

# State participation and local participation in oil and gas in Africa

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## 1. Introduction

There has been a marked intensification in recent years of international oil and gas industry activity across African regions, including recent focus on the potential of the east coast (eg, Mozambique, Kenya, Tanzania and Somalia) and the pre-salt plays of west Africa (eg, Angola, Gabon and the Republic of Congo). There has also been increased activity in 'frontier' states (eg, Namibia and Liberia) and those seeing revival following periods of political instability (eg, Ivory Coast and Egypt).

This upswing in international oil company ('IOC') interest brings into renewed focus the means by which African governments may seek, through legislative and regulatory regimes, to maximise the benefits of oil and gas investment to their host states. These efforts take several forms, including government-imposed requirements for 'state participation' and 'local participation'.

State participation in the oil and gas industry is the legislated or otherwise mandatory requirement that the state or a state-owned entity, such as the national oil company ('NOC'), participate in oil and gas activities as a working interest or participating interest owner. Local participation is the requirement that local persons or entities that are not state-owned participate in oil and gas activities as direct or indirect working interest or participating interest owners.

The public policies underlying state participation and local participation in the African context are different. State participation is ideologically driven by resource nationalism, which is a global phenomenon and is embedded in the wider oil and gas industry. It is inherently linked to international politics. Approximately \$2 billion a day of petroleum is traded worldwide, making it the largest single item in the balance of payments and exchanges between nations.<sup>1</sup> In this context, it is unsurprising that "many producing and importing countries have, at least at some point during the course of history, opted for direct state intervention rather than more liberal governance regimes."<sup>2</sup> Local participation has developed more uniquely in the African oil and gas industry in the light of wider political policies, such as economic empowerment.

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1 Silvana Tordo with Brandon S Tracy & Noora Arfaa, *National Oil Companies and Value Creation*, World Bank paper no 28 (2011), at p xi.

2 *Ibid.*

Both state participation and local participation have similar consequences for IOCs, in that they reduce the levels of IOC participation and control in oil and gas activities. Both also raise certain challenges for host states as well as IOCs. For IOCs, these challenges are part of the wider risks associated with doing business in Africa. For example, both state participation and local participation regimes are subject to the risk of political instability and regulatory uncertainty. In addition, local participation in particular may give rise to anti-bribery and corruption issues.

This chapter will consider the historic origins of state participation and local participation, their prevalence in the African oil and gas industry and the resulting challenges faced by host states and IOCs. Finally, this chapter will suggest means of addressing these challenges in the legal context with a view to risk mitigation.

## 2. State 'take' under petroleum agreements

In a chapter examining state participation, it is important to consider briefly the wider fiscal environment of host state/IOC interaction. Across the global oil and gas industry, the concept of financial or commercial benefit accruing to the host state is fundamental. This has been a feature since the royalty provisions of the earliest petroleum agreements (which originally took the form of concessions) between host states and IOCs, albeit historically the commercial and financial benefits to the state were limited. In addition to royalties, provisions concerning taxation, bonus payments and/or rental payments are other examples of the traditional mechanisms comprising the state's 'take' under an upstream petroleum agreement.

Nowadays, the fiscal framework varies between different types of petroleum agreements, being primarily concessions, risk service agreements and, most commonly in developing states, production sharing contracts ('PSCs'). Under the PSC model, the government's primary financial benefit derives from 'profit oil'. This is the amount of oil or gas production that is divided between the IOC participating parties and the host state under the petroleum agreement, after deducting the amount of oil and gas production that has been allocated to reimbursement of exploration and development costs and expenses. This concept of production sharing under petroleum agreements began in the 1950s, thereby preceding the introduction of PSCs (which were first introduced in Indonesia in 1966), but it is nonetheless the PSC that best illustrates this fiscal structure.

The modern legal framework for state participation progressed in tandem with the evolution of production sharing and PSCs. PSCs were the first host state agreements to provide that the ownership of and right to exploit oil and gas remain with the host state or its NOC, with the IOC being, in legal terms, a contractor hired to perform the operations.<sup>3</sup> As will be discussed, however, state participation as a concept pre-dates both production sharing and the PSC and goes beyond mere financial 'take'. The challenges for the host state of balancing fiscal concerns with the wider political and social aspects of state participation will also be discussed later in this chapter.

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3 Claude Duval, Honoré Le Leuch, André Pertuzio & Jacqueline Lang Weaver, *International Petroleum Exploration and Exploitation Agreements: Legal, Economic and Policy Aspects* (2009, Barrows, New York), at p 71.

It should be noted that fiscal aspects and state participation interact in different ways across different petroleum agreements, often creating a ‘hybrid’ approach. For example, many modern modern PSCs retain a royalty payment, and since the 1960s and 1970s many old-style concession agreements have also included an element of profit oil and/or state participation.<sup>4</sup>

### 3. State participation – the historical context

State participation in the oil and gas industry was first seen at the beginning of the last century. The first NOC was founded in Argentina in 1922, prior to which Russia had already nationalised its oil and gas industry (in 1918), with NOCs to follow there in the 1930s.<sup>5</sup> It was not, however, until the 1950s that state participation in the oil and gas industry advanced significantly. This occurred at the same time as the principle of state sovereignty over national resources was formally recognised by the United Nations (‘UN’) as part of the New International Economic Order, which was “a comprehensive package of multilateral policy options that aimed to improve the position of Third World countries in the world economy relative to the richest States.”<sup>6</sup>

By the time of the UN General Assembly’s ‘Permanent sovereignty over natural resources’ resolution in 1962, the concept of state participation already had widespread application and significant momentum under international law.<sup>7</sup> The resolution stated, among other things:

*The right of peoples and nations to permanent sovereignty over their natural wealth and resources must be exercised in the interest of their national development and of the well-being of the people of the State concerned. The exploration, development and disposition of such resources, as well as the import of the foreign capital required for these purposes, should be in conformity with the rules and conditions which the peoples and nations freely consider to be necessary or desirable with regard to the authorization, restriction or prohibition of such activities.*<sup>8</sup>

The ideological and public policy driver for direct state participation in the oil and gas industry was therefore the notion that it could secure crucial national interests more effectively than market forces and private initiative.<sup>9</sup> Simply put, sovereignty needed a ‘tool’.<sup>10</sup> Also important (and which remains the case) was the ‘strategic’ nature of oil, principally realised by way of the oil revenues generated for national treasuries.<sup>11</sup> As a result of these and a range of other (always context-specific)

4 *Ibid*, at p 68.

5 Charalambos Constantinou, ‘State Petroleum Enterprises in Developing Countries’, in *Natural Resources Forum*, Vol 3, Issue 1 (1978) at pp 73-82.

6 Adam Sneyd, *New International Economic Order (NIEO)*, Globalization and Autonomy Online Compendium McMaster University, available at <http://globalautonomy.ca/global1/index.jsp> (accessed January 2015).

7 Professor Dr Erica-Irene A Daes, *Indigenous Peoples’ Permanent Sovereignty Over Natural Resources*, UN Commission on Human Rights (2004), at p 6.

8 UN General Assembly resolution 1803 (XVII) of December 14 1962, *Permanent sovereignty over natural resources*, available at [www.ohchr.org/EN/ProfessionalInterest/Pages/NaturalResources.aspx](http://www.ohchr.org/EN/ProfessionalInterest/Pages/NaturalResources.aspx).

9 O Noreng, *Oil and Islam: Social and Economic Issues*, (1997, John Wiley & Sons, Chichester), as cited by Miranda Ferrell Wainburg, Dr Michelle Michot Foss *et al* in their 2007 working paper, *Commercial Frameworks for National Oil Companies* (University of Texas at Austin), at p 4.

10 Professor Paul Stevens, *An Overview of NOC Experience*, paper delivered at a workshop for the World Bank (2003).

11 Wainburg *et al*, *op cit* (note 9 above), at p 4.

factors, state participation became a key component of the public policy of petroleum states.

A prime example is that of Iran. In 1951, the Mossadegh government took the then radical step of nationalising the oil and gas industry, and the National Iranian Oil Company ('NIOC') was formed. This move was not only contested unsuccessfully by the British government at the International Court of Justice at The Hague, but also led to a worldwide embargo on Iranian oil. Despite this political upheaval, petroleum nationalisation pushed forward.<sup>12</sup> The NIOC first entered into an arrangement with an American and French consortium of IOCs and, in 1957, a 50/50 joint venture with Italy's own NOC, AGIP, to hold one offshore area in the Persian Gulf and two onshore in Iran.<sup>13</sup> It has been noted that, "somewhat ironically, it was the arrangement between a national oil company of a Western nation and the national oil company of a developing [host state] that led to the advent of... state participation" in the oil and gas industry.<sup>14</sup>

State participation became prominent again as a global trend during the 1970s. For example, in the North Sea, Norway, the United Kingdom and Denmark introduced state participation in the award of offshore licences. During the same period, a number of nationalisations took place in both OPEC and non-OPEC countries. Saudi Arabia presents perhaps the most extreme example of that era. In 1976, the Saudi government assumed 100% control of what is now Saudi Aramco and, by royal decree, obtained ownership of all Saudi petroleum assets. Today, oil and natural gas operations remain dominated by Saudi Aramco, which is the world's largest oil company in terms of production.<sup>15</sup>

Following the expansion of state participation and nationalisation during the 1970s and 1980s, the 1990s brought in an era of privatisation that saw many state oil companies morph into investor-owned IOCs. This was seen across both developing and more mature petroleum economies. For example, by 1999 previously state-owned NOC YPF Argentina had become 100% privatised, as had the UK's British National Oil Corporation and France's Elf and Total.<sup>16</sup> In other states, governments sought significant IOC investment in their NOCs, often retaining an ownership interest, as was seen in the case of, for example, Petro-Canada, Petrobras (Brazil) and Eni (Italy).

There were a variety of complex contributing factors to these privatisations, one of which, in developing countries, was the expanding role of the NOCs. As one commentator explains, looking back to the 1990s, the wider political and social roles of NOCs had:

*expanded rapidly based on perceptions of almost limitless cash available to the NOCs... and their near monopoly on local technical and commercial talent. At the same time, NOCs were expected to emulate the IOCs in the areas of technical and managerial skill*

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12 Duval *et al*, *op cit* (note 3 above), at p 45.

13 Eni online summary, *History of Eni's Operations in Iran*, available at [www.eni.com/en\\_IT/world-eni/iran/history-eni-presence/history-eni-presence.shtml](http://www.eni.com/en_IT/world-eni/iran/history-eni-presence/history-eni-presence.shtml) (accessed January 2015).

14 Duval *et al*, *op cit* (note 3 above), at p 46.

15 US Energy Information Administration, online *Country Analysis Brief: Saudi Arabia*, available at [www.eia.gov/countries/analysisbriefs/Saudi\\_Arabia/saudi\\_arabia.pdf](http://www.eia.gov/countries/analysisbriefs/Saudi_Arabia/saudi_arabia.pdf) (accessed January 2015).

16 Wainburg *et al*, *op cit* (note 9 above), at p 7.

*and the ability to generate profits, with the aim of either effectively counter-balancing the local influence of the IOCs, or of replacing the IOCs altogether... Politics, however, meant that priority was assigned to the achievement of social, economic and political goals, and the cracks that began to emerge with respect to attainment of commercial goals were ignored, papered over by massive cash flows. The oil crisis of 1986, the dramatic revenue drops associated with it, and continued lower real oil prices, exposed these cracks and the incompatibility of the dual roles the NOCs were expected to play.<sup>17</sup>*

Today, NOCs are considered crucial to economic development for many states. Nonetheless, there are many criticisms of NOCs, including with regard to their commercial inefficiencies, non-commercial agendas (eg, job creation, income redistribution, state borrowing), weak governance and significant budgetary requirements (notwithstanding their potential to generate income).<sup>18</sup> These issues can be seen as particularly significant for African states, each of which generally faces a unique and diverse range of developmental challenges.

Notwithstanding these issues, state participation in the global oil and gas industry today remains hugely influential and is embedded in the regimes of numerous developed petroleum economies. As a result, NOCs rank significantly among the global top ten oil and gas companies, based on production. These are: Saudi Aramco (ranked 1); National Iranian Oil Company (ranked 3); PetroChina (ranked 7); Pemex (ranked 8); and Kuwait Petroleum Corporation (ranked 10).<sup>19</sup> The influence of state entities often now extends significantly beyond the geographic boundaries of the state itself, as NOCs invest in petroleum ventures abroad. For example, Chinese NOCs now hold significant oil and gas interests throughout Africa.

*This is an extract from the chapter 'State participation and local participation in oil and gas in Africa' by John LaMaster and Caroline-Lucy Moran in Oil & Gas in Africa, A Legal and Commercial Analysis of the Upstream Industry, published by Globe Law and Business.*

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17 Charles McPherson, lecture *National Oil Companies: Evolution, Issues, Outlook*, World Bank National Oil Companies Workshop, May 27 2003, at p 2.

18 *Ibid*, at pp 4-8.

19 Based on BOE (barrels of oil equivalent) per day. See *Forbes 2013 Ranking of the World's Biggest Oil Companies*, November 17 2013, available at [www.forbes.com/sites/christopherhelman/2013/11/17/the-worlds-biggest-oil-companies-2013/](http://www.forbes.com/sites/christopherhelman/2013/11/17/the-worlds-biggest-oil-companies-2013/) (accessed January 2015).