National Participation in Oil and Mining

By Patrick Heller

Summary

Rather than leave control of all the technical and commercial elements of oil and mining projects in the hands of foreign companies, many countries seek strong participation by their own public and private companies. Sometimes, state-owned companies take a direct ownership stake in projects. In most countries, governments encourage national private enterprises and professionals to play significant roles in these industries, from management to logistics to the supply of goods and services.

If effectively run, a state-owned company can help ensure that oil and mining projects are managed according to the goals of the country. As these companies gain experience, they can reduce dependence on foreign partners, deliver sizable returns to the national budget, and fuel the development of locally owned service providers.

Involving a country’s companies and citizens in oil and mining (often referred to as "local content" or "indigenization") can energize a country’s private sector, resulting in positive spillovers throughout the economy. These efforts can contribute to sustainable development that will benefit the nation long after oil and mineral reserves are depleted.

National participation, however, carries serious risks. If not effectively staffed or supervised, state-owned companies can slow project development, decrease the revenue accruing to the state, or exacerbate corruption. Indigenization programs can create corruption by increasing opportunities for public officials to steer valuable contracts toward their own interests. National participation can also cause the economy to become more dependent on nonrenewable natural resources.

Parliaments can play a critical role in designing and enforcing national participation programs. Policies and legislation crafting such programs must promote accountability and create effective mechanisms for achieving realistic goals. National companies and the administrators of local content programs should be subjected to regular reporting and vigorous oversight.

State equity participation

State participation has been particularly prominent in the oil sector since the 1970s, when a wave of nationalizations in Organization of Petroleum Exporting Countries (OPEC) countries shifted the balance of control from private to state companies. Many governments take a direct ownership stake in oil or mineral ventures, either as the sole commercial entity or in partnership with private companies.
Table 1 – Levels of State Ownership

<table>
<thead>
<tr>
<th>Extent of Participation</th>
<th>Examples</th>
<th>Remarks</th>
</tr>
</thead>
<tbody>
<tr>
<td>100% Ownership</td>
<td>Saudi Arabia</td>
<td>National companies contract foreign companies as service providers, but do not give them an ownership stake.</td>
</tr>
<tr>
<td>Majority Ownership</td>
<td>Nigeria, Venezuela</td>
<td>Does not necessarily indicate full operational control, but gives the national company a strong tool for influence.</td>
</tr>
<tr>
<td>Minority Ownership</td>
<td>Azerbaijan, Ghana</td>
<td>Common among new petroleum producers and countries with limited oil sector capacity. Ownership stakes vary significantly by project and country.</td>
</tr>
<tr>
<td>No Ownership</td>
<td>United States, Gabon</td>
<td>The state exercises control through regulatory bodies and collects revenues through the fiscal system, but takes no commercial interest.</td>
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Proponents of government ownership of shares, or equity stakes, cite three principal benefits:

1. **Capacity Building**
   
   If equity is organized through a national company, that company can become a domestic expert in oil or mining. Over time, this can promote broader industrial development and reduce dependence on foreign partners, as has been the case with Brazil’s Petrobras and Malaysia’s Petronas. State ownership alone does not ensure this kind of capacity building; many state-owned companies have failed to develop. Success requires a consistent commitment to step-by-step training.

2. **Improved Monitoring**
   
   By having a seat at the table as a shareholder in an oil or mining venture, many governments expect to enhance their ability to monitor the activities of private partners. Experience here has been mixed. While countries like Trinidad and Tobago have used equity as a tool for stronger enforcement, many government shareholders remain excluded from major decisions. In these nations, the arrangement provides no more authority than the government’s basic regulatory powers.

3. **Direct Financial Benefits**
   
   Equity participants are entitled to receive some form of dividend payment if a project is profitable. Private companies, however, often control the accounting procedures that lead to the declaration of dividends. As a result, dividends are paid only after a project has recovered all upfront costs, meaning they are often awarded years after the project’s start and they are vulnerable to financial manipulation—leading to disappointing or nonexistent dividends for the state.

**Types of state equity**

With **paid equity**, the state pays a market rate for its shares and may have to meet cash calls for project development expenses, as a private partner would. This can increase a state-owned company’s focus on maximizing profits and accelerate its development as a viable, competitive entity. But in cash-strapped countries, the need to pay up-front or unanticipated costs can strain public resources and increase the economy’s dependence on volatile oil or mineral prices.

Alternatively, governments can receive equity on preferential terms. With **carried equity**, the private-sector mining partner finances the operation upfront and the government pays for its equity via foregone dividends. With **free equity**, the government pays nothing for the equity. Neither of these arrangements comes without costs to the state. They are seen as deterrents to investment and, where instituted, typically obligate states to make trade-offs elsewhere in the fiscal package, via lower taxes or royalties.

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**Petrobras: Brazil Births a Giant**

Since its founding in the 1950s, Petrobras has steadily evolved from a small company with limited petroleum-sector expertise to one of the world’s most significant players. Through a firm commitment to developing capacities and a particular focus on deepwater drilling, the company has over time become respected as an effective and sophisticated player both within Brazil and abroad. In addition to generating revenues for Brazil via tax and dividend payments, Petrobras has also served as an incubator for private Brazilian companies to establish footholds performing hundreds of different services in support of the country’s oil industry.
State participation and governance
Domestic oil or mining companies without strong mechanisms for oversight and accountability can exacerbate governance problems. Inefficient companies can bog down oil or mineral operations in poorly coordinated processes that slow or diminish revenue creation, as seen in Nigeria. They can become “states within a state” pursuing internal priorities with little attention to broader national objectives, as witnessed in Venezuela before 2003. They can be used as nontransparent vehicles to avoid public scrutiny on issues from road construction to arms purchases to political payoffs.

To avoid these governance risks, the roles of national companies and their relationships with other bodies of the state should be clearly defined in legislation. If companies are to play anything more than a purely commercial role—for example, if they monitor the compliance of private partners with national rules—the contours of these responsibilities must be transparent. Companies must be held accountable for their performance by the executive branch, parliament and citizens. Public reporting on activities and finances should be regular and rigorous.

Engaging citizens and companies in the oil or mining economy
Beyond the immediate fiscal streams from extraction, many governments seek to use oil and mining projects to spur the development of expertise and experience among their citizens and companies. Generating this local content requires concerted strategies in countries with low private-sector capacity, since many of the enterprises that accompany exploration and extraction are highly specialized and unlikely to develop spontaneously. Governments use a variety of tools to promote local expertise:

- **Quotas**, embedded in laws, regulations or contracts, which require companies to award a certain percentage of hires, contracts or equity ownership to local companies or professionals.
- **Training program requirements or incentives**, so foreign companies develop the skills of domestic actors over time.
- **Public education initiatives**, wherein the state opens training centers, establishes programs, or organizes overseas scholarships to build a cadre of expertise in sectors with strategic links to oil and minerals.
- **Incentives for small business development**, including better access to credit or business incubation centers.
- **Processing and production of derivative products**, such as refining crude oil or smelting minerals, that can capture significant economic benefits if done domestically, but also can be expensive and complicated to construct.

If planned or executed ineffectively, local content programs have little impact on the national economy and may create substantial costs for the country. Governments often have to spend money up front to develop these programs, which may entail sacrificing revenue from oil or mining to convince companies to fund them. Worse, if they create unrealistic expectations, the failure of these programs can exacerbate political frustration and social conflict. They can also be a major source of corruption if public officials use them to steer business to cronies rather than promote fair, competitive private-sector development.

Parliamentary strategies for effective national participation
Through their legislative role, parliaments can impact state participation and local content initiatives via the following instruments:

- **Overarching upstream oil or mining laws**, which frequently spell out local content obligations and the nature of relations between various government entities or state and private investors, including administrative and fiscal matters.
Briefing

- Laws establishing state-owned companies, which supplement framework oil and mining laws in some countries and detail the roles of the company and reporting structures.
- Tax laws, which determine revenues gained by the state. These laws do not usually touch directly on state equity or local content, but they influence the overall balance of benefits between companies and government, which is deeply intertwined with equity and indigenization.
- Local content Laws, which devise specific plans and requirements for promoting indigenization.
- National budgets and development plans, wherein it is necessary to link efforts to improve education and the business climate to specific initiatives to promote indigenization in oil or mining.
- Contracts, in countries where parliamentary approval is required that contain details on equity and local content regarding specific projects.

Through their oversight role, parliaments should:
- Insist upon regular reporting by state-owned companies, and hold their executives accountable for their performance in revenue generation, capacity building and transparency.
- Monitor the implementation of indigenization programs and track performance against stated goals.
- Periodically assess the overall impact of the oil or mineral sector on broader economic and private-sector development, and call for an adjustment of strategy if national participation policies are not working.

Questions parliamentarians can ask
- Do the state equity participation plans effectively balance the goals of monitoring and capacity building against the government’s payment obligations and risks of other economic trade-offs?
- Are adequate mechanisms in place to ensure that the state-owned company is held accountable for its activities?
- Do local content programs target realistic goals and install adequate measures for reaching those goals?
- Are adequate mechanisms in place to ensure these programs will be accountable and promote equitable private sector development rather than corruption?

Further learning
- Ask civic groups or parliamentary staff to prepare a briefing that identifies options, challenges and available tools.
- Contact peers from countries that have state-owned companies or local content or empowerment programs to learn from their experience.
- Read publications on national participation at www.revenuewatch.org.

Case Study: Losing Value from Gemstones
Tanzanite is a unique gemstone found only in the Republic of Tanzania. However, the country only ranks fourth in the world by value of its Tanzanite exports, trailing South Africa, Kenya and India. Most raw tanzanite is exported to the gemstone-cutting center of Jaipur, India, where it reportedly creates up to 250,000 jobs. The extraction of tanzanite contributes approximately $20 million in annual revenues to the Tanzanian government. However, once cut and polished, trade—done largely in the United States—generates around $500 million.

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