a good track record of implementation over the past few years, but let us not lose sight of the fact that Chad is one of the world’s poorest economies. It is in a monetary union with some of the other Central African countries, it has a very competent Central Bank that gives the country the advantage of a low inflation environment and good monetary management, but there are two major drawbacks that I would like in particular to point to.

One drawback is that currently this is a country that mobilizes roughly only eight percent of its gross domestic product in the form of tax and nontax revenue. That is about one of the lowest ratios in the world. I do not know any ratios that are lower than that. Possibly Haiti and the Central African Republic are two countries that come to mind. To place petroleum revenue into context, this revenue in the first years of oil production will add about another four percentage points of GDP to the eight percent of the revenue currently being collected. This translates into about a 50 percent increase in total revenue in the first two to three years of petroleum revenue flow.

The other problem about the macroeconomic setting is that the sources of growth are extremely limited in Chad. There is a very weak private sector, and just about every constraint to private sector development one can think of is there: a weak infrastructure, a weak regulatory framework, all sorts of barriers to domestic investment, lack of financing. It is very important to realize that, at the moment, virtually any activity outside of the oil sector in terms of economic growth potential is extremely limited.

I would also like to say a few words about the social and political setting. Again, Philippe sketched that quite comprehensively. What is important to remember is that this is a country that has been out of full-scale civil war and civil strife for only about a decade. It is still on the path to recovery. There is still a lot of tension with factions in the northern part of the country. Insecurity, although the situation has improved compared with what it was several years ago, is still pervasive. There is always this underlying risk of military spending. This is something the World Bank is concerned about right now, because in recent weeks there seems to have been some increase in the number of clashes with northern factions. Social indicator levels in the country are very low. This is a country where roughly 80 percent of the population
still lives in poverty on less than $US1 a day. So, it is important not to forget this context. Chad is one of the least developed countries in the world.

The strategy that has been put in place to prepare for the implementation of the revenue management program is very multifaceted. Part of it is a comprehensive and, as it has turned out, a very ambitious capacity building program. It also includes a broader policy dialogue on governance, an intensive focus on poverty reduction and the dialogue within the assistance program the World Bank has with Chad. A major part of the dialogue within the assistance program has been focused on economic diversification—what is this country going to be able to do besides oil? Then there are efforts and programs to increase public outreach and to develop democratic institutions, and I will come back to this at the end. There is a multiple layer supervision and oversight structure for this whole preparation effort for the revenue management program.

Philippe briefly alluded to the capacity building program. I think it is important to point out that there are two parallel building projects in place in addition to the petroleum development and the pipeline project, in which the World Bank and the IFC are participating and for which the major financing comes from the consortium lead by Exxon Mobil. One of them is a US$24 million project funded by two funds, called the Petroleum Sector Management and Capacity Building Project. This project’s goal is to build capacity for technical and environmental matters, both specific to the Doba region, which is the oil producing region, and the Doba oil project, but also more generally to the petroleum sector.

Then there is another project of roughly US$17.5 million dollars, “The Management of the Petroleum Economy Project,” which focuses on mechanisms for the effective mobilization and use of petroleum revenue. Philippe has already discussed a lot of the design issues, the petroleum revenue management law, and the offshore account that is being set up. The major components of this project are to strengthen Chad’s financial management capacity across the board, including ministry of finance, treasury mechanisms, budget making mechanisms, financial management procedures in the government, and procurement procedures. The project also aims at strengthening mechanisms for the oversight and control of the use of petroleum revenue by the auditor general’s office, which is an offshoot of the supreme court in Chad, and an independent oversight committee (I will come back to this). Known in French as the college de surveillance, this is an independent committee that comprises members of government, civil society, and the private sector. The committee is supposed to be an independent body that exercises oversight and monitors the mobilization and the use of this petroleum revenue.

A very important component in the Bank-Chad dialogue is an assistance program to the Chadian government. This program is more along the lines of analytical and advisory services that the World Bank provides to Chad, and it has to do with public expenditure management. A public expenditure review exercise in health and education is done annually with the support of the World Bank and is getting into some of the other priority
sectors like justice. The focus is on both content and policy issues in the allocation of expenditures but also on what is called budgetary institutions, and this speaks to the three levels: aggregate fiscal discipline, strategic prioritization, and value for money. Are the right institutions in place to make sure that those outcomes are achieved? In terms of public expenditure, tracking survey instruments have been put in place in the education and health care sectors in order to try to get a sense of a dollar that starts out being budgeted and is channeled through the system. How much actually ends up at the service delivery end of things? How much do schools, how much do local health care centers end up getting? The answer can very often be quite discouraging. So this is the capacity building aspect of it.

There is a very major portion of the World Bank’s program with Chad that has to do with a broader policy dialogue on governance. Procurement reform is a major part of it. Recently the World Bank team prepared a country procurement assessment report. The detailed recommendations for procurement reform derived from this report are being taken up now in a structural adjustment credit.

More broadly, the country has been doing a lot of work to create a good governance strategy with the assistance of the World Bank and other bilaterals and multilaterals. That strategy has to do with everything ranging from procurement and financial management procedures all the way to transparency procedures and things like putting up websites to make sure that major government audits are published and are available to the public in a timely fashion.

The Bank is supporting a fairly substantial civil society capacity building effort. Its aim is to increase the capacity of participatory mechanisms at the grass roots level, in particular in relation to the allocation of financing for local initiatives that are provided through some of World Bank’s project mechanisms.

Included are some dimensions of civil service reform that attempt to move the civil service sector toward a performance-based promotion system, to consolidate payroll and civil service census and, on a limited basis, to restructure government departments and strengthen staffing in critical areas.

The World Bank is also working with the parliament. The goal is to train parliamentarians to better examine and hold the executives accountable, particularly in the finance area. There is also a country financial accountability assessment—looking at financial management procedures—in process.

A critical part of preparing for the onset of petroleum revenue and its adequate mobilization and use is, of course, developing a poverty reduction strategy and gaining a better understanding of the critical link between what is needed to reduce poverty and the public expenditure that will be enabled by the added revenue from petroleum. Here the World Bank team has been doing a lot of work with the government on the preparation of strategies in the priority sectors such as health, education, transport, and rural development. Again, the ultimate
goal of this exercise it to gain a better understanding of the link between the desirable outcomes in terms of improvements in these sectors and poverty reduction and public expenditure; to gain a better understanding of why public spending is in many cases not that effective; and to consider how the effectiveness can be improved. We introduced public expenditure review exercises on an annual basis in the education and health care sectors, again to better understand the outcomes that result from public spending in those sectors.

The country has been working for the past two years on its poverty reduction strategy paper. That has provided an extremely important framework for putting together a broad and comprehensive poverty reduction strategy. One of the notable features of the Chadian poverty reduction strategy paper exercise is that the participatory process has been extremely good. Virtually all segments of the Chadian society, including at the grass roots level, have been able to participate in this exercise and add their input.

Another critical part of preparing for the onset of petroleum revenue and ensuring that it is adequately mobilized and used is to make sure that the extra economic boost that the onset of petroleum brings about also brings the nonpetroleum economy along with it. One has to be thinking very early on about economic diversification issues. Here are three items that I would like to bring to your attention and that are an integral part of our program.

First, IFC has an initiative that is just beginning to support small and medium enterprises by channeling financing for small and medium enterprises through the Chadian banking system. We are involved in a major way in reforms in the cotton sector and the electricity sector. The electricity sector is particularly critical, because this is a country where the generation capacity falls extremely short, and where there are still very frequent load shading, blackouts, or brownouts. In that type of environment small and medium enterprises in particular just do not have access to this major item of infrastructure, and this hinders their development.

There is also a program financed by an institutional development fund grant for the Chadian Chamber of Commerce to build the capacity of potential small and medium enterprises through, for example, schemes to help them establish business plans, mobilize financing and so on. We can already foresee that this issue of economic diversification has to be dealt with quite upstream and that it is going to require a lot of effort.

Providing technical assistance to increase the public outreach and strengthen democratic institutions is also very important. It is a dimension the importance of which has increased progressively for the World Bank Group. All along the process there was an extensive consultation between government and civil society, communities, and other stakeholders, but that has probably increased in intensity since the implementation of the project started and as the onset of oil production draws near. Media outreach and local ownership of the poverty reduction strategy paper are extremely important aspects. There are many initiatives underway to bring the local communities into this whole issue of what the petroleum economy is bringing, how the country should prepare for it, and what issues that the country needs to deal with.
All of that is an extremely important dimension, and we are progressively ratcheting up efforts to address it. There is also technical assistance to parliamentary functions and civil society and training of parliamentarians. I mentioned earlier that the World Bank provides selective capacity building support to civil society. Finally, a local initiatives fund is in place, and a full-scale regional development plan for the oil-producing region is being prepared. The participatory effort, in particular the inclusion of local communities, is an extremely important aspect of that—one that has been very challenging, but one that we recognize increasingly as absolutely critical.

Now I would like to say a few words on the oversight and supervision of this preparation effort as we get into the implementation phase of mobilizing and using petroleum revenue. At the country level, there are two major bodies on which the principle focus will be and that we have to worry about strengthening in time for the onset of petroleum revenue: the auditor general’s office and the petroleum revenue oversight and controls committee. The petroleum revenue oversight and controls committee, or college de surveillance, consists of independent members who represent government, the private sector and civil society. The committee gives an added level of safeguard in terms of monitoring the mobilization and use of this revenue.

As for the World Bank Group’s supervision, the World Bank and the IFC have their own project teams, but they also have at the corporate level the corporate oversight committee, through which the World Bank’s most senior level management keeps very frequent tabs on exactly what is going on in the implementation of the petroleum and the related capacity building projects. It lends its full support to the project teams when problems are diagnosed and need to be fixed.

Finally, there is external supervision and oversight, which is very important. There is the International Advisory Group. This is an independently recruited group of very prominent experts, five in total, who undertake frequent visits to Chad and Cameroon to periodically assess the progress in implementing these projects and in moving toward the petroleum economy.

At the World Bank we also have, as many of you may be aware, an inspection panel. This is a body to which private citizens or concerned parties in relation to any World Bank project can take a complaint. The inspection panel has already received one complaint related to the petroleum development and pipeline project. That was about two years ago. The inspection panel’s investigation was only recently completed and reviewed by our executive board. Approximately two weeks after the completion of that investigation, there was an inspection panel request from concerned citizens in Cameroon. You can see that this is an ongoing process, and there is a constant probing and investigation of what is going on in these projects. And finally, there are of course the project sponsors, principally the consortium lead by ExxonMobil, exercising oversight in their areas of competence.
Let me sum up the major challenges. First oil is approaching very rapidly—as I said, somewhere between June and August 2003. First oil revenue will come four to five months later. The date is looming very close. Many of us are getting increasingly concerned that the capacity building efforts simply are not keeping pace. The challenge is determining where we need to ratchet up efforts and put more resources into making sure that the country is at least adequately ready for managing petroleum revenue.

Timely capacity building is the major issue, but there is also an issue of absorptive capacity. According to the petroleum revenue law, mentioned by Philippe, petroleum revenue is supposed to be allocated principally to the priority sectors of health, education, and rural development. It is not yet clear, although we are working hard on it, that there will be mechanisms in place guaranteeing that the expenditures quickly result in better education services being delivered, better health care services being delivered, and rapidly improved outcomes in those sectors. The issue of revenue oversight, in particular building up the capacity of the college de surveillance (the oversight and controls committee) is still a major challenge. Civil society awareness, I think, is something that we need to continue to work on, but it is also at the same time a major check and balance on the whole process, and this is a positive thing.

Then there is an issue of country risk. The country still has some conflict going on in its northern part, and there is a continuing risk of diversion of public resources to military spending. This is an area that, I think, we are going to have to keep a very close eye on and ensure that it does not sabotage the petroleum revenue management effort. Thank you, I will stop there.

Revenue Sharing in Petroleum States

Roy Bahl, Professor of Economics, Georgia State University

I am going to introduce a different subject—the question of the sharing of natural resource revenues between different levels of government. It is not a major issue in every country in the world, but, where it is an issue, it can be a very significant and very contentious issue. I wish to discuss what I think we have learned over a period of years about this subject.

I propose to discuss three issues. The first is the linkage between natural resource revenue management and intergovernmental fiscal relations, or fiscal decentralization. The second is a normative question: Should natural resource revenues be shared between the levels of government, and what are the nonemotional arguments about why they should or should not be shared? The third issue is whether there is a case for a subnational government natural resource fund. If so, how could it work? (See R. Bahl and Bayar Tumennason, “How Should Revenues from Natural Resources Be Shared in Indonesia?” May 2002. http://isp-aysps.gsu.edu/papers/ispwp0214.pdf.)

I would like to begin with four stylized conclusions. The first is that subnational government sharing of natural resource revenues is irresistible. It is going to be part of the policy
in most countries that have significant natural resource endowments. The only question is how well this sharing will be done. The second point is that natural resource revenue sharing ought to be done primarily with transfers, rather than with direct taxes by sub-national governments, and it ought to be done in a transparent way. Third, the focus ought to be on reimbursement for the cost of natural resource activities in regions, and on replacing an exhaustible resource. Finally, I think, there is a case for a subnational government fund to protect heritage, and I will try to make that case for you. Having said that, I cannot point to many countries outside the United States or Canada where a thought has been given to the creation of a heritage fund. I will not be discussing a country-specific strategy, but I do have some data from Indonesia, where I have been working, and what I have to say fits a lot of countries. I think that those of you who work in Russia, Sudan, or Nigeria certainly will recognize part of the story.

**Fiscal Decentralization**

First let us take up the question of the relationship between fiscal decentralization and natural resource revenue sharing. The idea of fiscal decentralization is to move government closer to the people. Fiscal decentralization has become a major policy initiative in many countries over the past two decades. One reason for this movement is the increasing number of democratically elected governments at the sub-national government level. Government policymakers believe that people could get better public service delivery under a decentralized system, because there would be much more accountability to local voters. One of the arguments for decentralization—one that does not receive a great deal of attention—is its potential as an instrument for conflict resolution. This is a link with natural resource revenue sharing.

We know that, in many countries, there are tensions between the regions and the central government. Sometimes the root cause of these tensions is ethnic; sometimes it is religious; and sometimes it has to do with simple matters of geography. Whenever such tensions exist, the question inevitably arises about whether the region has been treated fairly by the central government. This question arises particularly in the case of natural resources. Regional representatives might state the farmers’ question as follows: “Why should the federal government tax the heritage that belongs to the people of this region, and not return a part of it to them?” When there is a situation in which the ethnic and cultural tensions match up with the natural resource sharing issue, then a particularly difficult problem arises, and natural resource revenue sharing must become a part of the intergovernmental fiscal system. Thus, natural resource revenue sharing becomes an element in the nation-building objective of fiscal decentralization. That is the motive of the work that my colleagues and I have been doing at Georgia State University. It certainly fits the Indonesia story, where some of the disaffected peoples in the country live in the regions that are well endowed with natural resources.

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The 2001 decentralization initiative in Indonesia has been described by many as a “big-bang” decentralization. The central government passed responsibility for all but five expenditure functions to the sub-national governments, transferred nearly 2 million civil servants to the local governments, and all but eliminated the provincial level of government. Financing of local governments is accomplished by a general-purpose grant from the central government and by natural resource revenue sharing.

A few statistical facts are worth noting. One is that the amount of money involved in the extractive sector, and, thus, the potential for revenue sharing can be significant. United Nations statistics show that the share of the extractive sector in GNP exceeds 10 percent in 16 countries. This means that there will be keen competition between the levels of government for those resources.

The second statistical hypothesis that one might argue is that, if there is a larger extractive share, there will be a higher level of taxation in the country, and, therefore, more revenue to distribute among the regions. That turns out not to be the case. Countries with a larger extractive sector do not raise a higher level of taxes relative to GDP. (R. Bahl, and Bayar Tumennason, “How Should Revenues From Natural Resources Be Shared In Indonesia?” 2002.) What we do find in Indonesia, however, is a substitution of oil tax revenues for nonoil tax revenues. In other words, the domestic tax burden—including income, sales, and value added tax, and excises—has been kept low, because the government was able to tax the natural resource sector. In the minds of the people in the country, there is a transfer from those who live in regions that are rich in natural resources to those who are in the formal tax sector, and who benefit from the lower levels of income and consumption taxes.

Finally, is there a relationship between a heavy concentration of natural resources and decentralization of the government sector? There is such a relationship. Even after adjustments are made for the level of income, for population size, and for economic structure, we find that countries that have more natural resource wealth are significantly more decentralized. In a way, there is a kind of test of the market, indicating that countries that have greater natural resource wealth tend to decentralize more fiscal responsibility to their subnational governments.

The Case for Sharing

Why should natural resources be shared? There are four arguments that continue to come up. One can be called the heritage argument, and most observers think that it is probably the most persuasive. The story goes like this: the region and its people have been given a heritage in the form of natural resources. If this endowment is going to be exhausted, it ought to be replaced; there ought to be some structural adjustment of this region’s economy so

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that its people may rely on some other economic base in the future. A share of the proceeds from the sale of this resource could be used to finance the structural adjustment.

Related to the heritage argument is a more philosophical question: Who owns the natural resources? Both the regionalists and the nationalists are persuaded about their position on this. This part of the debate cannot be resolved by either economics or politics.

The second argument is a cost reimbursement story. A region that is home to natural resource activities is subject to environmental degradation. Moreover, it has to pay for a significantly different and larger infrastructure. Natural resource activities may have attracted a particular workforce to this region that may involve a social intrusion for which people living in this region want to be compensated. Thus, there is a cost-reimbursement argument for sharing natural resources.

A third argument about why natural revenues should be shared is that, if there is a formal system of sharing natural resources with the regions or the districts, this system can preclude “backdoor” approaches to revenue raising, that arise if the central government does not give the region what the region considers to be a fair share of the revenue. If there is no formal sharing system, then various types of transfer taxes, transit taxes, increased fees and licenses and a whole range of nuisance levies will be enacted, that create problems for those trying to invest in the regions. There are many countries in the world where this sort of fiscal mischief has occurred.

Finally, there is the issue of politics and national unity, the notion that the country can be held together if some kind of revenue-sharing scheme is in place, through which the disaffected regions can feel that they have gotten fair treatment: “Give me a share of the revenue, and we will use that as a basis to stop the dissension and maybe even the shooting.”

The Case Against Sharing

What is the case against the sharing of natural resources? The first argument is that subnational governments have no business at all tying their revenue streams to natural resources, because resource revenue is highly unstable. Certainly for Indonesia, GDP originating in the extractive sectors is more unstable than other sectors of GDP, and oil revenues are more unstable than nonoil revenue. Central governments are more able to deal with a revenue flow that is unstable than are local governments, precisely because the latter usually cannot borrow. Local governments cannot run deficits, and they provide more essential services that are not easily postponed.

A second issue has to do with the macroeconomy. Higher taxes on natural resources can address the national deficit issue, and they can help to keep the domestic tax burden lower. Moreover, shifting natural resource revenues to local governments would allow the latter (versus the national government) more latitude in directing investment.
Third is the question of equalization and fiscal disparities. Natural resources are geographically concentrated. If natural resources are allocated according to where they are extracted, there will be significant disparities in local government revenues. In the case of Indonesia, some local governments received relatively little, while others received three times their budget in one year. Some would argue that such large disparities are not good public policies. Moreover, there can be some perverse distribution effects. For example, in Indonesia, the distribution of natural resource revenue sharing was inversely related to the concentration of poverty.

A major reservation about sharing natural resource revenues with local governments is that they will squander the money. One concern is that subnational governments do not have the capacity to deliver many types of public services at adequate levels. Another is that corruption is a major issue at the local level. A third concern is the windfall issue, that is, there is no capacity to absorb such a large amount of money in so short a time, and local leaders might choose to spend the funds unwisely. For example, the funds might be invested in activities that do not promote future income generation, or they may be invested heavily in government and nontradables, thereby crowding out some future growth in the export sector.

Policy Choices

What are the options for building an intergovernmental fiscal system for natural resources? First, any government facing this issue must decide on both the vertical sharing arrangement and the horizontal sharing arrangement. The vertical share is that percent of total natural resource revenues that will be allocated down to the subnational governments. Normatively, one could argue how much this should be: it is the amount of money that needs to be invested to restructure the economy for the loss of the exhaustible resource, plus the compensation for the environmental degradation, plus the value of eliminating social unrest. This is a first set of guidelines for thinking about establishing the vertical share.

In fact, these guidelines for establishing a vertical share are conceptual, and they are not easily quantified. There is some cost of a higher vertical share, however, that can be quantified. For example, what vertical share might be affordable if we did not substitute natural resource taxes for other taxes? If we were to drop the taxation of natural resources for general budgetary support in Indonesia, for example, the ratio of tax to GDP would have to rise by about 2.2 percent. Many would argue this to be a far greater cost than should be paid, and would therefore argue for a much smaller vertical share.

The horizontal sharing arrangements refer to the way the natural resource revenues are allocated among the local governments. In most countries which share natural resource revenues, it has been done on a derivation basis. The idea is to return the funds to the origin of collection of the natural resource tax.

Should we allow local governments to tax natural resources? The general answer is, “No.” The goal is not to allow local governments to have broad-based taxes on the
natural resource sector. One of the reasons mentioned in this conference is that countries need an overall tax regime that is conducive to the kind of investment policy that is desirable for the country.

Is special autonomy a good idea? In Indonesia, the central government negotiated a special agreement with Aceh and West Papua, and this is a good idea, in the sense that it is a way to recognize the differences between provinces in a country. Aceh is further along in using up its natural resources, while West Papua is just beginning to exploit its natural resources. Surely, it would be right to tailor such revenue sharing agreements to reflect those differences. However, the problem with special autonomy arrangements is that they never go away. The regions with special autonomy are like professional athletes. They want to renegotiate their contract when they think their bargaining power is greater. Special autonomy creates a situation in which everyone who has natural resources sooner or later will come to the door and point out that they indeed are “special” themselves. As a result, the country ends up with a system that is not transparent or stable, and which is subject to negotiation. Thus, while special autonomy is an easy thing to accomplish, it is a difficult thing to maintain.

The last issue is whether there should be a heritage fund for a subnational government in a developing country. Much of the discussion about central governments went toward questions of revenue stabilization. In the case of subnational governments, I think that this is not the key issue. Rather, the key issue is about replacing the exhaustible resource with another economic base. When the resource is gone, what will be the revenue base of that place? Here are the two problems:

On one side, there is a high probability that the windfall revenues that come in now will be squandered by the local government. They would not be spent on things that, in the long run, will lead to a restructuring. They may be treated as simply another source of current revenue.

On the other side is that the local governments do not trust the central government. The view, especially of the disaffected regions, may be that, when the central government offers to “save” that money for them (as was suggested), they do not believe that the money will ever find its way back down.

In Indonesia, the current arrangement for natural resource sharing is that the money is allocated to the local government with no strings attached. It is not at all pointed toward replacing an exhaustible resource.

What could be done? Let us take the case of Indonesia. A heritage fund can be created. What would be the characteristics of a heritage fund? There would be a regular set of payments of natural resource revenues, in terms of an established vertical or horizontal share for each district. A commission could decide this amount. The Indian model of a grants commission might be considered, or the Australian model could be used. How could the central government be made to follow up on the promise to pay the money into the fund? As we know, in many
countries, payments to such funds have been a problem. The money would have to be earmarked for pre-approved development projects. For smaller recipients, it could work as a conditional grant program. For larger recipients, it would have to be part of a larger development strategy, and it probably would have to be tied to a loan program in the long run. The financial architecture would be a challenge.

In a country like Indonesia, it seems unlikely that the central or local government could be agreed upon as the manager of the fund. And finally, I wonder how a subnational government fund could be managed directly or indirectly by a third party.

Thank you.

Petroleum Revenue Management: The Nigerian Perspective

Honorable John Udeh, JP, FIMC

Introduction

The issue of oil mineral resources and petroleum revenue in Nigeria has come a long way. From a modest start of about 5,000 barrels of crude oil per day in 1957, the country now has the potential of producing well over 2.4 million barrels a day. In the same vein, the revenue accruing from oil has run into billions of naira over the years, as shown in Table 5.1 for 1981–1999. On oil mineral deposits, a recent publication by the Nigerian National Petroleum Corporation (NNPC) states that proven oil mineral reserves in Nigeria amount to over 32 billion barrels of crude, while the proven natural gas reserve is estimated at 260 trillion cubic feet. Further exploration is still being undertaken both onshore and offshore, within the Nigerian continental shelf.
From Table 4.2, we can see that between 1981–1999 about N2,889.69 billion, or US$228 billion, was earned from oil revenue in Nigeria. Compared with the total revenue within the same period, the predominance of oil as a source of revenue for Nigeria is clearly apparent. This has not always been the case, as available data from the Central Bank of Nigeria (CBN) show that nonoil revenue contributed over 70 percent of the total revenue up to 1970, but declined steadily thereafter. This may be the reason why some have concluded that this reliance on crude oil revenue has led to a relative neglect of the other sectors of the economy and created a mental attitude of easy money and carefree spending.
The Principles of Revenue Sharing in Nigeria

In the history of Nigeria, starting from 1946 to date, nothing has sparked more constitutional, political and legal controversies, and sometimes violent clashes, than the issue of revenue sharing and management. This situation has been aggravated by the recent crisis in the Niger Delta region (that is, the oil producing states) because of their protest about the inadequacy of their share of the revenue from oil mineral produced from the region. They have therefore pressed for more control of the oil mineral resources in their area and for the formula for sharing the oil revenue to be made in their favor through the principle of derivation. Some states and individuals argue that the Federal Republic of Nigeria owns all the oil mineral resources and for this reason the entire federation should benefit equally from the revenue accruing therefrom, particularly given the strategic position of oil revenue as the mainstay of the Nigerian economy. The current constitutional provision, however, is that “the principle of derivation shall be constantly reflected in any approved formula as being not less than 13 percent of the revenue accruing to the Federation Account directly from any natural resources.” This is a clear recognition that oil-producing areas should be appropriately compensated for the ecological pollution and degradation of their environment from oil production.

Pre-Independence Period (1946–1959)

During the colonial period, from 1946–1959, three commissions were set up on revenue allocation. Thus in 1946, when the country was administered as a unitary system, Phillipson Commission was set up to determine the allocation of national revenue among the three regions that were then in operation. Phillipson’s recommendation, which was based on the principle of derivation and even development, operated between 1946 and 1951. From 1951–1959 two other revenue allocation commissions were set up. They were Hicks-Phillipson (1951–1953) and Chick (1953–1959). Thus, revenue allocation in Nigeria had been a serious policy/political issue even before the country formally became a federal polity in 1954. The allocation criteria during the colonial period were principally based on derivation, fiscal autonomy, and need. The vertical sharing formula was 80 percent to the federal government and 20 percent shared among the regions.

The Post-Independence Period (1960–1968)

This period witnessed three revenue allocation commissions: the Raisman (1958), Binns (1964), and Dinns (1968). These commissions operated between 1959 and 1967. (The Dinns commission operated through 1967, but made its recommendations in 1968.) The allocation criteria were:

- continuity of existing levels of service;
- basic responsibility of each regional government;
- population;
- balanced development; and
It was the Raisman Commission that first recommended that mineral producing regions should have the lion’s share of the revenue accruing from the mineral wealth. Accordingly, under the Raisman formula, 50 percent of oil revenue went to the region of origin, 20 percent to the federal government, and 30 percent to the Distributable Pool Account (DPA), which the state of origin also shared in addition to keeping personal income tax and receiving export duty proceeds on their produce. The Binns Revenue Allocation Commission, which was established in 1964, was simply a continuation of the Raisman Commission. In 1968 there was the recommendation of the Dinns Revenue Commission, whose criteria for revenue sharing were aimed at national integration. Dinns’s recommendations were, however, rejected.

The Military/Oil Boom Period (1967–1975)

This period witnessed a very rapid increase in oil revenue to the country and, with the Raisman formula still in operation, the oil producing regions got substantial revenue, while the other regions stagnated in revenue generation. The situation was further worsened by the structural reorganization of the country into twelve states during the Gowon administration. Against this background, between 1967 and 1975, the military introduced drastic changes by promulgating several decrees to adjust the revenue allocation formula they had inherited from the civilians. It increased the revenue share going to the federal government and reduced that going to the states. This created several basic problems in the revenue sharing scheme, as identified by Professor Oyovbaire in his paper, “Politics and Allocation of Revenue.”

The first problem was the glaring disparity in the social and welfare responsibilities of the states compared with those of the federal government. As Professor Oyovbaire analyzed, the revenue-yielding base of the states was small compared with that of the federal government. This situation could be remedied only by restructuring the expenditure of the states through a transfer of certain functions to the federal government or by giving more revenue to the states to deal with their constitutional responsibilities. The federal government took the first option by taking over some activities constitutionally assigned to the state (such as primary education, agriculture, road network, and broadcasting). The same period saw the federal government taking over the collection of major taxes, leaving the states with residual taxes. This further increased the dependence of the state governments on revenue collected and distributed by the federal government.

The second problem was that the operation of the principle of derivation in revenue allocation was undermined. On the whole, the principle of derivation suffered a major setback especially as it applied to mineral resources. In 1970, under Decree No. 13 of 1970, the sharing of mining rents and royalties became 50 percent of the Distributable Pool Account (DPA), 45 percent to the state derivation and 5 percent to the federal government. Four other major changes touching on excise duties on tobacco, export duties, import duties, and the basis of sharing the DPA were introduced. The vertical sharing formula remained federal government 80 percent and states 20 percent. These changes considerably enhanced the financial strength of
the federal government compared with the states as it enlarged the revenue transferred to DPA as well as introduced some measure of fiscal equalization among the states.

The above situation was worsened in 1971 by the federal government’s distinction between revenue from onshore and offshore production, taking 100 percent of offshore revenue for itself, thereby depriving the principle of derivation of much of its effect on the finances of the oil producing states. Again as a result of the OPEC price rise of 1973, the military government in 1975, under Decree No. 6, reduced the share of onshore revenue paid to the state of origin from 50 to 20 percent, while the federal government’s total share both onshore and offshore was paid into the DPA. The decree completely ignored the principle of derivation to the detriment of the oil producing states. This was the beginning of protest from oil producing states on the imbalances in the petroleum revenue sharing in Nigeria.

In 1979, prior to the second democratic regime, the military government appointed the Aboyade Committee to review the sharing formula. This committee recommended, among other things, that local governments should be accepted as having a right to a statutory share of national revenue. The government adopted this aspect of the recommendation and it was so enshrined in the constitution. Hitherto, under various constitutions, revenue allocation was solely a matter between the federal government and the states/regions as the position of the local governments was derived from that of the states. The Aboyade Committee recommended the following vertical revenue formula:

- Federal Government: 57%
- Local Government: 10%
- Special Funds: 3%

On horizontal formula the Aboyade Committee had a five point criteria that consisted of the following:

- Equality and access to development opportunities: 25%
- Minimum standard for National integration: 22%
- Absorptive capacity: 20%
- Independent revenue and minimum tax effort: 18%
- Fiscal efficiency: 15%
In the end, however, apart from accepting that local governments should have a statutory share of the Federation Account, other aspects of the Aboyade Committee recommendations were rejected on the grounds of being too technical.

In 1980, the Okigbo Committee was appointed to review the Aboyade recommendation. The committee came up with something different. It preferred the old system, which tied the finances of the local governments to the apron strings of the state. Using the total current and capital expenditure of each state as an index of revenue need, the Okigbo Committee revised the vertical revenue allocation formula as follows:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Federal Government</td>
<td>55%</td>
</tr>
<tr>
<td>State Governments</td>
<td>30%</td>
</tr>
<tr>
<td>Local Governments</td>
<td>8%</td>
</tr>
<tr>
<td>Special Fund</td>
<td>7%</td>
</tr>
</tbody>
</table>

On horizontal revenue allocation, the Okigbo Committee modified the five-point criteria of Aboyade and, instead, adopted a four-point system as follows:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Population</td>
<td>40%</td>
</tr>
<tr>
<td>National Integration</td>
<td>40%</td>
</tr>
<tr>
<td>Social Development Factor</td>
<td>15%</td>
</tr>
<tr>
<td>Internal Revenue Effort</td>
<td>5%</td>
</tr>
</tbody>
</table>

The novelty of the Okigbo recommendation lies in the inclusion of social development factor and internal revenue effort as criteria. The government accepted this report in its entirety.

This historical analysis shows how the restructuring of the allocation of revenue resources has helped to strengthen the position of the federal government relative to the states with more resources at the disposal of the federal government. Thus, the states have become largely dependent upon federally collected revenue, and this has continued to raise very serious political issues.

Thus, the period between 1967–1979 saw profound changes in the structure of authority over sources of revenue in favor of the federal government. At the time it was generally agreed that these changes fostered a much better and healthier growth of the federal polity and
economy. It was also made possible among other things the buoyancy of the total national revenue resources as a result of the oil boom and because of the monolithic structure of the military administration, which was dictatorial.

These military decrees formed the basis of the 1979 constitution on the sharing of national revenue resources among the three tiers of governments. This constitution required all revenue collected by the government of the federation to be deposited into an account, called the “Federation Account,” for distribution to the three tiers of government. Exceptions were proceeds from personal income tax levied on the armed forces, the police force, Federal Capital Territory (FCT) residents, and overseas employees of the Ministry of External Affairs. It also contained provisions for grants in aid to the states that required financial assistance. On the whole, the machinery for the sharing of the national revenue resources was quite flexible. The only problem was the concentration of fiscal power at the federal level.

With the advent of civilian rule in October 1979, after a lot of conflicts, including litigation, with intense debates in the National Assembly, extensive lobbying and complicated maneuvers, a new revenue allocation formula was enacted into law under the Allocation of Revenue Act No. 1 of 1982. The new formula gave the federal government 55 percent, states 30.5 percent, and local governments 10 percent and 4.5 percent on the whole to the oil producing states to be shared as follows: 1 percent for ecological problems caused by oil production; 2 percent on the derivation principle; and 1.5 percent for the development of mineral producing areas. This enhanced to some extent the financial position of the states while also providing some respite to the oil-producing areas after the serious financial handicaps they had experienced under the military regime. Subsequently, with increasing agitation from the oil producing communities about the lack of development of their areas, the federal government in 1992 established the Oil Minerals Producing Areas Development Commission (OMPADEC), with the mandate to address the difficulties and sufferings of inhabitants of the oil producing areas of Nigeria. This was indeed a laudable initiative. However, in the end, it was bogged down with corruption and mismanagement without substantially achieving the goals for which it was established. The OMPADEC was dissolved at the wake of the present administration and in its place the Niger-Delta Development Commission (NDDC) was established.

Provisions under the 1999 Constitution on Revenue Allocation

The allocation of revenue between the federal and state governments as well as the local government councils under the 1999 constitution is contained in Sections 162–168 and in items A and D of Part II of the Second Schedule. The following are the salient features of the fiscal arrangement between the federation and state governments as well as local government councils in Nigeria.

Sharing of Revenue Resources Through the Distributable Pool Account (DPA)

Section 162(1) of the 1999 constitution provides for a common pool of financial resources (called the Federation Account) into which is paid all monies to be distributed among
the federal, state, and local government councils in each state, on such terms and in such manner as may be prescribed by the National Assembly. Although this mechanism may look flexible, it is, indeed, not so if we consider the other provision under Section 162(2) dealing with the role of the National Assembly and the Revenue Mobilisation Allocation and Fiscal Commission.

Section 162(2) provides that:

The President, upon the receipt of advice from the Revenue Mobilisation Allocation and Fiscal Commission, shall table before the National Assembly proposals for revenue allocation from the Federation Account, and in determining the formula, the National Assembly shall take into account, the allocation principles, especially those of population, equality of States, internal revenue generation, land mass, terrain, as well as population density.

Provided that the principle of derivation shall be constantly reflected in any approved formula as being not less than 13 percent of the revenue accruing to the Federation Account directly from any natural resources.

We also have Section 162(5), which routes the share of the local governments from the Federation Account through the states and accordingly, subsection 6 thereof requires such (local governments) share to be paid into the State Joint Local Government Account, which according to subsection 8 shall be distributed to the local governments on such terms and in such manner as may be prescribed by the House of Assembly of the state.

In addition to what states will get through statutory allocation and shared taxes, the 1999 constitution also provides for federal grants to the states. Thus, Section 164(1) provides that “the Federation may make grants to a State to supplement the revenue of that State in such sum and subject to such terms and conditions as may be prescribed by the National Assembly.” These are grants of a general character aimed at augmenting the resources of those states that find themselves in financial trouble or mess due to natural disaster or simply to correct the disparity in services to the people of different states.

An Evaluation of Revenue Management in Practice

Nigeria’s current revenue sharing formula is summarized in Figure 5.1 below. The vertical formula gives the federal government 48.5 percent, states 24 percent, local governments 20 percent, and special funds 7.5 percent. The horizontal formula is shared as follows: equality 40 percent; population 30 percent; social development factor 10 percent; land mass and terrain 10 percent, and internal generated revenue 10 percent. Only federally collected revenue is subjected to this revenue sharing arrangement. The states and local governments keep whatever internal revenue they are able to raise themselves, but share in federally collected revenue. The reason for this is that virtually all the major taxes are federal taxes, and the revenue therefrom annually constitutes about 90 percent of the total revenue of all the three tiers of government in Nigeria (see Table 5.2).
Table 5.2: Revenue Collected by the Three Tiers of Government in Nigeria

<table>
<thead>
<tr>
<th>Tier</th>
<th>Annual Average</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Federal Government</td>
<td>90</td>
<td></td>
</tr>
<tr>
<td>2 State Governments</td>
<td>8</td>
<td></td>
</tr>
<tr>
<td>3 Local Governments</td>
<td>2</td>
<td></td>
</tr>
<tr>
<td>Total (all 3 tiers)</td>
<td>100</td>
<td></td>
</tr>
</tbody>
</table>

As the foregoing analysis has demonstrated, the complicated experience of the Nigerian federal polity (from unitary, to parliamentary, to military, to presidential systems) with the military regime playing a major role, has had a great effect on the scheme of distribution of revenue resources among the federal government, the states, and the local government councils. Consequently, these factors have contributed to overcentralization of financial power. The lot of
the states and local governments has not been a particularly happy one, as they operate under serious financial handicaps. It is because their share of the statutory allocation and their taxes are not sufficient to prosecute their development programs and provide the necessary social services that the constitution has provided other avenues (grants and loans) through which the federal government can transfer revenue to the state governments. Unfortunately, this arrangement has not worked satisfactorily.

Petroleum revenue management in Nigeria is faced with several problems. First, there had been leakages of oil revenue. Not all oil revenue finds its way into the Federation Account, even though under the constitution, all federally collected revenue is to be deposited into the Federation Account. Some of the oil revenue was paid up front into oil dedicated accounts that were earmarked for priority projects. Additional leakage also occurred in the conversion of the foreign exchange receipts into naira for deposit into the Federation Account. This had been particularly the case during the Abache regime.

As shown in Table 5.3, during 1994–1999, the federal government had been making upfront deductions from federally collected revenue before paying the balance into the Federation Account. These up front deductions are made for Joint Venture Cash Calls (JVCs), National Priority Projects, External Debt Servicing, Petroleum Trust Fund, and Stabilization Account. Altogether, these up front deductions have reduced the legitimate flow into the Federation Account by an average of about 52 percent annually during this period. In other words, over half of the funds which ought to enter the Federation Account failed to do so. States and local governments have thus been receiving annually less than one half of their legitimate shares of the Federation Account, which explains why social development has suffered drastically during this period.
Table 5.3: Nigeria: Transfers to Federation Account (1994-1999)

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Federally-collected revenues</td>
<td>143</td>
<td>354</td>
<td>417</td>
<td>452</td>
<td>424</td>
<td>667</td>
</tr>
<tr>
<td>Federal Govt. independent revenue (already included in item 1)</td>
<td>8</td>
<td>8</td>
<td>8</td>
<td>10</td>
<td>12</td>
<td>12</td>
</tr>
<tr>
<td>Legitimate Amount for Transfer to the Federation Account (item 1 minus item 2)</td>
<td>135</td>
<td>346</td>
<td>409</td>
<td>442</td>
<td>412</td>
<td>655</td>
</tr>
<tr>
<td>Actual Amount transferred to the Federation Account</td>
<td>86</td>
<td>161</td>
<td>179</td>
<td>208</td>
<td>189</td>
<td>262</td>
</tr>
<tr>
<td>Shortfall in transfer to the Federation Account (that is item 3 minus item 4)</td>
<td>49</td>
<td>185</td>
<td>230</td>
<td>234</td>
<td>223</td>
<td>393</td>
</tr>
<tr>
<td></td>
<td>(36.30%)</td>
<td>(53.47%)</td>
<td>(56.24%)</td>
<td>(52.94%)</td>
<td>(54.13%)</td>
<td>(60.0%)</td>
</tr>
</tbody>
</table>

Source: Derived from data in "Budget Briefings" by Minister of Finance and Federal Government "Approved Budgets," 1994–1999

In fact, over the years, the amounts going into the Distributable Pool/Federation Account have dropped sharply. These reductions were most disturbing from the points of view of state and local governments as they unfairly augmented the revenue of the federal government at the expense of the state and local governments’ share in the Federation Account. For instance, between 1994 and 1999, federally retained revenue was the equivalent of an average of 75 percent of federally collected revenue, as against the statutory share of 48.5 percent. Table 5.4 shows how the total revenue is derived, the various deductions made and how the balance is shared to the three tiers of government.
Table 5.4: Fiscal Operations of the Federation Account (1998 Budget Estimate)

<table>
<thead>
<tr>
<th>Description</th>
<th>1996 (N 'Bil.)</th>
<th>1997 Budget (N 'Bil.)</th>
<th>1997 Actual (N 'Bil.)</th>
<th>1998 Budget (N 'Bil.)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Oil Revenue</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>236 Crude oil sales, PPT Royalties, etc.</td>
<td>202</td>
<td>259</td>
<td>216</td>
<td></td>
</tr>
<tr>
<td>30 Other Oil revenues</td>
<td>41</td>
<td>27</td>
<td>41</td>
<td></td>
</tr>
<tr>
<td>266 Total Oil Revenue</td>
<td>243</td>
<td>286</td>
<td>257</td>
<td></td>
</tr>
<tr>
<td>151 Nonoil Revenue</td>
<td>161</td>
<td>166</td>
<td>167</td>
<td></td>
</tr>
<tr>
<td><strong>417 Total Oil and Nonoil Revenue</strong></td>
<td><strong>404</strong></td>
<td><strong>452</strong></td>
<td><strong>424</strong></td>
<td></td>
</tr>
<tr>
<td>Less</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>39 Joint Venture Cash Calls</td>
<td>45</td>
<td>45</td>
<td>55</td>
<td></td>
</tr>
<tr>
<td>44 National Priority Projects</td>
<td>53</td>
<td>44</td>
<td>54</td>
<td></td>
</tr>
<tr>
<td>44 External Debt Service</td>
<td>44</td>
<td>44</td>
<td>44</td>
<td></td>
</tr>
<tr>
<td>42 Transfer to Trust Fund</td>
<td>30</td>
<td>30</td>
<td>30</td>
<td></td>
</tr>
<tr>
<td>35 Transfer to Reserve</td>
<td>-</td>
<td>35</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>204 Subtotal</td>
<td>172</td>
<td>198</td>
<td>183</td>
<td></td>
</tr>
<tr>
<td><strong>213 Totally Federally Collectible Revenue</strong></td>
<td><strong>232</strong></td>
<td><strong>254</strong></td>
<td><strong>241</strong></td>
<td></td>
</tr>
<tr>
<td>Less</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>14 Federal Government Independent Revenue and VAT</td>
<td>20</td>
<td>24</td>
<td>26</td>
<td></td>
</tr>
<tr>
<td>20 Value Added Tax (States)</td>
<td>23</td>
<td>22</td>
<td>26</td>
<td></td>
</tr>
<tr>
<td><strong>179 Total Federation Account</strong></td>
<td><strong>189</strong></td>
<td><strong>208</strong></td>
<td><strong>189</strong></td>
<td></td>
</tr>
</tbody>
</table>

Distribution of Federal Account Revenue

<table>
<thead>
<tr>
<th>Description</th>
<th>1998 Budget</th>
<th>Actual</th>
<th>1997 Actual</th>
<th>1998 Budget</th>
</tr>
</thead>
<tbody>
<tr>
<td>Federal Government</td>
<td>-</td>
<td>48.5%</td>
<td>92</td>
<td>101</td>
</tr>
<tr>
<td>State Governments</td>
<td>-</td>
<td>24.0%</td>
<td>45</td>
<td>50</td>
</tr>
<tr>
<td>Local Governments</td>
<td>-</td>
<td>20.0%</td>
<td>38</td>
<td>42</td>
</tr>
<tr>
<td>Special Fund</td>
<td>-</td>
<td>07.5%</td>
<td>14</td>
<td>16</td>
</tr>
<tr>
<td><strong>179 Total</strong></td>
<td><strong>189</strong></td>
<td><strong>208</strong></td>
<td><strong>189</strong></td>
<td></td>
</tr>
</tbody>
</table>

Source: 1998 Budget Briefing by the Minister of Finance

The poor financial position of the states has been exacerbated by the general nonprovision of federal grants which, under the constitution, are required to be made to assist
states in distress. As has already been shown, Nigeria has not actually developed its system of federal grants to states, which, under the constitution, are required to address the problem of insufficiency of the state finances to cope with the expanding area of assigned services such as water supply, food, shelter, health services, and education at primary and secondary school levels. Usually, these services involve very huge amounts of money.

Effects of Debt Servicing and Joint Venture Contracts (JVCs)

The issue of debt servicing has been a major setback to the total mobilization of revenue accruing from oil and other sources in Nigeria. With a total external debt of about US$28.4 billion and an expected total annual repayment budget of about US$3.1 billion, the country is not likely to ever have enough revenue to meet its other obligations. Furthermore, with the rising interest on the principal loan amount as well as penalties and commitment charges on late repayment and withdrawals, Nigeria is not likely to pay off its debts in a hundred years.

On the JVCs, Nigeria is a weak partner, and there have been accusations of leakages of oil revenue as a result. Although the Nigerian government owns the oil wells, the crude is not under its custody. Similarly, the oil storage tanks are managed by the foreign partners. The Joint Venture Companies also supervise the lifting of oil and sharing of the proceeds. Though we contribute about 60 percent to the cash call, we do not have a robust mechanism to monitor the operations of the Joint Venture Companies, especially how they utilize our financial contribution to the venture. Again, our late response to the cash call often attracts very high interest charges and increases per barrel cost of production of our own share of the crude. Similarly, the JVC has a provision for local content in the oil production such as manpower training, succession plan, supplies of locally available raw materials and parts, but this is hardly ever adhered to, thereby leading to the repatriation of funds, which would have been spent in country. In a nutshell, Nigeria’s petroleum revenue suffers from undue external pressure, which also affects its management.

However, the establishment of the Revenue Mobilisation Allocation and Fiscal Commission with the responsibility for, among other things, “monitoring the accruals to and disbursement of revenue from the Federation Account, as well as reviewing, from time to time, the revenue allocation formula and principles in operation to ensure conformity with changing realities... advise the Federal and State Governments on fiscal efficiency and methods by which their revenue can be increased,” it is hoped that improvement will be made on the issue of mobilizing the total oil revenue and the effective management of the petroleum revenue.

Changes under the present Democratic Regime

Since the inception of the new democratic order in Nigeria in May 1999, the President of the Federal Republic of Nigeria, President Olusegun Obasanjo, has taken the following positive actions to ameliorate the fiscal relations of the three tiers of government:

?? State and local governments’ allocations from the Federation Account have been increase in line with the increase in oil prices since May 1999.
The constitutionally stipulated 13 percent derivation principle has been implemented, and the Niger-Delta Development Commission has been established and adequately funded to champion the social and economic development of oil producing states.

Since the Supreme Court judgment in April 2002, the treatment of external debt service as an upfront deduction from the Federation Account has stopped and only debtor states will suffer deductions at source from their statutory allocations based on the external debt service due from particular states, but this may pose other problems.

The so-called “National Priority Projects” have also ceased to be an item of upfront deduction from the Federation Account and such projects will instead be accommodated under the respective capital budgets of the relevant ministries.

These ameliorative actions already taken by President Obasanjo reflect a readiness to improve the revenue allocation regime inherited by him when he assumed office on May 29, 1999. They have also created a conducive atmosphere for further improvements in the system. In view of the foregoing, it is hoped that the Revenue Mobilisation Allocation and Fiscal Commission should seek to recommend a revised revenue allocation scheme that will:

- Complement and facilitate the ongoing democratization, fiscal federalism, and economic liberalization of Nigeria, which began after May 29, 1999;
- Reflect overall simplicity and easily understood fiscal arrangement;
- Avoid the mistakes of the past;
- Accelerate the pace of Nigeria’s development by fostering a healthy intergovernmental fiscal relation among the three tiers of government.

Conclusions and the Way Forward

We have seen the various factors that have had an impact on the sharing of revenue in Nigeria. Although the constitutional provisions for revenue allocation appear flexible, their actual implementation has generated a lot of heat, particularly from states and local governments. This is more a problem with the operation of the system rather than with the provisions of the constitution. Again, the problem is not lack of financial resources or financial regulations, but the management of these resources and the quality of governance—in particular the lack of transparency and accountability. In a report on Poverty and Welfare in Nigeria, jointly sponsored by the Federal Office of Statistics, National Planning Commission, and the World Bank, it was revealed that between 1970–1990, Nigeria earned about US$200 billion from oil revenue alone. Also, from Table 4.1, it is shown that between 1981–1999 Nigeria earned US$228 billion from oil revenue alone. Ironically, Nigeria is today classified as one of the poorest countries in the world. The question is; why is it that Nigeria’s huge earning from
petroleum is not translating into real development? The report painfully concluded that “Nigeria’s oil wealth has not been wisely invested to provide a sustainable stream of benefit to the poor.” The report is certainly correct because, as at 1996, the average per capita GDP in Nigeria is about ₦1046.4 (US$46.56 at the then going rate of ₦22.00 per US$1.00). At the current official market rate of ₦127.00 per US$1.00, this translates to about US$8.00 per capita, thereby putting Nigeria far behind other African countries like Zimbabwe, Ghana, Cote D’Ivoire, and South Africa, where there is little to no oil revenue.

One of the reasons for the above situation in Nigeria has been traced to budget indiscipline. There has been rapid expansion of overspending and extra budgetary spending to the extent that approved budget governed less than half of the total expenditures in some financial years. The height of financial recklessness was in 1992 and 1993, when the budget deficit was ₦39.6 and ₦107.7 billion, respectively. In the country today, the issue of fiscal federalism has become acutely problematic, largely because of budgetary factors, and not really as result of the basic scheme of sharing of revenue resources. Nigeria, indeed, is at a “crossroads.” The choice is between improving the welfare of the population and taking the country forward socially, technologically, and economically, or allowing the situation to deteriorate further, in which case, the irreversible consequences of continuing drift would drastically and catastrophically alter our national future. These underlying problems cannot simply be neglected. If we do not face them and deal with them now, they will sooner than later grow out of proportion and lead the country to an even worse situation.

One way forward toward ameliorating Nigeria’s present social and economic predicament is for the federation—the federal, state, and local governments—to agree on a comprehensive development framework that establishes a common agenda and a common focus for national development. First, the state and local governments should be made to take up fully their constitutional responsibilities of providing social and welfare services to the people. Therefore those functions that were taken over by the federal government because of limited financial resources of state and local governments, and which are best delivered at these levels, should be returned to them immediately. This would then justify increasing state and local government shares from the Federation Account. Another effective means of augmenting the resources of the states and local governments is by reviewing the tax powers of the three tiers of government to ensure the optimal exploitation of internally generated revenue possibilities at the state and local government levels. This will enhance their revenue bases to enable them to execute their socioeconomic programs without complete dependence on the Federation Account.

Second, governments at federal, state, and local levels must adopt policies of effective economic/financial management, which requires fiscal discipline and good governance. This would eliminate waste, mismanagement, and corruption, thereby making the constitutional provisions on sharing of revenue resources a veritable tool for addressing the complex and difficult problems of fiscal federalism. To this end my humble suggestion is that Nigeria should move fast and enact two important laws that will govern public expenditures and
intergovernmental fiscal relations. These laws, which we do not have at present, are the Public Expenditure Management Act and the Intergovernmental Fiscal Relations Act.

The Public Expenditure Management Act should aim at regulating financial management at the federal, state, and local government councils to ensure that all revenue, expenditure, assets, and liabilities of those government levels are managed efficiently and effectively; to provide for the responsibilities and accountability of persons entrusted with financial management in those government levels; to provide for monitoring and expenditure powers at different levels of government and to provide for matters connected therewith. The Intergovernmental Fiscal Relations Act should aim at promoting cooperation between the federal, state and local tiers of government on fiscal, budgetary, and financial matters; to prescribe a process for the determination of an equitable sharing and allocation of revenue raised nationally; to define the fiscal responsibilities of each tier of government and to provide for matters in connection therewith. The Intergovernmental Fiscal Relations Act in particular is very urgent in view of the current confusion on the status of the federal government relative to the states in Nigeria; especially on the monitoring of activities and fiscal management of state governments.

Third, as the World Bank Report *Nigeria Poverty in the Midst of Plenty: the Challenge of Growth with Inclusion* correctly observed, the challenge for Nigeria is not one of improving one sector or region at the expense of another, or of introducing policy distortions and inefficiencies in resource allocation to benefit one group at the expense of others, but to adopt growth and social service oriented policies that will enable all its inhabitants to improve their welfare.

Finally, it is about time for the three key players in the socioeconomic development of Nigeria, the government, the private sector, and the civil society at large, to join efforts and play their complementary roles in national development effort. For the government, the concern should be the maintenance of good governance in the polity. By this we mean total adherence to the constitution of the Federal Republic of Nigeria, democratic principles, the rule of law, respect for God and human rights, as well as making government business very transparent and accountable.

For the private sector, the way forward is to develop a real entrepreneurial culture that emphasizes hard work, investment, and savings. The private sector in Nigeria needs to become competitive locally and in the international markets. It should strive to upgrade its production technology, quality of product and services, and above all, its human resources at all levels.

The civil society at large can help in this enterprise by establishing positive norms and culture in which the national economy can grow. The people have the responsibility of engendering justice and peace by discouraging corruption and indiscipline in the society. The society can achieve this by rising and condemning all forms of questionable character, self aggrandizement, the above the law syndrome among the leadership, the craze for honorary
titles, conspicuous consumption and the acquisition and display of material wealth without evidence of hard work.

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Industry Perspective

Reg Manhas, Senior Advisor, Corporate Responsibility, Talisman Energy

Thanks for the opportunity to speak here today. I want to say a special thanks to Charles McPherson for considering me as a speaker. As senior advisor for corporate responsibility at Talisman Energy, I have been dealing primarily with our involvement in Sudan for a number of years. In my previous life, I was a chemical engineer and a lawyer. Now I do neither but my initial involvement in the Sudan project in June 1998 was on the legal side. For the past two and a half years, I have led Talisman’s Corporate Responsibility Department, which is focused primarily on the issues Talisman is facing in Sudan. But we’re a large company, with issues around the world, which I also focus on. However, today I would obviously like to
focus on Sudan and our challenges there, in particular oil revenue issues. My main focus will be on Talisman’s transparency and our role in Sudan. My focus is very much nontechnical and nonfinancial. I am not an economist, so I will be talking about the big picture here.

Talisman Energy, Inc. is a Canadian company based in Calgary, Alberta. We are the second largest oil and gas producer in Canada, producing about 450,000 barrels of oil a day around the world. Talisman was formerly called BP Canada, and therefore our pedigree is pretty much from BP. Many of our executives are former employees from the BP structure. BP sold Talisman when BP pulled out of Canada in 1992 and there was a name change to Talisman at that point. In 1992, Talisman produced about 40,000 barrels of oil a day. Since then our oil production has increased by a factor 10 in only 10 years. Out of all the Canadian based oil companies, we are regarded as the most international. About 50 percent of our production is based in Canada, while 25 percent of our production is based offshore in the North Sea. We are in fact the third largest operator in the North Sea. We also have some production in Indonesia, some formation of production and growth plans in Malaysia offshore and Vietnam and of course in Sudan. We have exploration activities in the United States, in Colombia, in Algeria, and in Papua New Guinea.

Our operations in Sudan defined our company, certainly in the United States. We have had a relatively low profile until recent years. It is interesting that Talisman’s operation in Sudan is only about 12 percent of our total asset base. We got involved in Sudan in 1998. The contracts with the government in Sudan were put in place by the current consortium in 1996. At that point in time the four companies that were involved were the Chinese National Petroleum Corporation, Petronas, which is a state-owned company in Malaysia, Sudapet, which is a state-owned company in Sudan, and a company called Arakis Energy, which was a very small Canadian company. Arakis, which had a 25 percent interest, ran out of money and could not fulfill its capital obligations under the agreement. It ended up in a sale mode before it defaulted out of the project and the partners simply could pick up the remaining interest left by Arakis as default. That is when Talisman stepped into the picture. We signed a contract with Arakis in October of 1998 to take over the 25 percent share of that former Canadian company. The structure of the consortium has remained the same in terms of percentage.

The operations are actually managed by a consortium company, which is known as The Greater Nile Petroleum Operating Company. It is a joint venture where each organization has representative employees in that operating company. The president is the designated Chinese position, the vice president is the Sudanese position. The most senior position Talisman has is the pipeline manager.

I should also point out that it is interesting to compare the Sudanese and Chad projects. When you look back at the formations of the Sudanese project in the early 1990s, from 1996 onwards, Sudan was very much out of the loop when it came to multilateral institutions. Sudan was not in the good books with the IMF or the World Bank and was under U.S. sanctions. When this project was initially formed and funded and came to its completion, it
was in a sense in a bit of vacuum when it came to the international multilaterals. We can see in this slide the leverage that has been exacted in Chad through the World Bank’s engagement, and that was something that was not the case in Sudan.

There is a huge concession area, about 12 million acres of exploration properties and operations. There are the other oil fields in Sudan run by other oil companies. Totalfina has an interest there, as does Lundin Oil. Petronas and CNPC have a number of other interests around the country. Talisman’s sole interest in Sudan is its 25 percent interest in this concession.

The project, as I said, first began in August of 1999 and reached approximately 140,000/150,000 barrels of oil a day fairly quickly and has increased over time to what it is presently—about 250,000 barrels per day. The plan for 2003 exit volumes is in the range of 290,000/300,000 barrels of oil a day.

We have dealt with a number of criticisms resulting from our operations in Sudan. One of the most intractable situations that we have had to deal with and respond to is that oil is fueling the conflict. It is a very common concern and it makes for good press. There has obviously been a conflict in Sudan for many years on and off since independence in the 1950s in fact. There was a relative period of peace from 1972 to 1983, but other than that, it has been a pretty conflicted country. There are many issues in Sudan in terms of the conflict. Issues of religion, race, resources, and power are generally oversimplified. There is the Northern Arab and Southern Christian dimension. It is much more complicated than that. There is almost a classic example of a conflict between the center of the country and all the other outlying regions of the country. Religion, while playing a big role back here in North America, plays perhaps less of a role than one would think in Sudan.

Most oil companies have two parts to the contractual arrangements with the government of Sudan: upstream and downstream. The upstream part, called the Exploration and Production Sharing Agreement (EPSA). It is a relatively standard contract when it comes to the production sharing agreement world, made up of two components, cost oil and the revenue stream called profit oil (40 percent of the oil is normally cost oil). That oil is given to the oil companies over a period of time at an amortized rate to repay capital expenditures in the project. At some point when the cost is recaptured, that oil would then move over to the government of Sudan. The profit oil component is on a sliding scale. It ranges depending on the production levels from 20 percent all the way up to 80 percent of the oil going to the government depending on how much oil is produced in particular blocks. Generally, the split between the oil companies and the government has been in the range of 2/3 to the government and 1/3 to the oil companies but that does vary depending on the specific blocks and the amortization period.

The downstream component of the project is called the Crude Oil Pipeline Agreement (COPA). This contract states that the oil companies have the franchise to the pipeline for 15 years. They charge a tariff on all of the oil that is going through that pipeline.
Normally charging tariff to sales and then to the portion going to the government that is transferred along that pipeline. After 15 years, that pipeline would revert back to ownership and benefits would accrue to the government of Sudan. The key thing here on the production-sharing contract the way COPA is built into this. There are no royalties or taxes paid by the oil companies. Oil is lifted and it arrives at the wellhead, and at that point, the legal division of the oil volumes occurs. The government gets its share of oil then oil companies get their share and we pump it along the pipeline at Port Sudan and each party has a right to lift its own oil at Port Sudan and make its own sales contracts and bring its own contracted tankers in and, most importantly for the oil companies, it allows us to keep our sales proceeds out of Sudan in the offshore banking system. That was a very key thing for petroleum companies but the important point there is no active payment by the companies. It’s just in fact the sharing of the oil volumes.

So how have we dealt with this criticism that oil is fueling the conflict—that we should be doing more to somehow solve the problem then simply leaving the country? We’ve been there for three years now and working very hard on a number of fronts. Though I am focusing on oil revenues, on the human rights front and the community development front, we have made great efforts.

First, we have had a level of advocacy with the government of Sudan. There has to be fair distribution of oil revenue for peaceful purposes in the country. We have brought to them other examples of regimes in the world where this is taking place. In fact, we have provided them with the Chad/Cameroon model to see if there is any attraction and we’ve had varying success on that issue. The strongest motivation that we have been able to push is that there is need for peace in the country and further development of the oil industry. Without a peace agreement in place, there will be no further exploration or production of the oil reserves. You’ll see decreased oil production over time. The government should be motivated and I would argue that the other side should be motivated as well too to share the so-called peace dividend. Again here, our mantra for a number of years is that oil should be viewed as a catalyst for peace in Sudan. That is our advocacy to the government.

Our advocacy or dialogue with the international community has been one of an open book. We have had obviously ongoing discussions with the diplomatic community in Khartoum, North America, our own government in Canada, the embassy in Khartoum, the U.S. State Department, and the European community in Khartoum about how we can be a petroleum management model. Though we cannot lead the processes, it’s always been our position that we can be part of the solution on transparency and leverage to the situation but it is not for us to create the model. We do not have the expertise obviously to do that. So we would hope to be part of the solution and we have made that very clear. I have been to Washington to meet with IMF people who deal with Sudan, as well just to provide some contacts and to see where we can be productive in a bigger picture initiative, again, an offer of total cooperation and information support.
The third prong has been our own community development project in Sudan. We cannot replace the government of Sudan; nonetheless, we need to show that there are some benefits to the local people in the area where our operations occur. The fourth prong that we have is bringing transparency to this project in terms of our corporate responsibility by reporting our oil volumes, and I will get into that a little bit later on.

Regarding our community development initiatives, again I have to be very clear that we are not an NGO. We’re learning as we go but we are not a replacement for the state. And that is a big concern that we do not want to become the infrastructure developers in Sudan. We are happy to take a role but we have to be very concerned, and there have been examples where there has been dependency created and we have actually allowed the government in some situations to step back from these obligations, and provided some cover for them through oil development. There are benefits to the people of the oil fields because all these hospitals and clinics are going in, but it has been the oil companies doing that. That is a commitment we have, but we do not want to supplant the government’s responsibility.

We have had a big impact in terms of the spending by the oil companies in the project. When we arrived in 1998, the total spending on projects for community development initiatives was about US$800,000 or less. The budget in 2002 was US$8 million. So we have increased that by a factor of 10. The operating company, GNPOC, spends some of that and all the partners share in the cost.

Talisman has its own separate community development program that we monitor and administer ourselves in Sudan and that’s about US$2 million. Our focus has been on health, water, and education. We have now added capacity building within the local people and we have partnered with some fabulous local NGOs and CBOs in terms of agricultural capacity building model farms, creating some of the highest yielding crops in Sudan. So there is potential in this country—great potential.

We are a company of entrepreneurs and business people and whenever I take projects to the steering committee, which consist of our President and our Vice Presidents of Legal and Operations, I have to demonstrate the business value to Talisman and how this builds capacity and sustainability. So, in that case we focus more on sustainable development than perhaps other NGOs who are focused on humanitarian aid. Again, we do not want to step into the role of government, and in Sudan we have particular political issues and a reputation issue with respect to working with international NGOs. There is a level of cooperation and communication on the ground, but when it comes to head office interactions and acknowledgements of working together, the political lines that have been drawn have precluded us from really working with international groups. But we have found many local NGOs and have helped to build their capacity in Sudan in terms of our projects.

On the issue of transparency, we have produced a corporate responsibility report since 2000. It is presently audited by PricewaterhouseCoopers. They have mainly been focused on Sudan and we are learning as we go but they are certainly transparent. We have
found it very valuable, and I think the civil society in Sudan has found it valuable as well. We have had many open houses in Khartoum and in the fields where we are trying to empower people in the country with information about this project and about oil revenues and all those things that they can now take to the next level.

Specifically, on the use of oil revenues issue, our report documents our advocacy efforts that I have walked you through. We have had a bit of evolution in terms of how we disclose oil revenues in Sudan. When we produced the first report in 2000, we were concerned about confidentiality issues. Obviously we can talk about issues that are related to Talisman specifically but when it comes to the government oil volumes, there are confidentiality issues that we had to face.

In 2000, we focused on the total benefits to the government of Sudan that accrued from our 25 percent of the project. It was a technical disclosure and Mr. Udeh’s point about readability and understandability perhaps was not fully achieved that year because of the way we reported our financial statements. We convert that number into a royalty number and tax number, regardless of whether it is a royalty structure in Canada or production sharing structure in Sudan, Algeria, or other places. What we have put in the report was the level of royalties paid to the government and the level of taxes paid, but it is very confusing, because I have just said earlier, that we do not pay those things so it is a conversion into the reporting format that the company does.

At the end of the day, there was a number, about US$300 million. So one could get the benefits to the government from our 25 percent interest and if you were clever, you could multiply by four because we have a 25 percent interest and you could come to a larger number that the government received. But it was not straightforward enough and it was unsatisfactory from my standpoint, so in 2001 we approached the government as part of our advocacy efforts and said we really must disclose the actual volume of oil that you received last year. We sold it to the government as a help tool, because perhaps the oil volumes that they have received and the benefit they received was less than what the media has said and perhaps what the NGOs are claiming. It was in their best interest to be transparent, and in the end we disclosed the actual amount of barrels the government of Sudan received in 2001.

The barrels that we reported were based upon the figures in GNPOC. In GNPOC, there is an extremely complicated computer modeling system that takes all the financial terms in the contract both upstream and downstream and on a monthly basis provides each company and the government with its volume that they received that month. It keeps a running ledger at Port Sudan in terms of the barrels that are stored. And when you receive a certain critical mass of volume at Port Sudan, you receive the go ahead to arrange for sale and bring in a tanker to take away your entitlement. Those barrels are in fact the actual barrels that the government lifted that year. This is actually what we put in the report. And I humbly think that this goes as far as any company has gone around the world in terms of being transparent and actually putting in the total amount of barrels that the government has received.
We are in a unique position obviously, but I think that we have come up with a unique response here as well. You will see in 2001 that the government of Sudan lifted a total of 32 million barrels of oil with an estimated value, based on the average FOB price that all of the oil companies received in Sudan in 2001, of about US$674 million, but if you look, the majority of the oil is in fact refined domestically by the government at their own domestic refineries, about 16 million or almost 17 million barrels. Again, I have put in an estimated value because the value was really the offset that the government was doing in terms of its own domestic import requirements that they would have had in the past. So I tried to put an estimated value on those. Then, when you consider Port Sudan: 12 million barrels actually of the government’s oil got to Port Sudan after all the domestic requirements. Of that, close to 5 million barrels in 2001 were repaid to the Chinese National Petroleum Company (CNPC) because in fact CNPC built the refinery in Khartoum. So over a period of years, they are going to have to repay that amount of oil back to the Chinese. At the end of the day, you are left with a net export number of 7.6 million barrels, which equals about US$150 million.

We have tried to be very clear as to how the oil is being used domestically and internationally, what the values were and this report was distributed widely in Sudan. It has been distributed to the media in Sudan, to an influential independent newspaper in Sudan. We have sat down with the editors and we have given them this information. We have provided it to civil society and we hope that this empowers people to then take the next step, which we can also be a part of but we cannot lead. “Oil is fueling the conflict” was a quote that I put up. And this quote that I am now putting up is our quote, and actually also is a quote from the Danforth report where Senator Danforth (a special envoy to Sudan) has talked about how oil could be a catalyst for peace.

Oil and resource sharing are the center of the ongoing peace talks in Sudan. As I said earlier, additional oil revenues are in conflict zones, so there will be no growth in the industry without peace. The U.S., to my great delight has now engaged in the Sudanese peace process in a big way over the last year and a half. The Center for Strategic and International Studies (CSIS) has been integral in that process in terms of providing recommendations on policy to the Administration and has also focused on the issue of oil. They have tried to create a baseline of the oil industry for the participants in the peace talks based in Kenya. We have made a number of presentations to CSIS and we have taken the numbers to that process and we have tried to empower that process with all the numbers to allow that peace process to move forward and allow both sides to understand what the future potential of the industry is. We have provided commercial information, geological information, and had an open door as to how we can be productive.

**Conclusions**

Use of oil revenues by domestic governments is an industry challenge, particularly for our company’s operations in Sudan. We have no control over the actions of the sovereign state. We can try, and we have had varying degrees of success in this area. The public and NGOs
demands for corporate response are always there, so you are sometimes dealing with unfair situations. We bring transparency to the equation, which is what an oil company can do especially in the type of framework that we find ourselves in Sudan. Corporate responsibility reporting, dialogue, and cooperation with the international community, and again each company in different periods of time in these countries’ processes are key when you look at what has happened in Chad and what has happened in Sudan. I am more than happy to answer any questions that you might have.

**Comments at the Open Discussion of Session 3: Revenue Distribution**

*James Bond, Director, African Region, Environmentally and Socially Sustainable Development Department*

What I am going to try to do is to run over what we have heard this morning, pick out one or two ideas, and then leave you with some thoughts and questions in order to launch a discussion on these topics from the floor.

What we have heard this morning was really about revenue distribution, the mechanisms of revenue distribution. As Christine Wallich indicated, when she opened the session, this is a contentious issue. This is also the issue that, I have noticed, is under evolution, and it is evolving very rapidly, new notions are coming up, and everyone is seeking the way forward.

Joel Turkewitz from the World Bank Institute spoke to us about public expenditure design and monitoring. He spoke to us about the fundamentals on how to spend the money wisely—not just oil revenues but generally public expenditure. He introduced three concepts: of aggregate fiscal discipline, which leads to having fiscal unity—one place where the money goes; allocative efficiency to ensure that the priorities are right; and operational efficiency to ensure that we get good value for money. The idea that he left with me, which I thought was quite interesting, was this notion of state capture—how states can be captured by the minorities or oligarchs or the like. I would like to compare that with what I have noticed in oil rich countries, and I would call that rent capture by institutions or organizations. For example, we know the case of national oil companies in some oil producing countries. They may be honest but they certainly are a state within themselves and they certainly have a different way of allocating the resources than possibly the fiscal mechanism would have had weren’t there that capture at the source.

Philippe Benoit spoke to us about negotiating the Chad-Cameroon revenue management program. This was a very interesting project supported by the World Bank. It had diverse objectives that evolved over time. The government wanted to develop the oil resources quickly, the companies wanted to mitigate political risks, and we at the World Bank wanted to transform these revenues into development. This has been a very long process that left me essentially with one feeling and that is: in a country like Chad, which is nearly a failed state, there
are real issues of sovereignty. The question I was left with was to what extent was this mechanism—the international oil companies and the World Bank working together—superceding the sovereignty of the Chadian state? And if this is the case, was that a good thing or was it the only way to go? There maybe a question of mission creep as we call it in the World Bank.

Ali Khadr, my colleague from the Africa region, spoke to us about implementing a public expenditure program: how this is actually going to be implemented in Chad. The oil is going to arrive soon. In June to August of next year the oil will start to flow, and the funds will start to flow by the end of the next year. And he left us all with a concern about what happens if the capacity building program is not able to catch up to ensure that there is a capacity to manage what is quite a complex system. That left me with the notion that in a case like this if a system like this were to fail (I hope it doesn’t and we in the World Bank would do everything we can to prevent it), but if it were to fail, who ends up bearing the cost? It is not the World Bank and it is not the oil companies but the people in Chad. Is there some way to ensure a better sharing of the cost of failure in a situation like that?

Roy Bahl spoke to us about revenue sharing in petroleum states and he actually did zero in on the Indonesian case. He spoke about sharing of revenues between different levels of government: national, regional, and local. There is this link between natural resource revenue management and fiscal decentralization. I think he put forward a very strong case for fiscal decentralization and for using revenue management as a process of fiscal decentralization. The questions he left me with are the following. First, I have not heard of a convincing way of knowing how to deal with the costs of the producing region. To what extent are these their resources? Second, if one starts to get into recognizing special groups, we could quickly get on the path that every person in the country belongs to a special group and has to have special treatment. This in fact is to some extent what has happened in Alaska and Canada, where some of the native peoples have had special royalties in mining, and this has led to the identification of a wide range of new ethnic groups that no one knew existed previously.

John Udeh spoke to us about his country Nigeria from a civil society prospective. I thought it was particularly interesting. He worked us through the mechanism and the way it has changed since the colonial times. Then he raised the key question: if the revenues flowing to Nigeria over the last 20 years are of about US$200 billion, why are Nigerians today in per capita terms poorer than they were 20 years ago? So this revenue management system which actually was quite well articulated has not led to the development of grass roots. That leads to questions about local governments’ ability to ensure development and the extent to which the local governments are actually representing the rights of the people on the ground, the local community. Isn’t there a state of local state capture at the local government level? If this is the case this local decentralization will not deal with the fundamental problem.

We heard from Reg Manhas from Talisman oil in Sudan, a complicated country. Talisman has really gone out of their way to introduce an important element that was not there
before and that is transparency in the use of oil. This is very much what the Soros Initiative is trying to introduce, and this is something that a small company like Talisman can bring to the table. The question I was left with is that there seems to be a lot of discussion with the Sudanese government, with the IMF, and with local NGOs, but I did not hear much about the discussions with local communities. That again leaves me with the question, whether we are missing the true ultimate beneficiaries, and to what extent the local communities are being left out of the system.

In finishing, I would like to stress again that this is an area that is evolving rapidly. There are two general areas which I would like to know more about. First I have not heard anyone today mention the key choice and that key choice is about who decides whether it is better to produce the oil now and use the revenues for development or to keep the oil in the ground for future generations? How can that decision be made? Because inevitably the governments will want the development now. What is the mechanism by which the country could make that trade-off between inefficient use of petroleum revenues today and more efficient utilization of them in 25 years, when there is a capacity to manage what is a very complex business. I have not heard any discussion of that and I think it is a discussion that really does need to be heard.

The other question, that I am left with and that my colleague Reg raised in his view from industry, is about the limits of the responsibility of oil companies. Essentially, what is the responsibility of the oil company? And as the annex, what is the responsibility of the World Bank? In particular, what do we do in the case of failed states or nearly failed states when we know that governments are not going to function the way we would like them to or the way they are expected to?

I think that here we can borrow a concept that is emerging in the mining industry, which is the notion of a license to operate. It is clear that any mining or oil company has a formal license to operate. The companies have a contract with the government that defines their rights and responsibility, how much taxes they pay, and how they can repatriate dividends, and so on. That is the formal license to operate, and I do not think it is really enough. We saw in the case with Shell producing in the Niger Delta that having a formal license to operate with the Nigerian government really did not shield them from what was a very distinct feeling of unease of the local population about the way they were benefiting from the oil production. That brings us to this notion of a social license to operate. I think the social license to operate is not only about having a contract with the government, but essentially having the local, regional, and national community to agree to a company’s being there and to the way the company is conducting its business there. I think this is a very important concept that has to be pushed further.

For oil companies to have a social license to operate implies that they would have to ensure equitable sharing of the revenues or not get involved in developments where there is no equitable sharing of the revenues; ensure local economic development, which means trying to create tangible benefits for local communities that will be left behind once the oil...
production ends; create sustainable communities in the region; ensure the transparency of payments, which would be similar to the Soros initiative where the government would put it all on the table and explain where the money is going.

And I would say something which is probably not related to revenue. There is the need for private investors to go into high rent areas, to consult very closely with local communities in order to hear what they have to say, to explain what is going on and to structure their development around what they are hearing that local communities want. This is going to be necessary to get that social license to operate. The downside of not getting this social license to operate is that these local communities can shut you down, can cause problems and can essentially become a very big cost of operating.

So those were some of the ideas I was left with. I want to hand it now across to you. I would very much like to hear from the audience comments, questions, suggestions, or ideas about this very stimulating debate we had this morning.

Comments from the Audience

Philip Daniel, Transborder

There are two matters I would like to raise. The first one is addressed to the Chad and Cameroon people and the other more generally. James Bond raised the question of whether Chad had any sovereignty left. I rather wonder whether those government officials have any time left to do anything else rather than manage the petroleum revenue management program. It did seem very effort-intensive at the bureaucratic level. I also have a question about the fungibility of resources, specifically in regard to targeting five poverty reduction sectors. What ensures that the other commitment from the budget to those sectors is not reduced as the petroleum revenues are dedicated?

My second question is a little different and perhaps directed to Mr. Manhas from Talisman, but also more generally in reference to yesterday. The Soros initiative talks about disclosing payments or, in the case of oil companies, disclosing volumes of production. It has always puzzled me. If companies operate under a tax and royalty system, the tax and royalties are in the law and publicly known. If for example a company has a license under the petroleum law or the telecommunications law in the United Kingdom that license is public. Then why do we have to go to Gordon Barrows to get production sharing contracts? Production sharing contracts are terms of access in most countries to publicly owned resources. There is surely a strong case for the next stage of this initiative to make an effort for the widespread publication of petroleum agreements and production sharing agreements.

Ian Gary, Catholic Relief Services:

We have been working on the Chad/Cameroon pipeline for the last four years. I have just returned from Cameroon and Chad. I think there were some important bits of
information that were left out of the presentation that I wanted to include. The first bit really is
the description of the various levels of oversight and monitoring. What have those various
monitoring and oversight mechanisms actually said?

The inspection panel said that the World Bank was in violation of numerous
operational policies, so I would appreciate more time on the discussion of the things that were
cited in the inspection panel report. The independent advisory group has noted over its’ past
three reports that there is a dangerous two-speed situation happening with the pipeline
construction barreling ahead, and the capacity building projects lagging dangerously behind, and
this is jeopardizing the poverty reduction objectives of the project.

The second bit that I would like to raise is about the revenue management law.
This is particularly interesting and related to what Joel Hellman said yesterday where you pierce
the bubble of some of these structures and the underlying power relationships are no different.
The revenue management law says that it can be changed by decree after five years and the
laws were passed at the end of 1998. Five years later is the end of 2003, and coincidentally is
when the oil revenues come online so I think that is an interesting bit of information that
President Darby can change by decree the allocation of revenues at the end of 2003.

The third bit would be the question of the amount of money that has gone to the
oil producing areas. Something we were just talking about in the plan is 5 percent, and this is
something the inspection panel raised as well in that they did not know how that number was
determined. Bank management said in response that this was through a process of internal
political dialogue. I just wonder what kind of political internal dialogue was going on in Chad,
especially in southern Chad where there were massacres in the oil producing region in the mid-
1990s, and the presence of armed security forces at least up to 1997 according to the
inspection panel reports.

Finally, two questions to the people who are covering Chad and Cameroon.
The first is College de Controle. There seems to be some debate when I was in Chad talking to
World Bank staff as well as civil society members of the body about the mandate. I would be
interested to know your opinions on the mandate whether they should be limited to overseeing
expenditures and revenues, or can be involved in all steps of the process from collection and
management, allocation and expenditure.

The second question I would like to ask is does the law only cover revenues
from the three oil fields in the Doba region? There is now significant exploration going on outside
of Dobar by Exxochad AKA ExxonMobil, En Cana, a Canadian company, and fields such as
Salima, Doseo, Sar, and so forth. I am wondering how revenues from these potential new fields
would be managed, as well as whether the social and environmental safeguards that were in
place for the Doba fields would be followed for these new fields?
James Bond:

Those are quite specific questions. I actually do not see Ali Khadr here. Is there anybody else on the Chad team? There is Philippe. We will deal with that when we come to it, so that is fine, otherwise I am suggesting that it might make sense if you have very specific questions, for you to spend time here in Washington. Ali is in Washington. Spend some time with him or with the staff who are working directly on this. There is a question here in the front.

Michael Ross, UCLA

I am a political science professor at UCLA. I teach a great many students at the university of California who are very skeptical about the World Bank’s work. They believe that it is some kind of global conspiracy to ultimately help corporations and corrupt government. And they look at me sometimes skeptically because sometimes I do consulting work and was a visiting fellow here. And I explained to them that really the underlying work of the World Bank is to alleviate poverty. I was very glad to hear James Bond’s statements at the end. Overall for the last few days, this is going to make my efforts to explain the World Bank and its operations much more difficult to my students. I have learned a lot more about how we can help governments collect and manage their revenue. But I have heard very little about how we can aid the World Bank’s ultimate mission which is to alleviate poverty. It would be incidental if we thought that more effective government programs in developing countries were the key to alleviating poverty. But in fact, as anybody who has read the World Bank’s research on this knows, that this really does not have a lot to do with how the countries manage to lift the poor or not. It has something to do with the structure of production, the development of labor-intensive sectors like agriculture and manufacturing. The obvious problem with the oil structure is that it tends to be capital intensive, uses a little skilled labor, and hence throws a special challenge to the oil sector to think about how its great profits can be used for poverty alleviation.

The question I want to raise is whether we should not be thinking about going around governments. Perhaps we are asking the wrong question here. Perhaps the question that the World Bank should be asking is not how can we make governments more effective in their collections and disbursement of oil revenue. Although that is an important question, we are losing the ultimate question which is how can we make oil-rich countries better at poverty alleviation, and perhaps those are not the same question. What we should be thinking about are initiatives that circumvent the government. I have seen some mineral and oil companies that have a very good sort of social entrepreneurship initiatives. That is one thing. And perhaps it is time to rethink something that has somewhat been put on the backburner in the development agenda for the last few years which is thinking about encouraging value-added production, not necessarily through government subsidies although I suppose some of that is inevitable. The thinking about whether there are other mechanisms that could be employed. Thank you

James Bond:

Thank you, Michael. Any other comments?
Karen Lissakers, George Soros Foundation

It is nice that you are crediting him with the transparency initiatives, but it really is sort of a collective initiative of global witness and many other groups. I have a short question to follow up on the transparency. I wanted to ask about the Chad team and Mr. Udeh. Whether there are any legal obstacles to the oil companies, say ExxonMobil, operating in Chad or other oil companies operating in Nigeria, to their disclosing publicly what they are paying either to revenue sharing/production sharing or through taxes and other fees, royalties and so on in Chad and other countries, in the manner that Talisman seems to be doing in Sudan. If there are obstacles, can you explain why there are legal impediments especially Chad where the bank seems to have some design in the system from the ground up.

James Bond:

Thank you very much. What I suggest we do is try and handle these and perhaps take some more questions later on. Philippe made some very important reflections on the time intensivity for the Chadian authorities in dealing with the World Bank and the IFC, the Inspection Panel, and the like. A very good comment. I do not know the extent to which Philippe would be able to answer that. He did suggest that the next stage in transparency is that all the contracts should be made available. I think that is a great idea by the way. Karen had a lot of detailed questions on the Chad-Cameroon pipeline. Some of them I am actually going to feed to Philippe. He may not actually be the best person because he is now in Société Générale and is not actually implementing it. I do not think he is dealing with or has dealt with the Inspection Panel. I am actually dealing with the second Inspection Panel at the moment. I am not on the oil and gas side. I am the Director of Rural Development, but I do have the safeguards people who work in my department. In my understanding, I did not see that the Inspection Panel found numerous things. The inspection panel did find a number of things. I think that the liveliest part of the discussion on that board was about the 5 percent. How did the regime end up getting 5 percent? Why not 10 percent or 20 percent or whatever. I think they felt at the end that the question was important. They were not sure if it is within the mandate of the Inspection Panel, which is really to see the degree to which the World Bank is respecting its own internal safeguards. I would ask Philippe to say a word about the mandate with College de Controle, and the question about how the laws affect the other regions.

Michael Ross from UCLA spoke about the fact that it is difficult to explain to his students about what it is the World Bank does and why we are not in cahoots with the corrupt governments. I do want to underline that what we are hearing today is a very small part of what the bank does. I cover rural development, agriculture, and social development in the environment and that across the bank represents about 25 percent of what we do. The oil guys, not wanting to make them sound less important than we are, represent 1 percent of the total bank efforts. So our efforts are really focused on poverty alleviation. I mean that is the role of the bank. I liked the idea about—shall we go around governments? How to work in countries where the government does not work well? And we are actually working at the moment on a
new tool called community-driven development which would essentially channel international donor resources right down to the local communities below the local government level, and they have a way that they can deploy these. This gives them power instead of the local government. It changes the power base between local government and the local communities—a very interesting theme. We would have to see how that develops. Then Karen spoke about the legal obstacles to ExxonMobil disclosing publicly in Chad. I am going to field those to Philippe. Philippe, could you talk to us about College de Controle, about the production laws in Chad, and legal obstacles to ExxonMobil to disclosing publicly the revenue flows.

Philippe Benoit:

Let me take some of those. There was one question on how to ensure that there was no substitution in terms of allocating to priority expenditures, and the approach we took was that there would be an agreement on the baseline expenditure program. What we agreed with the Chadians is that it had to be incremental and basically we agreed that we were going to look at expenditures in either 2000–2002, and for example, in education and health, it would have to be in addition to what they spent in that baseline year. One point that I would like to make that I think it is important is clearly the focus is on the efficient use of oil revenues. But I think it is important to note that that issue is relevant for the efficient use of fiscal revenues, for the efficient use of savings under the HPIC programs, and for the efficient use of resources that the World Bank provides under the structural adjustment program. In the spending side from our perspective on the Chad side, oil money was not different from other money and the critical issue was improving capacity in terms of oil revenues. Now what is different in terms of oil money is the way it comes in, and that has an impact. I mean it would be a lot easier to manage a situation where there was a significant increase in the price of cotton, at least that would come in directly to producers. Oil money is sort of a check that is written to governments—very much as structural adjustment money is a check written to the government. The focus is on how you spend that money, in trying to put the government in a better position to spend that money wisely, recognizing that you are going to get a significant increase in the amount of money to spend. In reference to the revenue management laws, it is absolutely correct about what was noted, that it allows the government to come in and change the allocation systems every five years, but that would have been a violation of the agreement with the World Bank. This goes back to the point that I made that there was a domestic component and an external component. The fact that the government built flexibility into the domestic component from our perspective was not unreasonable, given that their priorities may change, but our view with the government was basically you are agreeing that you would keep the money in these five sectors so if they were to come in and change the law in 2003, that would be a violation of the revenue management program and then legal undertakings made to the Bank. There has often been a lot of confusion about the 5 percent. I think what is important to note about the 5 percent is that the 5 percent is on top of the other monies. There are about twelve regions in Chad. Each region was supposed to receive their equitable share and the 5 percent on top of that. I think in some sense in Chad there was a desire to maintain some type of balance between how much the
producing region would get say \((5 + (1/12)*70)\) as compared to the other regions. In terms of the issues about the standards that would be applied to petroleum activities outside of the three double fields, something that we negotiated with the oil companies and with the governments, was that basically any oil that will go through the pipeline that the Bank was financing would have to have been developed according to the standards that the World Bank was applying to the Chad-Cameroon double field developing case.

**John Udeh, Nigeria Presidency, Revenue Mobilisation Allocation and Fiscal Commission:**

On the question as to whether there is any legal obstacle to disclosing information in Nigeria, my answer on JVCs and PSCs (Production Sharing Contracts) is no. There is no legal obstacle, but the problem is that of conspiracy between the senior government officials and the oil companies, also, the lack of state governments’ capacity to monitor adequately the oil companies’ operations. The question I will raise is, if the oil companies can sometimes arm twist governments to abide by their own terms of contracts, why can they not do the same to see that oil revenue is used for social development. That is my answer to the lady’s question. There is no legal obstacle, but it is a question of interest, especially during the military regime. The military did not want the civil society to know how much money the government was earning, and they would tell the oil companies to keep quiet about the revenue and the oil companies comply, but civil society is asking is can they not say no. As we have seen they say no in so many other things and get their way.

**James Bond:**

Are there any residual questions? I will allow just one, then I will allow Christine to sum up because I think she would have some last words.

**Charles Ebinger (Nexant):**

We heard the concept of a differentiation between administrative corruption and state-centered corruption, or whatever the term was called but meaning where the state is truly a major part of the problem. What I am wondering is that we have heard nothing about what the World Bank should ultimately do in a situation where the state is perceived to be the center of corruption, and many of the governments we have addressed in this seminar in the last two days fall in that category clearly. They have been failed states for many years. Their corruption is legendary. What I want to know is why does the multilateral community at some point not say we are not going to play this game anymore. We are going to work in states where there is reform, where there is serious economic policy, and we are going to go home and not pretend that we are helping in some way, when we know it is all going into some foreign bank accounts.

**James Bond:**

I can answer that immediately and I think many of my colleagues in the bank can answer that. A couple of years ago a very influential document came out called *Assessing*
Aid: What Works, What Doesn’t, and Why which essentially says that aid into a country that doesn’t have good governance is a waste of money. This means that our programs in countries like Nigeria under the Sani Abacha regime was close to zero. They were not exactly zero for a number of technical issues relating to maintaining social programs that deal with safety nets, but there was absolutely no new lending. This is the case with Sudan. We have not had a program for at least 15 years. And this is true for every country where we feel that there is not a chance of development because of corruption or other governance issues. With that I will hand over to Christine for some sort of closing summary.

Christine Wallich:

Thank you. I would not try to summarize, but I would like to say a few words about operating in what was called here failed states. James is quite right when he describes the Bank’s engagement strategy with countries where there is not a formula approach, but a combination of formula and judgment that allows us to become more and more involved with the country and supporting its programs as we have more confidence in its ability and willingness to use its resources wisely. The other side of the coin is what do we do in the failed state? We actually have a name for them, we call them the low-income countries under stress, and we have a formal strategy for them. There are other names for them but stress was the name we all converged on some time ago. The strategy is essentially about building capacity, it is not about lending for precisely the reasons you gave. In situations where we feel that resources are required there is an explicit strategy to go outside the government and to try and use grass roots organizations through community driven development, through NGOs, or through whatever means one may be able to find. It is a case-by-case, country-by-country thing. That strategy is on our website. If you want to talk to people who run the program, we can put you in touch with them. I would be very disappointed if you went away thinking that the World Bank’s work in the energy sector and indeed any other sector was not consistent with its poverty mandate because I think what we do in the stressed countries is different from what we do in the better of and more capable countries.

I will just close by saying that there is an awful lot in this whole discussion for the bank. There is a lot on the line for the Bank and its clients because I think ultimately the reward is quite great if we can find tools and mechanisms to manage the revenues and the expenditures in a way that can benefit populations quite broadly. Reg put it very well that public demands and NGO demands are adding to the public scrutiny of what we do, and what the oil companies do, and making it a much more challenging environment to work in. The unholy trinity of Bank, big oil companies, and corrupt governments was mentioned and I think that leads very quickly to the risk-averse Bank. The World Bank does not want to get involved in difficult projects for precisely those reasons, and I think what we are here to do is to learn from you and from the experience across different countries how we can avoid the risk of becoming a risk averse and having a non engagement strategy or a disengagement strategy, because it is not at all clear to me that these countries or their poor people are better off with a disengagement or
nonengagement strategy. I think it is a strategy of constructive engagement in a learning mode where we do try to ensure that a lot of mechanisms and safeguards are built in, but also a lot of mechanisms for midcourse corrections for sensitivity to what we see on the ground, a lot of flexibility and a lot of soul searching about what we do. I want to thank everybody for their contributions and also for the provocative questions because I think that is the sort of thing that keeps us focused on learning, and to look for where we can find solutions and safeguards to the problems that are there. There is no avoiding them. As I said about disengagement or nonengagement, it is not clear that it is the right solution either. The counterfactual needs some thinking through as well.
Keynote Address: Petroleum and Violent Conflict

Paul Collier, Director, Development Research Group, the World Bank Group

Thank you, Charles. The enterprise I have been engaged in during the last three years has been research on the statistical patterns of conflicts. I first went to a global data set of all the big conflicts over the last forty years and tried to see what the global patterns are, and then moved on to what is the scope of policy intervention to change things. I will share some of those patterns, especially as they pertain to oil.

The overall conflict pattern of big civil wars over the past 40 years is that the geographic incidences have changed a lot and the durations have changed a lot. Increasingly, civil wars have become concentrated in Africa, and the duration of civil wars has tended to last longer. The typical civil war today goes on longer than it did twenty years ago.

What seems to cause wars? About 99 percent of the studies on conflict are case studies done by political scientists and anthropologists. Perhaps because of that, they tend to find that it is either all politics or all ethnicity, and I don’t find that at all. I just want to start with this rather curious remark that when I look at the statistical pattern, there is a big disconnect between the statistical pattern and the discourse. The discourse is all about politics and ethnicity, and the statistical pattern just does not show that. I do not find strong links between political repression, inequality, and the risk of civil wars. I do not find strong links between many different ethnic groups, many different religious groups, and civil wars. What I do find are strong links between economics and civil wars, the economic endowment and civil wars. Today I am going to talk about two aspects of the link between the economic endowment of a country and the risk of conflict.

The first is a strong link between the level of income, the rate of growth of income, and the risk of a civil war. Civil wars tend to be concentrated overwhelmingly in low-income countries, and they tend to happen in countries that already are stagnating or in economic decline. As a rule of thumb, each 1 percent added to the growth rate takes one point off the risk of conflict. Each time per capita income doubles the risk of civil war is halved.
Where do natural resources and oil in particular come into this? One way they come in is through their effects upon the growth of income. We know that is a pretty complex set of effects. The best example I can give you is not an oil example but a natural resource example: the contrast between Botswana and Sierra Leone. Thirty years ago these two countries had similar levels of income and huge diamond endowments. Today the economy of Sierra Leone is about one third of what it was 30 years ago. Botswana is about 10 times the economy that it was thirty years ago. Something has driven a thirty to one differential between those economies with the same broad set of opportunities, the same broad set of resource endowments. This example illustrates that something interacts with the resource endowments to produce either catastrophe or spectacular success. Botswana was the fastest growing economy in the world for 20 years.

What do we know were the causal mechanisms? I will just sketch three here. I do not have any profound remarks on them. The one that caught economists’ attention about thirty years ago was Dutch disease—natural resource endowment leads to appreciation of real exchange rate, and that is bad for the rest of the economy. I think, to be honest, too much has been made of that.

The second cause where we know there is a problem is volatility. Volatility is associated with all primary commodities, and certainly it is associated with oil. Shocks in both directions seem to be highly problematic. The econometric evidence seems to suggest that booms are basically wasted. They do not translate into sustained growth and big crashes do translate into sustained periods of lost growth. The crashes are semipermanent bad news and the booms are missed opportunities.

How do we deal with that in the case of oil? My own preference is that volatility should be dealt with through insurance rather than through savings strategies. It is basically an insurance problem, and so I think that hedging instruments are the most appropriate form of intervention. At the moment there are no good instruments to deal with the volatility problem. Until a couple of years ago the world had two instruments: STABEX* and the Compensatory Commodity Financing Facility. Both have been abandoned for the very good reason that they were both lousy. They were lousy instruments for a problem that is very real. We have to find better instruments. It is helpful that they have been abandoned because the slate is now clean. People can not hide behind the existence of lousy instruments.

The third cause is obviously that primary commodities, natural resources in general, and oil in particular, tend to produce a weakening of economic policy and economic institutions, a deterioration in governance. I want to take that last effect—the deterioration in policy, institutions and governance—back to the original point about Dutch disease because I think those are tied up in a broader concept of the absorptive capacity of an economy for oil revenue. The absorptive capacity depends critically upon the institutional and policy environment. This link can be actually quantified. I will say as a rule of thumb, where oil revenue is more than about 15–20 percent of GDP the country is only going to get something good out
of it if it has good policies and institutions. Take a country like Nigeria, which over the last many years has had something like 40–50 percent of GDP coming from oil and very poor policies and institutions, and where oil revenue is way beyond the absorptive capacity of the economy. As an approximation, the first half of oil revenue is doing some good; the second half is doing some harm; and the net effect is probably zero to a first approximation, which is why the Nigerian economy is no better off today than it was 30 years ago.

Where absorptive capacity is low, it needs to be raised by improving policy institutions and governance, and under those circumstances the sensible strategy is: don’t absorb oil revenue in the first place, save it. Of course, it is precisely in environments in which poor policy, institutions, and governance exist that governments are least likely to take the wise view of not spending the money. I am personally a bit skeptical about oil funds and high savings strategies, because the circumstances under which they are appropriate are those under which the government is least likely to adopt the policy. I fear that savings strategies are not transfers from a foolish present to a wise future. They are transfers from a wise present—because the only circumstance where they will be saved is where there is a wise government—to some foolish government in the future.

There are no good answers here, but one rule of thumb I have drawn is that if a country has big oil income it should not have high taxes. It should try to transfer as much income to the private sector as possible, and the simplest way of doing that is to cut taxation. Many oil rich countries actually have high taxation, not on oil but on nonoil activities, and that seems to me crazy. I describe that situation as “tax and lend.” The government taxes the population and tries to save the proceeds. Even Norway’s strategy I think is a bit weird. They are taxing Norwegians very heavily and parking the money in America at 1 percent interest per year. That is Norway’s aid program to America. It is not completely stupid for Norway because Norway is very rich and it does not have a lot of absorptive opportunities within Norway, but it is not a good strategy for low-income countries. So much for the first and indirect link between oil and conflict: that is that conflict risk goes up with low income and low growth and oil can (but need not be) be associated with disastrously poor growth.

But even if one controls for the level of income and the rate of income growth, there is still a link between natural resources and conflict, and it is quite a strong link. Overall primary commodity dependence, and natural resource dependence in particular, is associated with big increases in the risk of civil war. Let us think of why there might be this big association. Other than through income, controlling for income and the growth of income, why are natural resources pushing up the risk of conflict? There are three reasons.

One is that natural resources finance rebellion. Look at diamonds, UNITA and the RUF. The rebel groups were deriving finance through predation on these commodities and that sustained them. Maybe it even motivated them but at least it sustained them. I do not want to be boxed into the position of saying that rebel groups are motivated by the greed of grabbing resources. Sometimes they are, sometimes they are not. But for the agenda of a rebel group to
be viable, the rebel group needs financing, and natural resources can finance all sorts of agendas, not necessarily greed agendas. So finance is one link.

The second is the lure of honey pots upon victory. The winner grabs the natural resources and that is sometimes an attraction. It is particularly an attraction in the case of secession and identity wars. I will come to that in a moment when I turn to oil in particular, because I want to argue that oil is particularly dangerous for its links to victory honey pots and secession.

The third link between natural resources and conflict risk is through corruption. Corruption and poor governance directly raise the risk of conflict. To sum up there is this overall strong link between natural resources and conflict risk, which is running partly through the growth effects, partly directly, and the direct effects run through finance, victory honey pots and through poor governance.

Is oil any different from this overall natural resource effect? Yes and no. It is not as different as one may expect. If one looks at the overall links between oil and conflict risks versus nonoil natural resources and conflict risk, the structure of risk looks a bit different but the overall level of risk does not look very different. As natural resource dependence increases, if the resource is oil the risk goes up further than with most other commodities. So the risk is a bit higher, but I do not want to make too much out of that. Oil is dangerous and so are other natural resources. I think the differences come when we unpack these three routes of financing conflict, victory honey pots, and poor governance.

With financing rebel groups, oil is less of a problem than most other natural resources. It is harder for a rebel group to capture control of oil revenue during conflict than it is for it to capture control of diamonds or timber or gems during conflict. That does not let oil off the hook, because oil is still financing rebel groups, not because rebel groups capture the oil but because rebel groups capture the oil men. There is a significant link from oil operations, kidnapping, ransom and finance of rebel groups. Kidnapping is sometimes quite big business. A pretty big rebel group like the FARC in Colombia is generating something like US$700 million a year, out of which US$500 million is from primary commodities, mainly drugs, and US$200 million is from kidnapping. Some of that US$200 million is your money.

The type of conventions that say not to pay for kidnapping are honored in the breach more than the observance. Can anything be done about it? I don’t vouch for this but I have been told that the local level security is a charge to the subsidiary company in the field whereas ransom payments are a charge to corporate headquarters. Anyway, there is a free rider problem here, a collective action problem that in any particular instance it is sensible to pay the ransom. However, we all know what happens if we pay the ransom.

In the finance of rebellions, oil is not as bad as most other commodities, but there is an issue there. In secession oil is really bad. A regression of secession shows that secessionist wars as opposed to ideological wars are much more likely where there are natural
resources and particularly likely where there is oil. I will talk about Scotland because it is a great example of oil-based secession. The Scottish Nationalist Party existed for years and attracted virtually no votes. Its appeal was to romantic historical nationalism, and romantic nationalism has rather modest electoral appeal. It was a recent appeal, and it was fragile, and it can be dated very precisely when the votes went up for Scottish nationalism. In the 1970 election, the Scottish nationalists were nowhere. They got one seat in the parliament. In the two elections of 1974, they ended up with 30 percent of the vote. What happened between 1970 and 1974, which might conceivably have influenced how Scottish voters thought? The oil price went up like mad and so oil became a symbol of value. I remember a cartoon in the British papers of two tramps talking. One tramp is saying to the other “and then there was North Sea oil and there didn’t seem any point in working anymore.” The Scottish electorate I believe got that mentality and thought that this value could be divided not by 55 million people but by 5 million people. That did not lead to violence. That same motivation very often does lead to violence. Biafra is an example.

What can we do about it? There are no easy answers. What happens is that oil is discovered somewhere and the people who live above the oil then acquire an identity—we are the people sitting on top of the oil. There is always some ethnic group sitting on top of the oil and so they get a political agenda: we are different, we could be rich. What is the best approach to that? Here is a rare instance in which Nigeria got it right. What happened was that instead of three states, one of which was sitting on all the oil, there are now thirty-six states; it is not credible for any one of those 36 states to secede, and that seems to me a pretty intelligent political solution to the problem of natural resource-based secession.

To sum up, there is a finance route by which oil is not very guilty; there is a secession route by which oil is pretty guilty; and there is the corruption route on to conflict, and we know that oil is particularly vulnerable there. What can we do about it? There are no simple rules here. However, oil companies have huge leverage power for improving governance. We are just at the beginning of using that leverage intelligently and that is one of the big challenges of the coming years.

Let me end by drawing a few implications. Let me go back to Botswana versus Sierra Leone, this 30:1 divergence with the same natural resources. We know pretty well why Botswana worked so well. It was not because of any fancy global policy. It was because Botswana happened to start with three good able people at the top. And three people at the top were enough to make a difference between the catastrophe in Sierra Leone and the brilliant outcome in Botswana. Directly that is not very helpful. If the answer is to find three good people at the top, there is not much that we can do about that. But it does I believe calibrate the scope for international policy action here. What we have to ask ourselves as an international community with all our G8s, our international financial institutions, the power of our oil companies is whether we can in some way collectively substitute for three missing people. Maybe the answer is that we cannot. That I would say is not proven. I will stop here. Thanks.
**Comments from the Audience**

*John Udeh:*

To say that the civil war in Nigeria was a struggle for resources, from my point of view is completely incorrect. When Nigeria first went into conflict, it was purely an ethnic issue that had sparked it off. Then the soldiers struck and when the second head of state was killed, even the North wanted to secede. They were the first people who wanted to secede. However with the advice of the British, who warned them that if they seceded they would lose all the oil in the South, they dropped the idea. So it is not our own thinking, we were not thinking about economics or science. We had our own traditional cultural problem that led us into division. My argument is that the secession problem in Nigeria was not oil based. Many of us did not even know about oil until the late 1970s. Thank you.

*Paul Collier:*

I know that you are a Nigerian so I guess you have an advantage over me. Where I think you are wrong is that across Africa there are many ethnic divisions, Nigeria is not peculiar in ethnic divisions. Ethnic divisions do not usually produce civil wars. It was not to my mind a fluke that the secessionist movement occurred precisely in the area where there was oil, and precisely the time after the oil had been discovered and recognized to be valuable. We will have to agree to differ.

*Karin Lissakers:*

I wonder if you could elaborate a bit on your statement that the oil companies have potential leverage that could be used significantly to improve governance. What sort of things were you thinking of?

*Paul Collier:*

There is a range of things. The big emphasis at the moment is on transparency but I would like to emphasize that transparency is a necessary but not a sufficient condition. What we are really talking about is effective domestic scrutiny, effective pressure from the domestic population for good use of resources. The heart of the matter is empowering appropriate domestic points of pressure, in parliamentary systems that will often be within parliaments. It is not just a matter of rousing up NGOs. It is often using institutions of scrutiny through a parliamentary procedure where possible, and this is my preferred route. A necessary step is that the scrutinizers should have the numbers, and the oil companies at a minimum have a role to play in making sure that those numbers are provided.

Where you are not dealing with effective parliamentary systems then scrutiny and pressure has to be by definition extraparliamentary. To my mind that is a very inferior route to proper parliamentary scrutiny but if there is no proper parliament we have no choice. However we have to try and empower substitutes for proper parliamentary procedures. The oil
companies have a great deal of experience now of working with civil society. Much of the focus of oil companies’ involvement with civil society to date has been in the locality where the oil is extracted. The oil companies try to work with the local community so that they do less kidnapping. That is sensible enough but it is a very narrowly conceived view. There is also a broader engagement with civil society to empower scrutiny. Transparency is not an end in itself. It is a means to scrutiny.
Roundtable and Closing Discussion

Oby Ezekwesili, Special Assistant to the President, Office of the President, Federal Government of Nigeria

Thank you very much Rashad. I want to particularly thank Charles, whose great idea it was to have me join distinguished members of this audience in discussing a very topical issue. Listening through the various discussions we have had since yesterday, clearly my nation seems to be the poster child for poor management of oil revenue. Whether that is a myth or reality is a different discussion, perhaps for the same audience. I do need to put whatever discussion we have about oil revenue management within a more robust framework of both the internal and the external politics of oil revenue management. We seem to have narrowed it to such a level that we forget that a lot of countries, such as Nigeria, are caught in the web of politics of oil, both as a dominant factor in economic relations between nations as well as in intrarelationships within enclaves where oil exists.

I would like to divert my attention a little and look at the issue of Nigeria. Clearly there are certain pertinent issues for us as a country as far as the fiscal control of our joint venture partners is concerned. I think that the very basic one is the issue of strengthening the institutional capacity for our revenue collection. The Department for Petroleum Resources (DPR) and the Federal Inland Revenue Service are institutions that have come out of a long period of military rule. The military period required certain skills and competencies that are different from the requirements in a democratic environment. Who is going to bear the cost of overhauling these institutions? How is it going to happen? Is it something that the countries can deal with, even in a country such as Nigeria, which seemingly did not fight a war but resembles a post conflict economy? In whose interest is it that these institutions be able to function appropriately? National Petroleum Investment Management Service (NAPIMS), which is the institution that is supposed to monitor and audit our joint venture accounts, wallows in a situation of information asymmetry, with the oil companies having all the information as to how their costs are generated. I listen to the discussion on transfer pricing, which is the kind of discussion that the Ogoni man would like to listen to, and he would rage: who is defining cost? Who is putting a
value on cost? These are real issues. We also have the issue of the central reconciliation unit. What model as a nation should we be looking at?

In terms of the institutional capacity strengthening, we have great difficulties in determining the reserves addition bonus. That is a very difficult one. There are claims and counter claims as to how transparent the oil community really is. Nobody can afford to stand on a moral pedestal until there is a joint recognition of the weight, resources, and deficiencies we have in being able to solve the problems that we have as far as institutional depth is concerned. The problem of our tax administration is colossal but then, as I said, we have had civil service stagnation. What do we do? I mentioned the quality of our joint venture course: clearly inflation of costs is not the exclusive preserve of misbehaving nations. Equity issues arise in terms of costs. Who is dealing with them? The audit and monitoring strategy, the need for procedure reviews and the improvement of local content are issues on which multinational oil companies need to be focusing. Who is going to get them started on that? In looking at the central reconciliation unit, are there strengths in our current loose arrangement? Charles, you are very conversant with what we have currently in the country. Is there any strength at all in having it that way considering the kind of history we are coming from, or should we have a model that resembles a formalized structure? Those are issues that will need answers.

Zeroing in on the issue of politics and economics of fiscal transparency, I dare say that fiscal stability and transparency are imperatives but they are not sufficient for economic growth and development. If the reason we gathered is to look at oil revenue management in so far as it achieves economic development that impacts the lives of the people, then I think that our debate ought to have been more robust than it has been since we started.

Also, what is the definition of vast oil wealth? I have listened to the discussions of vast oil wealth. Nigeria, a nation of 120 million people, is going to earn about US$9 billion this year. It does not even resemble the budget of the fire service in New York, and Nigeria is a great giant of Africa. What is the definition of vast oil wealth? There is some meat to that.

As for the role of oil multinationals in economic development, where are the economists pricing pollution, environmental distortion, and devastation? Is there no cost for that? Who is bearing that cost? Who is being asked to bear that cost? Who is pricing it appropriately? Negative externalities—these are the issues to which no one seems to be giving much attention.

What is success? How do you define success in oil revenue management? The resource gaps in nations like mine are real. Where are the incentives for reform? I speak from a position of authority because I come from a background of being, with my former colleague Peter Eigen, one of the founders of Transparency International. I served on the board of Transparency International from the very beginning until 1999, when I stepped down. I do know what I talk about when I say that even if you cleaned up all the corruption in an economy such as Nigeria, the resource gaps would be still very huge. It is not sufficient to just talk about
effective and efficient oil revenue management. The truth is that both the buyers and sellers of oil need a total deliverance from the clutches of oil. How do we get there?

Corruption is truly a bar to oil economies’ development, but we must resist using the issue of corruption as the alibi for the international community’s inertia. Look at the issues of proceeds of corruption. What is the international community doing about it? Is it just going to sit apathetic while a government like that of President Olusegun Obasanjo gets constrained into entering some minimal level arrangement in order to get the proceeds that were stolen from the nation? Is the international community going to sit back and talk about this vast oil wealth, while nearly 12 times the amount we spend on health, seven times the amount we spend on education, is being used to service debt, most of which was corruption induced?

Finally, I work for the President of Nigeria. Together with my colleagues, we have succeeded in enhancing the quality of capital projects within the government of Nigeria using an instrument we call the due process. Everybody says today in Abuja that the fear of due process is the beginning of expenditure wisdom. Yet I do not bask in triumphalism, because I know that the road to travel is far. But it is a step in the right direction. It is a very critical step in ensuring efficiency in allocations and operational technical efficiency. It is the right step in ensuring that cash flow is managed in to avoid perennially suffering the boom and bust syndrome of a volatile oil economy.

The government today has a fiscal responsibility bill that is supposed to address the issues of a stabilization fund, aggregate borrowing levels and other macroeconomic issues that we require as a fiscal federalist state. We have tried to implement the Supreme Court judgment that makes the distribution of oil revenue as equitable as possible taking away all possibilities of extra budgetary expenditure. The new revenue distribution formula is being worked on by an independent agency, which you heard John Udeh speak about. The strengthening of the Niger Delta Development Commission is something that is begging for public-private sector partnership in order to enhance its credibility and results.

The real issue behind oil revenue management is diversification of economies in which oil is found. For as long as the path for development in my country continues to be the singsong about oil, we are not going anywhere. The understanding that we have to diversify, we have to stop making oil the end and entirety of our destiny, is the sense that is driving the process of developing nonoil sector competitiveness. We have woken up to the fact that we should give Thailand a fight or a run for its money in the area of cassava competitiveness. We have woken up to the fact that we could do without having to import the long grain rice from America because we can actually do a lot of rice production ourselves. These are the aggregate of policies that we require.

One of the major issues for me listening to an audience such as we have had here is that we simplify the cost of paradigm shifts. The paradigm shift of moving from an environment of low transparency to an environment where transparency becomes a watchword has a huge political cost. Who is helping? Indeed the President that I serve, Olusegun Obasanjo,
has shown me the greatest commitment as far as dealing with the issues of corruption. Yes, he has not fried as many big fishes as you would like to see him fry. But it is simplistic to just say “fry the fish.” You need to take care that you do not get fried yourself, and that the instrument for frying fishes is saved.

Thank you.

Presentations at the Roundtable

Alan Detheridge, Vice President, External Affairs, Exploration & Production, Shell International

Thank you Rashad—and thank you Oby for your speech. I did not feel too bruised at the end of it, and I hope you will not feel too bruised, either, when I have finished speaking. I have to say that I have found this a humbling experience sitting through the last two days. What it has done, at least for me, is to confirm the depths of my ignorance in many aspects of this whole stream of revenue management—from its generation, to its distribution, to its eventual end use. I think this is probably the first meeting of its type that I have attended that has really covered that broad front and, has had representatives of all the stakeholders present, including the NGOs, the companies and, of course, host governments and the multilateral organizations. In particular, it is distinguished for me by the attendance of the representatives from the host governments—from Nigeria and Angola—who have taken some knocks during this conference. The oil companies have taken knocks, too, but we expected that. In Oby’s case she has given some back. Having said that, Charles, we owe you gratitude for putting this workshop together. I hope it is not the end of something but the beginning of an initiative, perhaps country focused.

My first comment on this issue is that it is not something that is going to go away. I do not think it ever has been away, but to me, all the signs say the issue of governance of oil and mineral revenue is here to stay. It is not just the pressures from the NGO community, although they do exist. It is not just the attention from home governments such as the UK government, which, as you know, has a keen interest in this particular issue. It is not just the New Partnership for African Development (NEPAD), to take a particular example, that is interested in this whole issue. As Oby said, there are the communities themselves, in and among whom we operate. For them, this is a very real concern.

The other thing that strikes me is that I have not heard anybody arguing against the underlying principles. It would be a brave person, particularly with this audience, who would argue against the principles of good governance, transparency, and the fight against corruption. To me, what that means is that there is a need to get engaged in the dialogue about this issue. As pointed out by Willy Olsen, we all have something to contribute. The oil companies perhaps
have more to share at the front end of the revenue management chain, but I will make a few remarks about that in a second.

Before I do so, let me voice another thought, which was sparked by James Bond earlier this morning when he talked about the social license to operate. It seems to me that with some of these seemingly intractable problems, such as oil revenue distribution, if all of us—the oil companies, civil society, host governments, multilateral organizations—if we each retreat into our shells and say that our responsibility goes this far and no further, then gaps will appear in the accountability chain. And there will be people who fall through these gaps—people in our host communities. That is why I think this workshop is so important—because it has begun to create a debate about where these responsibilities lie.

I promised I would say something about the front end of the revenue management chain—about transparency of payments that companies make to host governments. This is the focus of the “Publish What You Pay” campaign and also the UK government’s “Extractive Industries Transparency Initiative.” The idea is that international companies should freely disclose what they pay to governments in terms of royalties, taxes, signature bonuses, and the like.

The problem is that the agreements that are signed—production sharing agreements, joint venture agreements—specifically prohibit such disclosure unless you have the consent of your joint venture partners (which, in many cases, includes the state oil company). So, in effect, you need the agreement of the host government. John Udeh was asked this morning whether there were any reasons why a company should not publish what it pays to the Nigerian government. John was right to say that there are no such reasons—because, if asked, the Nigerian government would give its consent.

But not all governments are going to be as enlightened as the Nigerian government. This is why Global Witness and the “Publish What You Pay” campaign are proposing a regulatory approach that, if it can be made to work, is a neat way around the problem. But there may be other ways, and these would be worth debating.

However, there is another fundamental problem. Take the case of Nigeria, for example, and let us assume that all the companies operating there disclose what they pay. If you add up all of these payments, they will not equal the government’s total revenue stream from oil. The reason for that is very simple. The state oil company participates in joint ventures with the companies concerned—and is entitled to a share of the crude oil produced by them. For example, in our joint venture in Nigeria, the state oil company receives 55 percent of the crude that is produced. The revenue from that stream of crude oil would not show up in the payments that we make to the Nigerian government. And it is a significant sum of money. Roughly speaking, taxes and royalties represent only some 30 percent of the total government revenues from our joint venture in Nigeria.
To some that is an argument not to publish what they pay. They say it is just a small piece of the jigsaw puzzle—so why should we do it? I have to say that argument does not hold water—because the sums are material and they are an important piece of the jigsaw. But this does point to the need to focus on what governments have received—in addition to what they have been paid by companies.

Let me conclude by saying something about corporate social responsibility. What we have found, throughout our efforts in Nigeria and elsewhere, is that it is important to earn what James Bond called the social license to operate. Some people think that the way to do this is through development projects with your host communities. I agree that this is very important and needs to be done with great care and great skill. Generally speaking, great skill in the area of community development is not something we have within oil companies. We in Shell are not shy about saying that—and it is why we form partnerships with other organization that do have those skills. We are very proud of many of our community development projects—but, through independent verification, we find that some do not work as well as they should, and we publish figures on that in Nigeria.

But even if we did all of those projects magnificently, we still would not have earned a license to operate. Because there are more fundamental issues in places like the Niger Delta and, unless they are fixed, we will continue to have problems: we the communities, we the oil companies, and we the government. The issue of revenue distribution is one of those issues—and our feeling is that we have to get involved. The discussion will be difficult in places, no doubt—but, in the end, it will be worthwhile.

Those are my comments. Thank you.

**Bennett Freeman, Principal, Sustainable Investment Strategies**

I would like to thank Charles McPherson of the World Bank for asking me to participate on this panel with my friends Alan Detheridge, and Oby Ezekwesili.

I come to the subject from my interest in promoting corporate responsibility and human rights, both in my prior capacity as a U.S. government official and my current involvement as a consultant to companies and advisor to NGOs—with a particular focus on Indonesia, Nigeria, Colombia, and the Caspian region. I have had a particular interest in how opaque and inequitable revenue distribution contributes to regional tensions within certain countries, deprives local oil-producing communities of their right to development, and feeds tensions between those local communities and the oil companies operating in proximity to them.

This combination of factors has all too often forced the companies into the unwanted role of acting as “surrogate governments”—as primary providers of basic services—and even risked putting them in the especially unwanted position of appearing complicit in human rights abuses committed by security forces attempting to quell local unrest and disruption of oil operations. As Arvind Ganesan of Human Rights Watch pointed out yesterday, patterns
of revenue management and mismanagement are inseparable from the most basic issues of accountable governance and, in turn, are inseparable from an oil-dependent regime’s willingness or ability to protect and promote human rights.

I want to use my few minutes to highlight two specific opportunities to advance the cause of revenue transparency: one in a country-specific context, the other on a global basis.

**Equatorial Guinea**

First, let me highlight a particular country that should, in my view, be the focus of far sharper attention in this context: Equatorial Guinea. Equatorial Guinea has emerged in just the last several years as the third largest oil producer in sub-Saharan Africa—following only Nigeria and Angola. Major oil and gas finds since the mid-1990s have pushed output to more than 200,000 barrels a day, with official reserves estimated at 2 billion barrels—enough to sustain astronomical annual growth rates of up to or even in excess of 50 percent for a country with a population of only about half a million.

This rapid development comes against a backdrop of poor governance, serious abuses of human and labor rights, and tensions among ethnic groups. Despite an official transition to multiparty democracy, Equatorial Guinea remains essentially a personal family and clan-based dictatorship. And despite an easing of rampant human rights abuses and impunity over the last several years, a number of suspected political opponents of the regime were arrested earlier this year and held in detention, incommunicado.

Moreover, the government’s management of these massive revenue flows remains opaque, and its development priorities are unclear. Although the oil companies are beginning to fund some commendable community development and infrastructure projects, revenue transparency does not appear to be on their agenda—let alone on the government’s. And the World Bank has had only a minimal presence and role in the country.

To complicate matters further, it appears that with such massive revenue flows coming to the government, neither of the home country governments of the companies operating there—the U.S. and France—have much leverage to influence government policy on revenue management or distribution. This especially appears to be the case as the strategic imperative of increasing oil flows from the Gulf of Guinea and West Africa generally is heightened in the post-September 11 climate of concern over the stability of supply from the Persian Gulf.

Yet, in my view, there are reasons why those host country governments, the World Bank and IMF, and the companies themselves should explore ways to use whatever leverage they may have to begin a discussion with the government of Equatorial Guinea on revenue management, transparency and distribution. Apart from the people of Equatorial Guinea who lack a democratic voice in shaping their development priorities, the companies and their home country governments may come to regret inattention to these issues. Just when Equatorial Guinea could develop as a model that benefits from learning the lessons of the experience of its neighbors Nigeria and Angola and could benefit from some elements of the approach the World
Bank has taken to the Chad-Cameroon pipeline, this opportunity appears to be one that is already being squandered. The companies in particular should be concerned about the risks to reputation that may develop over the next few years if the revenue juggernaut continues to accelerate without accountability and transparency, and with the real possibility of further human rights and labor rights abuses along with ethnic tensions. If they are not mindful of these risks, no doubt some of the international NGOs that have been focusing on the link between revenue mismanagement and poor governance will be prepared to remind them.

“Publish What You Pay”

Second, I want to add to what Karin Lissakers said yesterday about the importance of the “Publish What You Pay” campaign launched in June by George Soros and the Open Society Institute, together with Global Witness and an impressive group of other supporting NGOs.

I know how difficult the issue is and how seemingly insurmountable the hurdles to achieve rapid progress may seem: from the perspective of governments benefiting from oil revenue, which may shun such an invasive challenge to national sovereignty; from the perspective of the multilateral institutions such as the World Bank and the IMF, which can proceed only as the traffic can bear with those governments; from the perspective of the oil companies, which may feel pressures to be more transparent in their dealings with governments but do not want to get caught out from the pack and be put at competitive disadvantage; or from the perspective of the home governments of those companies that place the greatest weight on the security of oil supply and are reluctant to complicate that and other bilateral interests by highlighting the issue.

Nonetheless, the launch of the “Publish What You Pay” campaign is the most encouraging development so far—especially encouraging because it effectively globalizes the issues and puts forward the goal of national regulation by the home country governments of the companies in part to tackle the competitive disadvantage issue head-on.

One route to eventual success that may be promising is to forge an OECD standard similar to that developed in the mid-1990s on the issue of illicit payments—namely bribery. Such an approach, though it would no doubt take several years to take shape, would reinforce the national regulatory path and nail the level playing field concern right on the head.

At the same time, voluntary approaches may be more viable in the short term if a critical mass of home country governments and companies can get on board. Especially encouraging in this regard is the initiative of Prime Minister Tony Blair, working with the Foreign Office, Treasury, and DFID, to explore such possibilities. The fact that several of the largest UK-based oil and mining companies have indicated their intention to work with their government along these lines is very positive.

I believe that the U.S. Government now has an important opportunity to lend its voice and weight to the goal of revenue transparency in all countries: by backing at least a
voluntary approach to “Publish What You Pay” on the part of American companies; by working with the United Kingdom and other like-minded governments in the G8 and OECD arenas, and by raising the issue directly with the governments of countries that are its major sources of supply.

There are at least two compelling reasons for the U.S. Government to do so. Both are factors which have emerged on the American and global agendas in unforeseen but powerful ways over the last year.

One reason is the post-Enron crisis of corporate governance, which has put an unprecedented focus on corporate transparency and disclosure in this country. Although most of that focus of course has been on financial fundamentals, it feeds into the growing pressure for social and environmental reporting and disclosure coming from the socially responsible investment community and interested NGOs. “Publishing What You Pay” should gain some political traction in this context.

The other reason why the Bush Administration would be wise to take an affirmative position on at least a voluntary approach to “Publish What You Pay” and greater revenue transparency on the part of oil-producing countries is because it is in the long-term foreign policy and national security interest for the U.S. government to do so. As access to and security of oil supply from sources outside the Middle East becomes a critical interest, it is essential to understand what the durable foundations of access and supply really are: governments that are accountable to their own peoples, including the peoples of their oil-producing regions. Without such accountability, the legitimacy and even stability of those governments are open to challenge. And the conditions that can lead to local community unrest, civil strife, attacks on oil pipelines and facilities, and disruptions of supply are all exacerbated.

Prime Minister Tony Blair has given this interest of the UK government a name: in Johannesburg at the Conference on Sustainable Development in Johannesburg in August 2002, he called it “sustainable investment.” Such sustainable investment is certainly in the interest of the governments around the world, whether they are home to the international oil companies or are the governments of oil-producing countries that want to continue to host those companies and the wealth they help generate. Progress toward revenue transparency is not just a challenge to improved corporate responsibility; it ultimately challenges governments to recognize their own fundamental long-term national interests—unless they wish to run the risk of ruling unaccountably now and paying the price, politically and economically, later.

Conclusion

The World Bank Group and the IMF, of course, have a major role to play and are to be commended for their growing focus on the governance underpinnings of development and growth over the last several years. I hope that the Extractive Industries Review, in particular, can result in more stringent standards of revenue accountability as the IFC and the Bank overall evaluate current and proposed projects—and its country relationships.
Thank you very much for the chance to comment.

Alan Gelb, Chief Economist, Africa Region, the WBG

Thank you very much. This is a most interesting workshop—it deals with many issues, which are becoming more important to us in the Africa region. Unfortunately, several of our client countries are moving toward dependence on oil rather than toward more diversified economies.

Comparing where we were in 1974 and where we are today, we have gained considerable evidence, on the technical side, of what works. We understand better what the prerequisites are for good management. In 1974 a lot of things were not so clear. If you remember, there was a concern about the recycling problem, about how quickly natural resource rich countries could reabsorb their increased income. Now we have found out that that rapid rise in revenue does not help much in terms of real development. Experience has taught us lessons in terms of revenue collection, revenue management and revenue use. However, it is still the case that many countries remain way below the policy and institutional frontier. Experience has not often been translated into better management.

This brings us to issues of politics and governance. And that is why this workshop has been very interesting. It is one of the few meetings that has brought together the political and the technical sides of the management of natural resources, and this is what has made this workshop very productive.

As I see it, there are two or three large issues in terms of linking oil to poverty alleviation. One priority is the need for good economic management in a general sense. The second is, specifically, the focus on good use of public resources, including oil resources, within that generally sound economic management. Both of these require strong institutions. Such institutions are fundamental to the links we look for following on from the work on aid effectiveness.

Over time there has been a shift in the emphasis of what “Dutch Disease” really means. At the beginning, the disease was thought of in terms of real exchange rate appreciation and growth of the nontraded sector relative to nonoil tradeables. Then the emphasis moved on towards issues of instability and poor macroeconomic management. Most recently it has moved further, towards the question of political and social institutions and their tendency to deteriorate when revenues rise. There has been a progression in our understanding of what the nature of the problem really is.

The question we are all struggling with is the following. Consider first the technical side. A lot is known, even if there may be some disagreements and policy options. How does the technical side contribute to the political side of the equation? What can be done on the technical side and on the associated policies and implementation processes, which will make the adoption of good management on the political front more likely?
One option is to try to provide some separation, some space between the political and the technical sides. In the short term this can make a lot of sense. In all the cases where management is good, one sees a strong bureaucracy to a greater or lesser degree insulated from short-term political pressure. But underneath this is the deeper issue of how to create a constituency for good economic management, and that is a key issue we are all struggling with. We need good economic management both in terms of cautious macromanagement in general (avoiding boom and bust cycles), and in terms of good allocation and use of the oil resources. Although these are separate issues they usually tend to go about together. If you consider, for example, cases like Indonesia during the first part of the Suharto period there was strong macroeconomic management and quite effective use of resources. The same has been true for Botswana: excellent macroeconomic management and very good use of resources. These are part of a common pattern. Political participation may be a factor, but it is not enough to produce sound management. Transparency is certainly part of it, and this conference has been particularly interesting in terms of what can be done in this area.

Many competitive political systems also tend to have very short decision horizons, which is a huge problem when applied to management of natural resource rents. Under those conditions a country may or may not suffer from massive corruption but it will certainly experience tremendous macroeconomic instability. It will suffer from capital flight, which is just as bad as having the oil money taken out of the country in the first place. Such problems have been especially notable in Latin America.

This leads us to three further questions. One is the role of parliament. What do we expect from parliament in a political system? Clearly parliaments should be central in any representative system. But in many countries parliamentary institutions are weak. There has been a tendency in much of the development dialogue to bypass parliaments. As one looks at the Poverty Reduction Strategy Paper (PRSP) process, which is going on in our many client countries, there is a sense that parliament has not been involved as integrally into that process as it ought to have been. We are making efforts to restore the balance. But since parliamentary institutions are very weak in many countries, this will not be productive unless parliament can be strengthened—to serve as a representative and wise guiding body, as opposed to a group of special interests that simply want to appropriate rent.

The second type of interest group that we could consider are economic sectors, specifically the nonoil tradable sectors. In some countries, that have succeeded in managing their revenues well, the nonoil tradable sectors have been quite important interest groups, because they are the ones that are damaged when the economy is shattered by the imprudent use of oil resources. Take Malaysia for example. The strength of the interests in tin and rubber was important in making sure that oil was managed in a way which did not destabilize the economy. In Indonesia, there was much concern about the food sector and later about the future viability of labor-intensive manufacturing. We may want to think about how some of these interest groups, with longer-run interest in good management, can be identified? How can they be nurtured? What kind of information do they need to be effective political actors? How can some
of the natural resource rent from oil be used to raise their productivity, through better infrastructure, or through various other mechanisms, to lower costs of production in the nonoil sectors and help diversification? We do not think about such issues as systematically as we should.

The third potential interest group, of course, is the people themselves. I have always been impressed by what happened in Alaska. Oil income goes into a fund and dividends are distributed among Alaskan citizens—not from current oil revenues, but from the fund. This system was created explicitly with the view of strengthening civil society as a check on politicians. I do not think that the Alaska model is exactly applicable to many of our client countries. But there may be analogues to it, in terms of encouraging direct subventions to individual schools or to individual communities, perhaps somewhat along the lines of the social funds in the decentralized programs that the World Bank has been implementing. This might help spark involvement by civil society in what is actually happening to oil revenues, and strengthen mechanisms for oversight.

Of course, as one thinks more about the countries the issues of leverage and sovereignty arise. They pose very difficult issues, to which we do not have good and consistent answers. Some of the global constituencies that would argue against oil-extraction investments in certain countries on the grounds of poor governance and use of oil resources might also argue for faster debt relief to those same governments, despite the fact that debt relief and oil both provide revenue to government. This is a very complex area.

I would like to make three quick points on taxation. First, I was struck by the degree of complexity of some of these tax systems, and wonder if one of the elements in the drive for transparency could be a simplification of tax systems.

Second, I agree very much with what Paul Collier said about nonoil taxes. A number of countries (you do not even have to go as far as Norway), have inadequate government capacity to manage and spend oil revenue, yet also have, at least on paper, a nonoil tax regime with high marginal rates. We need to be more imaginative and consider how to combine the resource side and non-resource side, for example, going for very low tax rates to improve competitiveness while strengthening tax administration and compliance. That would also greatly encourage transparency.

Third, I wonder whether there is a role for international financial institutions in providing certified savings or hedging facilities to lower levels of government that desire to manage their resources well over time. Often there is a lack of trust between lower-level government and higher-level government. If for example, some states in Nigeria want to manage their financial resources well, can they save them and be assured that the savings will be there when they need them and not appropriated by the federal government? This is just one possibility—there may be other constructive approaches to encourage sound management.
Menachem Katz, Assistant Director, African Department, the IMF

First I would like to express my thanks to Charles McPherson for organizing this wonderful workshop. In fact, I attended a similar workshop organized by the IMF Fiscal Affairs Department a few months ago with some of our colleagues and we found it extremely useful. We suggest having additional Bank-Fund workshops and conferences on the subject, not just in this format but also with country authorities and oil companies in specific countries. The aim would be to draw country-specific lessons from the wealth of experience that exists today.

Let me touch quickly upon two issues that come to mind regarding petroleum revenue management. First is the need to create an enabling macroeconomic environment. I agree with many speakers at this workshop that the issue is how to convert what some people term a “resource curse” into a blessing. One of the key issues that has received ongoing attention is macroeconomic volatility. There is a need to find a way to stabilize the economy. The economies of countries that depend heavily on oil are frequently dominated by government spending and as my colleagues have indicated fiscal expenditure goes up and down. If you look at the economic history of Nigeria over the past two decades, revenue has increased and decreased with the oil price, and expenditure has also increased and decreased with the oil price. Therefore you have strong macroeconomic volatility that is not conducive to economic activity and private sector investment.

To move away from the short-term oriented policies that mirror the movements of the oil price, we are suggesting to move to some kind of fiscal rule. Our colleagues discussed the question of oil funds. Funds can work only up to a point. What is more important is to have a fiscal rule that leads to stable fiscal spending over the medium term. Fiscal rules may be violated or bypassed occasionally but at least they represent something that can serve as an anchor. The rule we are proposing is to have a balanced budget at a certain price of oil. When the actual price exceeds the benchmark price the government has a budget surplus and puts aside the excess revenue; and conversely when the oil price is lower the government runs a deficit and finances it out of earlier savings. This way the government can stabilize the level of expenditure and move away from the stop-go approach. This needs to be developed further in the context of Nigeria where you have not only the federal government but also state and local governments that complicates matters.

The second topic I would like to touch upon is governance and transparency. The work on governance issues has evolved tremendously over the past years. I worked on Mexico in the 1980s and we saw quite a bit of abuse of public oil funds but at the time governance was not on the agenda so we could not do anything about it. Later I moved to Kenya where the only thing we could do was to write a confidential memo regarding governance. Then I moved to Cameroon, which was at the time perceived by Transparency International to be the most corrupt country in the world. By then we felt we could give it a try and do something. The budget had received very little of the oil revenue and the government
could not pay wages because it did not have enough revenue. The perception was that oil money did not go to the budget. Rather it went to the presidency, and so we worked with the authorities to develop constructive means to get all the oil money to the budget.

After establishing fairly basic revenue accounting in the budget, of course the question was how could we know that all the oil money got to the budget? So we said we needed to have an audit. What kind of audit? It had to be a financial audit by an internationally reputable accounting firm. The accounting firm came and we discovered that there were limits to what a financial audit can do. It can certify that an amount of money went from here to there but what about the cost structure? Are the oil companies exaggerating and overreporting costs and so on? We recognized we needed an operational and managerial audit to look at these other aspects. I am no longer on the Cameroon desk but I believe that these audits have become part and parcel of the program and the landscape, and at least in Cameroon, though it is not a major oil producing country, oil money is coming to the budget and the government can pay wages and hopefully more than that.

That just gives you a sense of what can be done. At the same time there are many other issues that have to be addressed. Mr. Bennett Freeman mentioned Equatorial Guinea where I visited a few years ago when it was first starting its oil development. At the time we received copies of the contracts between the government and the international oil companies operating in the country. The country is Spanish speaking, the contracts were in English. I am not an expert in oil contracts but upon reading the contract I discovered that there was a formula on how to calculate the would-be taxable income. The formula went over 20 pages with many details: for the interest rates one had to refer to an IMF publication row so and so on page so and so; and if the debt is between this and that then the company in question pays so much and if it is between that and that, and so forth. In short, I do not think anybody in Equatorial Guinea can check and determine whether the oil companies are paying what they should be paying.

Mr. John Udeh made a good point. We have already started this initiative on improving transparency in Nigeria. We approached all the stakeholders in the oil sector, the major oil companies, the NNPC (the government-owned oil company) and we said: let us open the books and make findings of audits public. Initially of course a lot of people raised their eyebrows and asked what the aim was. Then we explained that we wanted to ensure transparency and openness. There is a lot of suspicion on the part of the public and the parliament, which is that maybe the oil companies are not paying what they are supposed to be paying. There are some question marks about the national oil company’s upstream and downstream activities as well. The management of the national oil company said that they did not want to be the only ones to open the books. If everybody else would agree to participate then they would consider joining in. Then they asked how all this was going to be done considering issues of confidentiality. I am glad that the federal government of Nigeria is willing to waive the confidentiality clause from its perspective so that we can move forward.
However, there are several other issues. How do you know that you know that you are getting all the oil money? If you do not, you need to build capacity so that you can really examine and make sure that you are actually getting paid what is due, and not only regarding international oil companies, but the same goes for the national oil company. Audited accounts are very complex in the best of cases. For the parliament and the general public, that is not good enough. You could give the public a long list of numbers which does not mean anything to them. You need to translate those numbers into something more meaningful. The idea we have developed with Charles and his colleagues, is to have an independent regulatory entity headed by somebody reputable who will collect the audits of all the foreign and national oil companies and put them together in a simple format so that everybody can know: this is how much oil was produced, this is what the oil companies have transferred to the budget and this is the balance. This will put pressure on the government to become more accountable with regard to what it is doing with the money.

Somebody mentioned that an examination by the World Bank concluded that in Nigeria between 1995–1999 there were no major discrepancies in the oil revenue proceeds. You do not need to be an oil expert to doubt the validity of this result. In the mid-1990s there was a character by the name of Abacha who ruled Nigeria and it is in the public domain that billions of dollars were misappropriated to say the least, and in the very short period of the transitional government of Abubakar in 1998, according to some reports, some three billion dollars “disappeared.” This shows that doing a good job with accounting for the oil proceeds cannot be the end of the story. If you account for the revenue but then Abacha raids the coffers of the Central Bank and takes off with it, how good is it? You need to have a comprehensive way of accessing financial information that will put pressure on everybody.

Ms. Oby Ezekwesili is absolutely right. It is not just oil revenue management that will do the trick and bring about economic development. Everybody needs to focus on how the nonoil economy can start growing and how you can use both oil money and other revenues at the federal, state, and local levels in a productive way so that you can start realizing some vision for the future and move away from oil. I hope that this workshop will give some impetus and create better understanding on the part of oil countries on how to proceed on this basis. We would very much like to move forward in Nigeria and other countries in this regard and have some way of preparing for the general public a certified summary table showing how much revenue the government received. This would make both government’s and public’s life easier because they would know what they know and would feel comfortable with what they get. The hope is that the accountability would make the system work better.

And finally I am not a linguist but I have had to learn a few languages over the years and I discovered that this very key word—accountability—does not exist in all the languages so, can you be accountable if you do not know the word?

Thank you.
Thank you very much Rashad. As Rashad said there are number of parallels between mining and oil and gas. I would not go into the parallels we have already seen. Instead I would look at the project level perspective and, in particular, impacts on project affected people.

The mining project perspective: This is the other side of the coin from the macro economic or oil perspective. Mining projects tend to produce less revenue but they typically create more harm than oil projects. This is because mining involves moving the dirt and disposing of mine waste which is typically much more disruptive than just drilling wells and installing pipelines. What is the objective here? To channel a part of the revenue of the mining project back to the affected community. Why? This is because (particularly with mining) there is a need to compensate and mitigate the negative impacts, to reduce the dependency of the community on the mining activity, and to diversify away mineral extraction and create a long-term sustainable future. Let me look in more detail at these micro, project-level aspects.

What are the negative project impacts? They include environmental damage, loss of access to land, and social disruption. There are different levels of social disruption. For some it may be relocation; for many it is reduced income-generating opportunities particularly in rural areas where there may be loss of fishing, forestry, and agriculture. Very important is the disruption caused by a large influx of outsiders. There is stress on the family and the community. In some cases, crowding and slums develop. There is often cultural conflict and crime as outsiders come into the community. Very importantly there is greatly increased pressure on government services. We did not mention much about government services in the past two days. Also there are higher living costs—food prices, land prices, goods prices, and transport prices all increase when a new project is developed.

At the project level, the question is how can the revenue distribution aspects that we are addressing help to compensate and mitigate these negative impacts? For some individuals and families, there is direct compensation from the project developer. For a number there will be employment and good wages compared to previous income earning opportunities. But there will be many who will not receive compensation or benefit from employment. For this latter group, what matters is that a minerals development results in increased revenue and capacity building for local governments to meet the expanding demand for services, such as education, health, sanitation, transportation, police, counseling, and planning. Most importantly, government needs to provide a social safety net for the poorest. This is especially important regarding food security and for land access because often times, particularly in remote areas, it is the poorest who are least able to enter the monetary economy and least able to take care of their needs in a period of rapid development.

What can be done in terms of diversifying away from over-dependence on mining or oil and gas and avoiding the “company town” syndrome with the company delivering the service. We have talked in rather conceptual terms about redistributing revenues back to
local areas. In fact, it is revenue distribution which provides the funds and to provide the capacity building (which cannot take place without funds) needed for local governments to be able to provide services without which the community will fall back to dependency on the company for services. Diversification has been mentioned at the country level but it is equally important at the community level. Over the life of the project, well-designed and implemented revenue distribution can help communities diversify away from dependence on projects with depleting resources by providing funds and training that help support local enterprise development, small and medium enterprise development, cash crops and agriculture, essentially economic activities that have a life separate from the mineral activities.

This leads us into the development of sustainable futures—which I think was mentioned specifically in the Nigeria context. Revenue distribution can contribute to a sustainable future for the community by successfully providing funds to create productive infrastructure, more nonmining business development, skills for the present generation, and better education and skills for the future generation.

If I could just for a moment bring us back to what is the heart of the discussions. Peter Woicke in the opening session said what is at stake is either to put an end to poverty or to see social distress continue. I think in this panel, we started to bring things back to linking them to poverty. A lot has been said about sound fiscal management that I will not repeat here. I will just say that perhaps within the Bank Group, given all the demands placed upon our country economists, it may well be that this type of workshop should be made available specifically for country economists working on countries with extractive industries.

I would like to focus for a moment is on the governance question. Joel Turkewitz this morning said there is no relationship between social spending and social outcomes in poor governance countries. We recognized it, but as we slipped back into a lot of the technical discussions, I think we started to lose sight of the fact that if you do not have good governance in the country at large, it may be unrealistic to expect to have good governance for the oil funds. Again Joel also commented and it caught me a little bit by surprise (although when you think about it it is not so surprising), the issue in many low-income countries is not the quality of the audit but if an audit even exists in the first place.

Yesterday we had some most interesting presentations on Kazakhstan and Azerbaijan. We had the social scientist Joel Hellman comment on the arrangement of those funds as “the King has tied his hands” and even more importantly he pointed out that these are a type of compact and you need two parties to make a compact. If the king ties his own hands, it has the pernicious result of excluding others from the compact. In this context we should also remember the comments of Arvind Ganesan pointing to the dangers of consolidation of political and economic control leading to the emergence of the self serving elite which comes in the arena of state capture.

Coming back to Kazakhstan and Azerbaijan, I think perhaps we have to ask ourselves “Are the present arrangements adequate?” Otherwise, a few years from now, from a
rather narrow “Bank-centric” point of view, we may face considerable reputational risk. More importantly we would have failed to deal with the moral issue of how much of the benefits from the oil flowing to those countries really goes to the people at large. Some of the major instruments for the Bank are the Country Assistance Strategy, the Country Economic Review, and the Public Expenditure Review. Interestingly, I am not sure if any of these were mentioned at all in the past two days. Is there something coming out of these two days which we need to consider introducing in the country assistance strategy for the extractive industry countries?

Along with our economic tools, I think as an institution we have to ask ourselves are there some noneconomic tools that are needed in addressing the governance area. In this regard, and as a final point, I would like to underscore the point that Alan made about building other constituencies to counterbalance the elite. We all recognize the importance of improved governance and this may be a key way forward also, especially for countries with extractive industries.

Thank you.