Local content policies and corruption in the oil and gas industry

Query
What has been the experience of corruption in local content policies, particularly in oil and gas? Are there any practices or approaches on how anti-corruption has been integrated into local content programmes?

Purpose
Contribute to the agency’s work in this area

Content
1. Introduction to local content in the oil and gas sector
2. Corruption risks in local content policy in the oil and gas industry
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Summary
Local content policies in the oil and gas sector aim to encourage the participation and development of domestic industries and labour, as well as to support the transferring of technology and capital. Local content rules are seen as a promising way of promoting social and economic development in resource-rich countries.

However, if not implemented carefully and if not subject to public oversight, local content can also be prone to corruption. Politicians and public officials may abuse their power and influence to use local content requirements to benefit their allies and/or family members, and international companies may pay bribes and kickbacks to local companies to serve as the “front” in bidding processes in order to gain access to oil agreements, among other irregularities.

Preventing and curbing corruption in local content requires a set of measures aimed at enhancing transparency and accountability in the public administration, including rules on conflicts of

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interest, asset declaration, public access to information, as well as strong oversight mechanisms. More generally, to prevent corruption, some of the countries requiring local content in the oil and gas industry have included anti-corruption clauses in their licensing agreements, published contracts and implementation monitoring reports online, committed to disclose beneficial ownership and established clear rules on public procurement.

1. Introduction to local content in the oil and gas sector

What is local content?

Resource-rich developing countries usually suffer from low levels of economic and social development. Increasingly, governments have strived to introduce policies and rules that would allow society as a whole to benefit from oil and gas activities, bringing economic benefits that are not related to tax or royalties; local content is one of these policies (Esteves et al. 2013). Local content is defined as “the added value brought to a host nation through workforce development (employment and training of workforce), and investments in supplier development (developing and procuring supplies and services locally)” (International Petroleum Industry Conservation Association 2011).

As such, the main objectives of local content policies are to: (i) create jobs; (ii) promote enterprise development; (iii) accelerate the transfer of skills and technologies (World Bank 2013).

Local content policies vary greatly across countries. The objectives and guiding principles of these policies are sometimes outlined in policy statements and/or economic plans, and further detailed in primary or secondary legislation as well as in negotiated individual contracts, licensing agreements or concession agreements between the government and international oil and gas companies (World Bank 2013).

Some countries have adopted severe penalties in the event of non-compliance (for example, Kazakhstan), and others have kept it as a recommendation, encouraging oil and gas companies to give preferential treatment to local suppliers and workers, without establishing any penalty for non-compliance (Esteves et al. 2013).

The policy tools used to implement local content also vary according to the areas the host country wishes to benefit/incentivise. They may include determining that a percentage of petroleum rights should be given to a local company; adapting special taxes and tariffs to local companies; establishing rules on employment and training arrangements (for example, the number of local staff per level that should be hired); establishing procurement rules that determine the percentage of contracts in the sector that should be awarded to local companies; or requiring that multinational companies enter joint ventures with local companies in order to operate in the country (World Bank 2013).

Local content in practice

As of 2013, Angola, Equatorial Guinea, Indonesia, Kazakhstan, Nigeria, Russia, South Africa and Zimbabwe were among the countries that had adopted specific national laws regulating local content in the oil and gas industry. Other countries have done so using other instruments, such as procurement rules or licensing agreements, as mentioned above (Esteves et al. 2013).

Existing local content rules vary across these countries. For instance, in Nigeria, the Oil and Gas Industry Content Development Act of 2010 specifies the minimum amounts of local materials and personnel used by oil and gas operators in the country. In Kazakhstan, a target of 50% local procurement from Kazakh suppliers has been established. In Angola, a series of local content rules apply for the procurement of goods and services. For instance, there is a list of goods and services that can only be supplied by companies based in Angola; for other goods and services, foreign companies can only participate in tenders in association with an Angolan-owned company.

The literature on the implementation of local content in the oil and gas industry is still very limited. Moreover, considering that the benefits of local content policies are only achieved in the medium to long term, in many developing countries it is still too early to assess impact, failures and successes.

Nevertheless, studies on the application of local content in countries such as Brazil and Trinidad & Tobago, highlight that a successful local content policy has the following elements: (i) transparent and independent regulatory oversight; (ii) critical vocational training and support to small and
medium enterprises; and (iii) support to local companies and staff by setting the standards for commercial success rather than benefiting well-connected individuals/companies (Esteves et al. 2013).

In most developing countries, however, there is a handful of practical challenges that may hamper the effective implementation of these policies, including limited industry capacity to kick-start the process, lack of coordination and often coherence among government agencies, high levels of bureaucracy and opacity, as well as widespread corruption and weak accountability mechanisms.

Indeed, corruption is considered to be one of the main impediments to resource-rich countries fully achieving the economic benefits that oil and gas exploration could bring, and it can seriously damage the implementation of local content policies.

This answer provides an overview of the main corruption risks in local content in the oil and gas sector, and discusses the main steps that have been taken by governments and oil companies to mitigate these risks.

2. Corruption risks in local content policies in the oil and gas industry

Local content is seen as a key tool to help developing countries to reap, in a sustainable manner, the economic and social benefits from their natural resources. Yet, if not implemented and managed carefully and if not subject to public scrutiny, local content can also offer significant corruption opportunities (Global Witness 2012a).

Global Witness describes this form of corruption as “even more damaging than one-off payments for contracts because it means revenues can be stolen from the state continuously and in a way that is much more difficult for an audit to detect”. In addition, corruption in local content may provide disincentives to international companies to invest in such an environment and risk violating foreign bribery laws in their home countries (Global Witness 2012a).

The literature on corruption risks in local content is, however, very limited. Available reports indicate that many of the corruption challenges faced by developing resource-rich countries also influence and have an impact on local content policies. Within this framework, measures that are usually adopted to curb corruption within the public administration, such as enhancing transparency in decision-making, establishing clear and transparent procurement rules, providing access to public documents, and strengthening oversight, are also instrumental to prevent and curb corruption in local content.

Nevertheless, there are some characteristics specific to the development and implementation of local content policies that may offer opportunities for corruption. As such, the main corruption risks in local content policies in the oil and gas sector include:

Favouritism and conflict of interest

The decision to adopt local content policies may be closely aligned with public officials’ or investors’ interests rather than the promotion of local businesses (Esteves et al. 2013). In fact, this is the major risk highlighted in the literature.

Many resource-rich countries are considered to be patrimonial societies where the distinction between public and private is very blurred. Politicians and decision-makers are usually very close to the economic elite, and in several cases are the main beneficiaries of local content requirements. As such, local content rules end up benefiting and generating revenues for government-affiliated individuals, failing to achieve some of their objectives such as promoting enterprise development and the broader sustainable development of the country.

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1 Resource-rich developing countries are among the poorest scorers in Transparency International’s Corruption Perceptions Index. In addition, according to the 2011 Bribe Payers Index, companies in this sector are perceived to be more likely to bribe than those in other sectors.
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There are several examples of conflict of interest and favouritism in the design and implementation of local content policies. This has been the case in Nigeria, where local content may easily be used by the political and economic elite to extract rents, as well as in Uganda, where close ties between senior public officials and the private sector may distort the policy-making process and the award of licences and other local content benefits. In fact, studies have shown that local policies and resources are often directed to groups based on their affiliation, ethnicity and loyalty to the president (Oxford Policy Management 2012).

Similarly, Angola’s local content policy has been considered highly vulnerable to exploitation by public officials and their close allies in the private sector. Investigations conducted by Angolan organisations and the US government have raised questions regarding contracts awarded to companies belonging to Angolan decision-makers. According to the investigations, in compliance with the local content law that requires international companies to partner with local companies to be able to operate in Angola, an American company entered into a consortium with two Angolan companies to participate in oil blocks. However, it turned out that the real owners of one of these local companies were the former chairman and CEO of Sonangol, the Angolan state-owned oil company (responsible for the agreement with the American company), and a minister of state (Ramos 2012; Financial Times 2012).

Moreover, opaque and discretionary decision-making may also allow public officials to extort international companies wishing to operate in the country, in order to favour their own companies or those of close friends and family members. As such, public officials responsible for the award of contracts and licences may force operating companies to enter partnerships or sign service contracts with particular companies. In many cases, the local companies chosen by the public official do not even deliver the services contracted. International companies merely have to pay the agreed cost – that here functions as a bribe in order to be awarded the contract – and perform the services themselves (Global Witness 2012a).

In Kenya, for example, the rules in place are considered inadequate and prone to corruption. According to NGOs operating in the country, “there is a likelihood of local firms being imposed on foreign companies as condition for securing petroleum contracts; and this could provide room for politicians to perpetuate their interest in the oil industry at the expense of the nation” (Kenya Civil Society Platform on Oil and Gas, no year).

Undue influence by international oil and gas companies

There is also risk of corruption and undue influence in deciding local content policies. As mentioned, several instruments can be used to regulate and promote local content, such as national law, petroleum agreements and procurement guidelines, among others. In spite of these instruments, multinational companies may try to influence the process to their own advantage. For instance, in order to compensate for local content regulations, multinational companies may lobby for tax breaks or public subsidies that often are not in the interest of the host country (Esteves et al. 2013).

There is also the risk that international companies offer illegal commissions, gifts and entertainment (such as first class flights, expensive hotels, dining) to public officials and politicians during the negotiation process, which could unduly influence the decision.

These negotiations usually take place in a non-transparent way and are not open for citizen oversight or consultation, making it difficult to assess whether decisions have been made taking into account the public interest.

Political interference and discretionary power of public officials in implementing and enforcing local content rules

The discretion often enjoyed by public officials responsible for implementing local content policies, combined with this lack of transparency, opens the door for uneven implementation and enforcement of local content rules.

In Kazakhstan, for instance, international oil companies have complained that local content implementation is “uneven, irregular, and non-transparent, particularly at local levels of government” (US Department of State 2013). Companies in the country have also complained of the indiscriminate use of sanctions for non-compliance with local content requirements (Tooshi and Umarov 2014).
Discretion is also enjoyed by public officials to decide the circumstances in which local content rules do not apply. This is the case in Nigeria, where the minister for petroleum resources can decide to waive the obligations for a given firm or project under Nigeria’s 2010 Content Development Act. Such discretion may provide incentives for corruption, particularly if the criteria for evaluating waiver applications is not made public, or is not applied in an objective or transparent manner (World Trade Institute 2013).

In addition, political interference in the application and enforcement of the law is also problematic in the majority of these countries, where the Executive branch of government exercises huge influence over other government branches and agencies as well as state-owned enterprises. In Mozambique, for instance, the national oil company ENH plays a key role in defining the country’s local content strategy. Nevertheless, the company reportedly suffers from political interference and its senior executives are closely connected to the political and business elite, opening space for these groups to extract rents in the sector (Oxford Policy Management 2012).

In the UK this is an area of concern for oil and gas companies, as they were already subject to the most prosecutions for bribery and graft of any sector during 2008 and 2012, and for payments and kickbacks made abroad by themselves or partners (Chazan 2012).

Corruption in joint ventures
Joint ventures are used by oil and gas companies as “a way to share the higher risks and costs associated with the industry or as a way of bringing in specialist skills to a particular project” (Deloitte 2012). Joint ventures have also been used in the implementation of local content policies. In some countries, international companies wishing to operate in the oil and gas sector can only do so by entering joint ventures with local companies – which usually are state-owned enterprises (Law 360 2013).

Corruption risks in this process are many; there are the risks of corruption in the negotiations phase as discussed above, in the selection of joint ventures partners and risks of conflict of interest, among others.

In fact, in the majority of countries, international companies do not have extensive options for potential joint venture partners. Considering the oil and gas industry in developing resource-rich countries and the close ties between the political and economic elite, partners are usually state-owned enterprises or companies that are somehow connected to public officials. As the main characteristic of a joint venture is joint control (Deloitte 2012), partners are able to appoint government officials to sit on the joint venture board. This generates two main risks of corruption. First, the risk of conflict of interest and favouritism as discussed above. Second, according to international anti-corruption laws, such as the UK Bribery Act and the Foreign Corruption Practices Act (FCPA), international oil companies are liable for any bribes or corrupt behaviour by joint ventures partners who act on their behalf (Ernst & Young 2013; Chazan 2012).

International companies face similar compliance challenges with regard to their relationships with third parties. When subcontracting part of their operations to local companies, international companies may also be held liable if these companies engage in corruption (Ernst & Young 2013).

Fronting and use of shell companies
Local content policies may also be circumvented through the use of “fronts” and shell companies. International oil and gas companies may “hire” local established companies to serve as fronts to satisfy local content requirements. In this case, international oil companies may pay companies registered in the host country to participate in bidding processes; the services are then implemented by the international company, as the local company does not have the capacity or exist (World Trade Institute 2013).

For instance, in Angola, there is evidence that international oil companies are paying illegal fees to contract with front companies in order to comply with host-country laws. The ownership and shareholding structure of these companies is often opaque, and they often lack the capacity to deliver on the awarded contract, with the work usually being carried out by the international oil company (Ramos 2012).

In addition, special purpose vehicles, such as shell companies, may also be used to circumvent local content requirements, particularly in countries where local content rules do not clearly define what constitutes a “local” or “indigenous”
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Within this framework, any company or international service provider registered in the host country, without having to disclose their beneficial owner, can potentially bid for contracts (World Trade Institute 2013). Without requirements to disclose the beneficial owner it is difficult to assess whether the company in question is actually owned by a national.

This was the case in Nigeria, where local content requirements were misused and contracts to supply the oil industry were awarded to shell companies, inflating costs and increasing the project cycle (Mwakali and Byaruhanfa 2011). Moreover, shell companies may also be used by politicians to disguise conflict of interest and facilitate the award of local content contracts to companies in which they hold interests.

Public procurement corruption

Procurement processes are usually assessed as one of the areas in the public administration most prone to corruption, and this is no different in the implementation of local content rules. Unclear and opaque procurement procedures, restricted use of competitive bidding procedures, and the great amount of money available for local companies encourage and facilitate corruption in the application of local content rules. In addition, the fact that the industrial and service sectors are not yet fully developed or capable of delivering the required services in the field limits competition and creates further opportunities for corruption throughout the procurement process.

For instance, in many countries, a government body is responsible for keeping a list of potential local suppliers. In the case of Kazakhstan, for example, the National Agency for Development of the Local Content is responsible for maintaining a database of Kazakh firms located across the country, including the services these entities offer in the oil and gas sector. There is a risk that local companies may bribe or offer kickbacks to public officials to be included in such lists (Ernst & Young 2013).

Limited competition and opaque mechanisms in the public process also facilitate the formation of cartel and bidding rigging among local companies, which in turn can lead to higher prices and delays in the delivery of products and services.

Moreover, in many cases there are no clear criteria for selecting the winner, and the lack of transparency throughout the application and decision-making process facilitates decisions that favour a certain individual or group, rather than supporting technology and knowledge transfer and building local industry capacity. In Nigeria, for example, a bidding round for oil licensing seem to have benefited a Nigerian senator, who chaired a parliamentary committee with direct oversight authority over the upstream oil sector, creating doubts about the fairness and integrity of the country’s bidding processes (Global Witness 2012b).

Nepotism and cronyism in the hiring of local staff

Employment regulation is one of the most commonly used tools in local content policies. In order to promote the local economy and give employment opportunities to nationals, countries have established rules imposing local employment obligations, minimum salaries, the reservation of certain jobs or levels for citizens, and training requirements, among others (World Bank 2013).

For instance, in Kazakhstan, the local content policy includes rules to hire local staff; medium and large companies have to employ a minimum of 70% of Kazakh executives and 90% of Kazakh technical personnel. In Angola, at least 70% of the workforce must be Angolan in companies with more than five employees.

These rules are important to build technical capacity, create opportunities for nationals and reduce developing countries’ dependence on foreign companies’ expertise. However, considering the lack of good and well-paid employment opportunities in the majority of resource-rich developing countries, local content positions may be in high demand, which – combined with opaque mechanisms and political interference – could also open space for corruption.

There have been instances where local content policies have been abused and positions filled on the basis of family ties, party affiliation or ethnicity rather than qualifications (Oxford Policy Management 2012).
3. Anti-corruption mechanisms adopted in local content in the oil and gas sector

General anti-corruption mechanisms that have been adopted so far to prevent and curb corruption in local content in the oil and gas sector include: (i) the adoption of anti-corruption clauses; (ii) establishment of independent oversight bodies to review local content implementation; (iii) clear procurement rules; (iv) requirements to disclose beneficial ownership in some circumstances; (v) the publication of contracts and information regarding the implementation of local content rules; and (vi) the adoption of stronger compliance mechanisms by multinational companies operating in resource-rich countries, including due diligence and whistleblower policies.

This section analyses some of the general anti-corruption mechanisms adopted in resource-rich countries that, when effectively implemented and enforced, also help to prevent corruption in local content. While some countries have adopted these measures, in the great majority it is still too early to assess their impact on control of corruption.

Anti-corruption clauses

Anti-corruption clauses seek to spell out the behaviour expected from the contracting partners and send a strong signal with regard to the government's or company’s commitment to fight corruption.

The International Chamber of Commerce (ICC) has drafted a model anti-corruption clause to be included in contracts, under which parties commit to complying with ICC rules on combating corruption or to putting in place and maintaining a corporate anti-corruption compliance programme.

In the oil and gas sector, anti-corruption clauses have been included in petroleum agreements between governments and international oil companies, joint venture agreements, and also on contracts between international companies and local partners.

For instance, in Ghana, the government has included anti-bribery provisions in four out of six petroleum agreements. The measure still has to be approved by the Parliament. The clause also requires companies to certify compliance with the US Foreign Corrupt Practices Act, the UK Bribery Act, and the anti-bribery convention of the OECD (African Energy 2014).

Establishment of independent oversight bodies to review local content implementation

Dedicated and independent oversight bodies, in addition to autonomous audit and anti-corruption bodies, are instrumental to ensure the effective implementation of local content policies.

Several resource-rich countries with local content policies have established such bodies, but guaranteeing their independence seems to be a challenge. In many countries, oversight agencies are part of the ministry of energy and are subject to political influence (World Trade Institute 2013).

Unfortunately this is also the case for other oversight bodies that could play a role in ensuring the fair and correct application of local content policies. For instance, in Mozambique, the audit body is assessed as lacking autonomy, and being influenced by personal relations and party loyalty. Within this framework, it is unlikely that the body would pursue audits and investigations on irregularities in the implementation of local content laws. Similarly, the country’s tax authority, in spite of recent reforms, still faces challenges in verifying companies’ technical or financial data (Oxford Policy Management 2012).

Clear procurement rules

Clear and transparent procurement laws that guarantee fairness throughout the procurement process are key to preventing corruption in the implementation of local content. In particular, considering that the number of companies bidding in local content tenders is usually small, measures to avoid overpricing, bid rigging and cartel are very important.

Within this framework, several countries have included clauses restricting the procurement of local content. For instance, in Mozambique, according to the law, preferential treatment in the purchase of local goods and services should be given “when such goods and services are internationally comparable in terms of quality, availability, and quantity required and are offered at prices inclusive of taxes not higher than ten percent of the available imported goods”.

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Other countries, such as Ghana, have made specific mention of bid rigging and cartels. According to the Petroleum (local content and local participation) Regulations, the oversight commission is entitled “to launch investigations to ensure that (a) the Ghanaian company principle is not diluted by the operation of a front; or (b) bid rigging and cartelisation are avoided in the procurement process”.

Requirements to disclose beneficial ownership in some circumstances

The disclosure of beneficial ownership is instrumental to ensure that local content contracts are not awarded to political groups and that “front” companies are not being used to circumvent local content requirements.

The Extractive Industries Transparency Initiative (EITI) has launched a pilot project on beneficial ownership that seeks to ensure that information about extractive companies’ beneficial owners is available to the public. The project aims to assess the feasibility of requiring beneficial disclosure through the EITI. Twelve countries, namely Burkina Faso, the Democratic Republic of Congo, Honduras, Iraq, Kyrgyz Republic, Liberia, Niger, Nigeria, Tajikistan, Tanzania, Trinidad & Tobago and Zambia have signed up to the pilot.

Publication of contracts and information regarding the implementation of local content rules

Requirements for transparent reporting on local content covering the number of local personnel employed, goods and services procured by foreign and local companies, and beneficiaries of local content policies are essential to assess whether local content rules are implemented in a way that supports the achievement of their objectives and whether corruption, mismanagement or other wrongdoing took place. This includes the publication of all contracts and licensing agreements awarded in the sector.

In Ghana, for example, the Ministry of Energy published online the main petroleum agreements signed in the country (Revenue Watch Institute 2012).

In South Sudan, according to the recently adopted Petroleum Act, companies must prepare and publish an annual report on their use of local companies and services over the previous year (Global Witness 2012a).

Other anti-corruption mechanisms

In addition, to effectively curb corruption in local content in the oil and gas sector, specific measures should be implemented to address the corruption risks identified in the previous section.

These include the adoption of rules regulating conflicts of interest, revolving door, and gifts and entertainment; requirements for public officials and senior executives of state-owned enterprises to regularly declare their assets; the adoption of access to information laws and rules opening up the decision-making process, particularly ensuring civil society participation and oversight in the negotiation of oil agreements.
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