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REVENUE WATCH INSTITUTE

SELLING THE CITIZENS' OIL

The Case for Transparency in National Oil Company Crude Sales

Alexandra Gillies

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Summary

The sale of crude oil by national oil companies (NOCs) generates a large share of government revenue for oil-producing countries. These export sales bring in more than two-thirds of total government revenue in countries including Angola, Azerbaijan, Congo-Brazzaville, Iraq, Saudi Arabia and Yemen. Even in Mexico and Norway, both countries with diversified economies, export sales equal around 15 percent of the national budget. At this scale, suboptimal processes, small leakages or the unauthorized retention of funds by the NOC can reduce the resources available for public goods and services.

Citizens have direct interest in the sale of what is essentially their oil. NOCs sell oil that they own as well as oil that is owned by the state. Depending on the ownership structure of the NOC, this crude belongs to the nation entirely or in large part, with the government acting as the public's steward in its management.

Given the high stakes and direct impact on public interests, both the NOC and the buying company hold responsibility for regularly disclosing sale data. Transparency encourages strong selling practices, bolsters government accountability and limits abuses of authority. Drawing from research on how 11 producing countries sell their oil, the Revenue Watch Institute recommends the following:

- NOCs should publish the buyer, volume, crude grade, price and date for every cargo of oil sold.
- As with other significant revenue streams, oil sale payments and receipts should be fully disclosed and reconciled under the Extractive Industries Transparency Initiative (EITI).
- Companies should disclose annually the price, volume, grade and date of each cargo that is purchased from a wholly or partially government-owned entity.
- Governments should require commodity traders and other buyers registered or listed in their country to report on payments made to producer country governments.
- Along with reporting on oil sales, NOCs should disclose how much oil they receive and the amount of all financial transfers to and from the government.

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ABOUT THIS SERIES

Revenue Watch researched how eleven countries sell their shares of oil production. The results are detailed in four briefs that recommend transparency, identify good sale practices, and explain how oil sales and global oil prices work. The Oil Sales briefs are: *The Case for Transparency in National Oil Company Crude Sales*; *The Governance of Oil Sales: Early Lessons on Good Practice*; *How Governments Sell their Oil*; and *When the Price is Right*. They can be found at www.revenuewatch.org/oilsales.

ABOUT THE AUTHORS

Alexandra Gillies is the Head of Governance at Revenue Watch.

Introduction

NOCs sell oil on behalf of their nations.[1] First, they sell oil that belongs to the government, acting as an agent of the state. The proceeds from these sales usually enter the treasury directly, though the NOC often retains a fee for its services. This oil includes the government's share of profit oil that it receives through production sharing agreements, the oil that is extracted by companies working under service contracts, or royalties that are paid by companies "in-kind" rather than with currency. Second, NOCs sell the oil that they themselves produce, or their production entitlement through their equity holding in various concessions.

The oil is sold either domestically or for export. For the portion that is exported, buyers are either end users—companies that process crude into usable products such as petrol, diesel and heating oil—or commodity traders—companies that specialize in buying and selling commodities but typically do not produce or process these resources themselves.[2] Usually NOCs set the sale prices for their specific type of crude, and this price changes frequently according to a wide range of market factors (see *When the Price Is Right*). Roughly two-thirds of global sales happen through term contracts, which give buyers regular access to specified volumes over a period of time. The contracts establish how the price, volume and other mechanisms of the shipments are to be determined. Most of the rest of oil is sold on the spot market, where individual cargos are sold through a negotiated deal or auction (for more on these systems, see *How Governments Sell Their Oil*). Once the deal is set, cargoes of oil are loaded onto ships ("lifted") for export.

Despite the size and importance of government and NOC oil sales, they are poorly understood outside of industry circles. Sale transactions have not yet featured in the extensive global efforts to improve extractive sector transparency, such as through the EITI or mandatory disclosure requirements.[3] They receive limited attention from international financial institutions compared with other major economic transactions, and they draw less scrutiny from local and international press coverage and the public than upstream company activities.

To address this information gap, the Revenue Watch Institute commissioned exploratory studies of how oil is sold by 11 diverse producers: Angola, Azerbaijan, Brazil, Congo-Brazzaville, Iraq, Kazakhstan, Mexico, Nigeria, Norway, Russia and Saudi Arabia. Drawing on the findings, this brief explains why the transparency of oil sales is essential for strengthening accountability and ensuring fair returns in oil-exporting countries.

Why sales should be subject to thorough transparency

The oil sold by NOCs essentially belongs to the public. Many countries place ownership of subsoil resources with the nation and its people. Others—with a few exceptions such the United States—vest ownership with the state, which should represent the long-term interests of the nation. At the international level, the 1962 United Nations General Assembly Resolution 1803 (XVII) establishes this same principle through the doctrine of permanent sovereignty over natural resources. This principle of public ownership applies fully when NOCs sell the government's share of production. Oil owned by the NOC itself belong entirely or partially to the public depending on the NOC's ownership structure.

1 While this study focuses on oil, many of the concepts described here also apply to gas and mining, especially when a government or a state-owned company receives a share of extracted minerals. As the liquid natural gas market develops, more volumes will be sold through methods other than long-term fixed price contracts. Just as with oil, when liquid natural gas is owned or partially owned by government, sale transactions should be declared.

2 A number of traditional trading companies are expanding into extraction, such as Glencore International's extensive mining operations, and processing and sale, such as Trafigura's purchase of Puma Energy, a midstream and downstream company.

3 These include Section 1504 of the 2010 U.S. Dodd-Frank Wall Street Reform and Consumer Protection Act and a 2011 European Union directive on extractive sector revenue. For more, see http://www.revenuewatch.org/issues/dodd-frank.

Oil sales directly and significantly affect the resources available in the government budget to fund public goods and social services. Figures 1 and 2 illustrate the large size of oil sales relative to the total government budgets. In countries including Angola, Azerbaijan, Congo-Brazzaville, Iraq, Saudi Arabia and Yemen, crude sales bring in more than two-thirds of *total* government revenue. Even in Norway and Mexico, with their more diversified economies, export sales are equal to 14 and 17 percent of state revenue, respectively. To put this in perspective, the value of NOC oil sales is seven times as large as the health budgets in Angola and Azerbaijan, 10 times as large in Saudi Arabia, 15 times in Congo-Brazzaville, and 21 times in Iraq. Small leakages, suboptimal process or unauthorized retention of funds by the NOC can reduce the resources available for government to spend.

Figure 1

In-kind revenue, as reported through EITI, as a share of total government revenue.

Source: EITI reports IMF World Economic Outlook

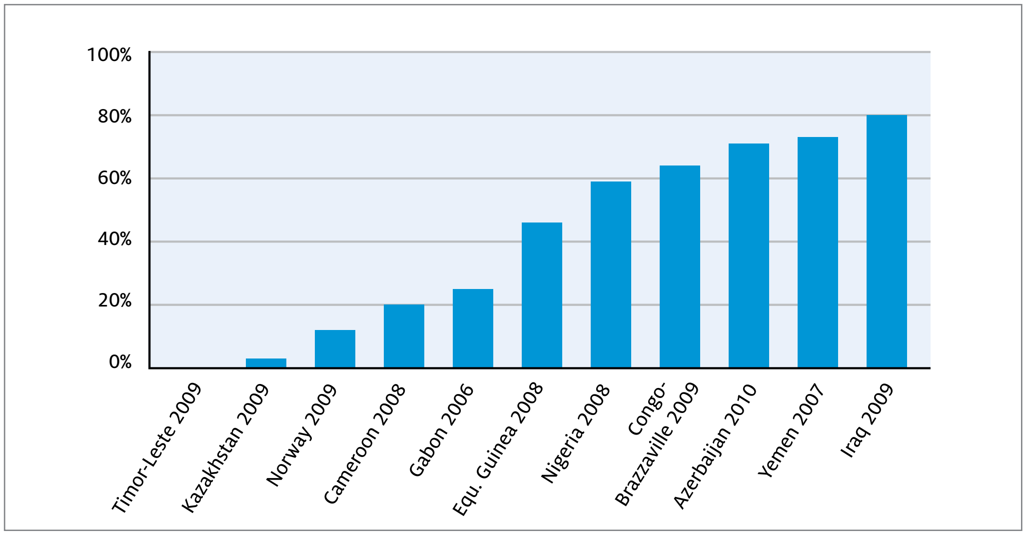
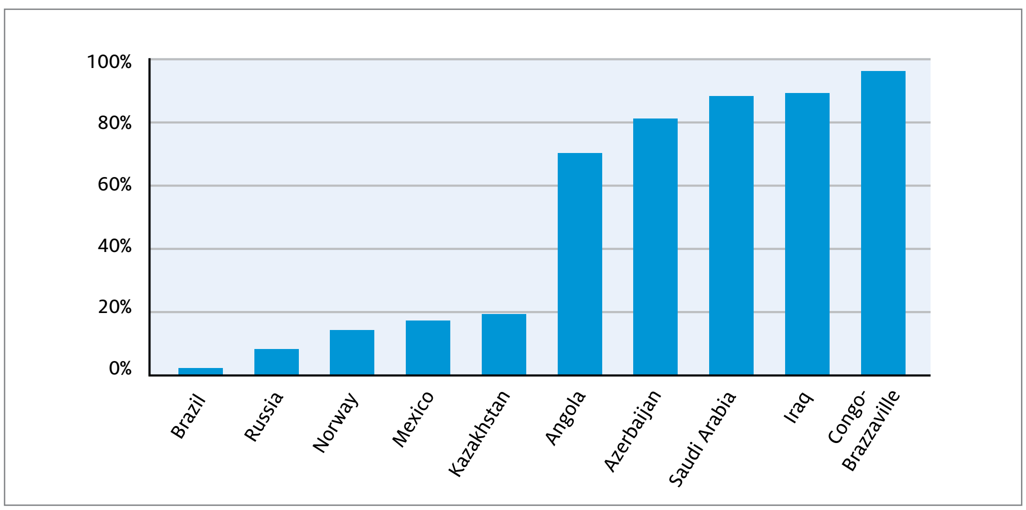


Figure 2

Estimated value of 2010 National Oil Company exports as a share of total government revenue.

Source: NOC data, IMF World Economic Outlook



Oil revenue transparency improves public accountability. It sheds light on whether a government gets a good deal in exchange for its resources. It increases public pressure to utilize oil revenue properly by revealing how much NOCs and governments receive for the oil. And it deters abuses of authority, which undermine state integrity and responsiveness. This logic underlies the growth of EITI, increasing disclosures by numerous governments and companies, and new legislation that requires corporate disclosure of payments to governments.

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Transparency would improve the governance of oil sales, netting higher returns for the nation. In the brief *The Governance of Oil Sales: Early Lessons on Good Practice*, Revenue Watch presents findings of how 11 NOCs sell their oil. The strong systems consistently maximized the selling price and limited the use of middlemen such as commodity traders. Their NOCs were accountable and largely free from political interference. They also avoided production losses such as oil theft. Transparency is a practical tool for helping to realize these good practices. The disclosure of crude sale data encourages NOCs to seek out the best price, identify optimal buyers, protect their ability to make commercially (not politically) driven decisions, and maintain full control over production volumes.

Transparency could also improve public returns on oil sales by reducing informational asymmetries, especially between NOCs and other arms of government. Entities such as finance ministries often lack detailed information about oil revenue, and oil sales in particular. In a startling example, the International Monetary Fund (IMF) reported in late 2011 a $32 billion discrepancy in the Angolan government's accounts that stemmed from the retention and expenditure of funds by the NOC Sonangol, the majority of which was crude sales revenue.[4] In Nigeria, 2011 oil revenues were 39 percent less than what was estimated in the budget, despite higher than expected prices.[5] The unilateral withholding of oil sale proceeds by Nigerian NOC, unanticipated by financial authorities, was a leading cause of the shortfall.

In addition to serving accountability functions, transparency could help buyers and sellers. Oil companies have identified transparency as central to their "license to operate," or the legitimacy and utility of their engagement in the countries where they do business. Moreover, in an industry such as oil that is replete with uncertainty, transparency could offer reassurances to potential buyers, especially in unstable environments. Timely export sale data, for example, would inform potential buyers how regularly governments deliver on their contractual allocation commitments—a leading factor in determining the market's attractiveness.

Who should disclose information

Some producing governments and NOCs publish revenue data, but few do so on crude sales. A few EITI reports produce limited data on these transactions, as do the revenue reports contained in country budget documents. Some NOCs provide aggregate data on crude sales, usually in their annual reports. The annual reports of NOCs in Brazil and Nigeria provide annual sale volumes, and those in Norway, Mexico and Azerbaijan provide that information as well as average prices. Going a step further, Iraq's oil marketing company publishes monthly volumes and sale revenue (and therefore monthly average prices) for its two main grades of crude.[6] To realize full transparency, NOCs should report per cargo data that includes the buyer, date, volume, price and grade.

In countries that participate in EITI, the full disclosure and reconciliation of crude sales should be mandatory. To implement EITI, a government hires an independent firm to collect and reconcile payment data on all material extractive sector revenue streams, and this process is overseen by a multi-stakeholder body that includes government, company and civil society representation. Oil sales generate a material revenue stream and therefore should be required within this reporting regime. Buying companies would participate much the same way that upstream companies currently participate.

Commodity buyers also should report on the oil they purchase from NOCs to corroborate government figures or shed light on payments in countries where the government refuses to

4 IMF (2011). "Angola—Fifth Review Under the Stand-By Arrangement."

5 Nigerian Federal Ministry of Finance (2011), Budget Implementation Report, Q2.

6 http://somooil.gov.iq/en/index.php?option=com_content&view=article&id=126:-2011&catid=44:2010-04-13-14-35-16&Itemid=18

report. A few extractive sector companies, such as Statoil and mining companies Newmont and Rio Tinto, voluntarily report in their annual statements on the tax and royalty payments they make to foreign governments. Buyers of state oil should do the same.

Commodity traders are highly relevant to this endeavor, as they frequently buy oil from NOCs, thereby directly or indirectly affecting public revenue. Because of their logistical prowess, access to financing and high-risk thresholds, traders often end up working in countries with weak institutions[7]—environments where transparency is all the more urgent. For example, Vitol has an exclusive contract to sell the government share of oil in Ghana, Trafigura buys state oil from Sudan, Nigeria sells nearly all its oil to traders, and Libya has begun selling to traders again.

Governments should require the disclosure of payment data by the buying companies that are based or listed in their countries. Voluntary disclosures alone, such as those achieved through EITI, will not bring about sufficient disclosure. Often transparency is needed most in countries where governments are least likely to make information available. Section 1504 of the 2010 U.S. Dodd-Frank Wall Street Reform and Consumer Protection Act requires petroleum and mining companies to disclose payments made to producing country governments, and the European Union (EU) is considering similar legislation. Even so, Dodd-Frank does not cover the sale of commodities by NOCs, and neither would the EU proposal, which perpetuates the exclusion of these high-value transactions from view. New disclosure requirements are needed to secure broad-based reporting.

What should be disclosed

Disclosures should contain enough detail to generate accountability gains. To help secure a good deal and inform citizens about the resources that government has at its disposal, disclosures of export sales would need to include basic information about each cargo sold: the price, the volume, the crude's grade and the identity of the buyer. This would permit the comparison of the actual prices paid by NOCs with the market value of the particular grade of crude at the time in question. Domestic sales would require similar treatment.[8] Much of this data is already available to industry participants, but not to the general public.

Disclosure requirements should be tailored to specific environments. For example, buyers sometimes provide loans to the NOCs or government in exchange for preferential access to oil. In Angola and Congo-Brazzaville, for instance, some NOC oil is used to repay loans.[9] Only alongside the basic terms of the loan agreement would the sale data make sense.

Transparency is a practical tool not only to generate accountability gains, but also to bring about the governance best practices identified earlier in this brief. It would encourage NOCs to seek out the best price, identify the optimal buyers, foster healthier relationships between themselves and the rest of government, and avoid production losses by controlling theft and maintaining strong metering and oversight systems.

This type of information on crude sales could be used in several ways. Finance officials, legislators, representatives of international financial institutions and citizens could compare NOC crude sale earnings with the government's oil revenue figures and ask questions about any gaps. Better understanding of sale systems would also permit stronger oil revenue forecasting. Journalists and public interest groups could investigate the sale of oil to companies that are connected to public

7 Berne Declaration (2012). *Commodities: Switzerland's Most Dangerous Business*.

8 Additional information would also be needed, given the complex involvement of NOCs in the administration of petroleum product subsidies or in the processing of crude oil. This brief focuses on export sales but recognizes that domestic utilization and sales require transparency and accountable management as well.

9 Sonangol 2010 Annual Report; https://www.cia.gov/library/publications/the-world-factbook/geos/cf.html.

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officials, or the discretionary award of favorable prices to individual buyers. The selection of buyers and the allocation of volumes—both processes that are prone to bribery and politicization—would receive scrutiny. Enhanced revenue transparency would reduce high levels of suspicions in countries where oil revenue is divided across regions or countries, such as Sudan/South Sudan, Iraq and Nigeria.

Aggregate or incomplete data hold less promise. Existing EITI reports illustrate several methods for reporting on production share earnings that fall short of a useful standard:

- Azerbaijan, Cameroon and Congo-Brazzaville provide only the number of barrels that constitute their production share and in-kind revenue. Citizens have no way of knowing what the NOC did with that oil or the monetary value it generated.
- Yemen reports the volume of government exports and transfers to domestic refineries. It also assigns a monetary value to the exported oil, but it provides no information about what price was used. As a result, the actual sale revenue remains unknown to the public.
- Norway reports how much its central bank receives from the NOC Statoil after Statoil sold the state's share of production. The sale transaction itself is not covered, nor is it known if Statoil retains a fee or other portion of the sale proceeds.
- Nigeria provides the amount of total NOC revenue from oil sales, but this aggregate figure hides important information. For instance, the government sells 445,000 barrels per day of its crude to the NOC NNPC. The EITI report finds that through its pricing practices, "NNPC is taking advantage of its position as both buyer and agent for the seller to make a profit at the expense of the Federation [the government]."[10] The size of this advantage remains invisible because sale transactions are opaque.

Iraq is the first EITI implementing country to reconcile export sales data through the EITI. The report,[11] published in December 2011, provides the following data for 2009:

- Description of the sale process and a list of the 34 buyers.
- A monthly reconciliation of volumes extracted for export that compares data from the two national oil companies, SOMO (the state oil marketing agency) and the Ministry of Oil.
- An annual reconciliation of volumes sold that compares payment data from the buying companies with receipt data from SOMO.
- Explanation of any variances in the data when possible.
- Average monthly prices and export quantities for the four main buying markets: North America, Europe, Asia and the special bilateral deal with Jordan.

This information reveals the revenue implications of policy decisions (such as the decision to sell 3.6 million barrels to Jordan at a heavy discount of $18 below the Brent benchmark price), provides SOMO revenue figures that can be cross-checked with oil revenue reported in the national budget, and deters manipulation of the sale of transactions that were abused in the 1996 to 2003 UN oil-for-food scandal.

Best practice reporting would go several steps further. The templates used to gather data for the Iraq EITI report illustrate how this would look. They ask each buying company to report information by shipment, including the shipment number, contract number, invoice number and data, quantity, price, loading port and data, quality of crude, destination, due date, settlement and vessel name. This information was not contained in Iraq's EITI report. The regular publication of this data by SOMO would represent thorough oil sale transparency.

10 NEITI (2012). Nigeria Extractive Industries Transparency Initiative 2006–2008 Financial Report, p. 18.

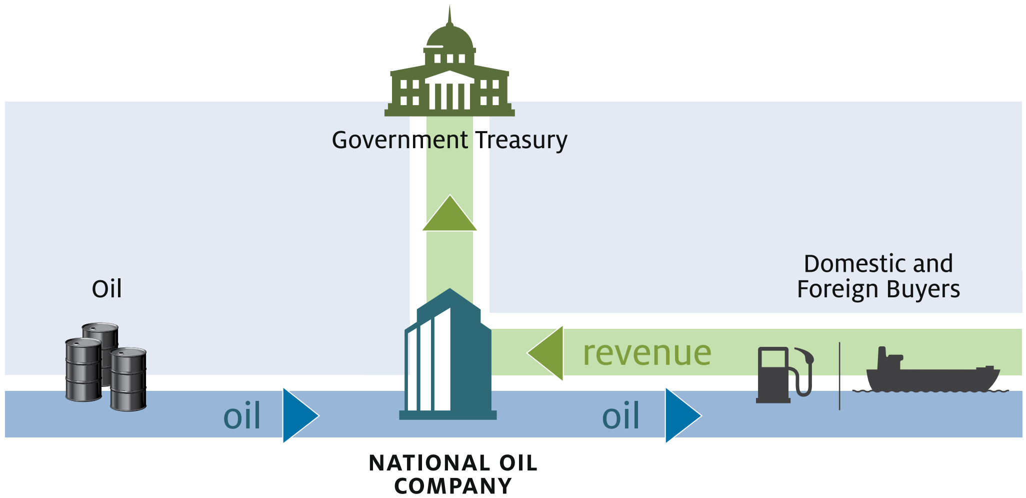
11 http://ieiti.org.iq/uploads/English%20IEITI%20Report%2020%20Dec.%202011.pdf

Along with oil sales, NOCs should report on their oil receipts and the transfers to the treasury. To trace the chain of transactions, depicted in Figure 3, information is needed on:

- The volumes of oil received by the NOC.
- The sale of that oil to foreign and domestic buyers, and the revenue received in return—the focus of this brief.
- The amount of the revenue that is transferred to the treasury, either as direct transfers, taxes of NOC oil sale earnings, dividend payments or other methods.

Figure 3

Major NOC transactions that require transparency.



Recommendations

Revenue Watch recommends that:

- NOCs should publish the buyer, volume, crude grade, price and date for every cargo of oil sold.
- As with other significant revenue streams, oil sale payments and receipts should be fully disclosed and reconciled under the Extractive Industries Transparency Initiative.
- Companies should disclose annually the price, volume, grade and date of each cargo that is purchased from a wholly or partially government-owned entity.
- Governments should require that commodity traders and other buyers registered or listed in their country report on payments to producer country governments.
- Along with reporting on oil sales, NOCs should disclose how much oil they receive and the amount of all financial transfers to and from the government.

Given the volatility of oil markets, the demonstrated correlation between oil wealth and unaccountable governance,[12] and the importance of oil sales to funding public budgets, transparency of NOC oil sales represents a concrete and practical tool to help ensure that these transactions optimize the long-term interests of citizens.

12 Ross, Michael. (2012) *The Oil Curse: How Petroleum Wealth Shapes the Development of Nations*. Princeton University Press.

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The Revenue Watch Institute promotes the effective, transparent and accountable management of oil, gas and mineral resources for the public good. Through capacity building, technical assistance, research, funding and advocacy, we help countries to realize the development benefits of their natural resource wealth.

1700 Broadway
17th Floor
New York, NY 10019
Phone 1.646.929.9750
rwi@revenuewatch.org