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Oil, Gas & Energy Law Intelligence

Sao Tome and Principe Enacts Oil Revenue Law, Sets New Transparency, Accountability, and Governance Standards

by J.C. Bell & T.M. Faria

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March 3, 2005

Sao Tome and Principe Enacts Oil Revenue Law, Sets New Transparency, Accountability, and Governance Standards

By Joseph C. Bell and Teresa Maurea Faria[*]

Executive Summary

President Fradique de Menezes of Sao Tome and Principe signed on December 29, 2004 an exemplary new law establishing an oil fund and providing an open and transparent regime for the management of country's oil revenues. The fund will be held by an international custodial bank, and all oil revenues will be paid directly into the fund. There will be a single annual withdrawal from the fund to support the budget, but the withdrawals will be limited so that the fund will preserve the oil wealth of the country. In addition the last provides extensive transparency and good governance provisions including a public information office and a petroleum oversight commission. Finally, it endorses the Abuja Joint Declaration signed by President de Menezes and President Olusegun Obasanjo which provides for a transparent regime in the development zone jointly controlled by Sao Tome and Principe and Nigeria. Sao Tome and Principe's oil revenue law sets a prime example that may be followed by oil-exporting countries elsewhere in West Africa and the developing world.

Introduction

West Africa's smallest democracy, the archipelago nation of Sao Tome and Principe, is leading the way to greater transparency in the natural resource industry. On December 29, 2004, President Fradique de Menezes signed a landmark new oil management law earlier approved unanimously by the National Assembly creating a national oil fund and establishing new standards for openness and transparency in the receipt and management of oil revenues.

Although currently one of the world's poorest countries, Sao Tome and Principe has the prospect of significant oil wealth. It shares with Nigeria deep-water prospects in the Joint Development Zone established by treaty between Nigeria and Sao Tome and Principe, and it may have significant oil in its own exclusive territorial waters. Just after the law was adopted, ChevonTexaco and its partners signed the first production sharing contract in the Joint Development Zone. The signature bonus of $123 million payable by

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Copies of the law in Portuguese and English and extensive background information are available at www.earthinstitute.columbia.edu/cgsd/STP/index_stp.htm.

ChevronTexaco and other contract holders will generate the first oil income for the country.

In drafting the law, Sao Tome and Principe was keenly aware of the "curse" of oil. As is well known natural resources in general and oil in particular have frequently been the source of great waste and often corruption in the developing world, and in many places have resulted in weak and ineffective governmental institutions. Indeed, although there are exceptions, most developing countries with significant natural resources have developed slower than those not so well endowed.

The law is a serious attempt by Sao Tome and Principe to try to confront these issues in advance and to put in place strong governance provisions before the hoped for flood of oil revenues. Indeed, the process of developing the law itself was a good example of open democratic processes. The *ad hoc* national oil commission which was responsible for the law was composed of representatives of all political elements: the President, the government, and the National Assembly including the opposition, and its work involved months of multi-partisan efforts.

Equally important, there was a National Forum process which held 55 local meetings throughout the country to explain what oil might mean for the country and to seek input into how oil resources might be used. Thus the drafting process itself increased democratic participation in the country and enhanced public support for an open and transparent regime.

Summary of the Law

The law as passed provides for the establishment of a national oil fund to be held by an international custodial bank. All oil payments must be made directly into the fund. There is to be a single annual transfer from the fund to the budget. The transfer is limited in size and purpose. Deposits, withdrawals, and holdings of the fund will be made public through a newly established public information office and by posting on the world wide web. A portion of the deposits will be retained to create a permanent reserve to foster development even after oil resources have been exhausted. The law also creates a new public oversight commission which includes representatives of civil society to monitor the law. It requires competitive tenders for oil contracts, makes oil contracts public, and mandates the inclusion of anticorruption and transparency provisions in such contracts. Finally, the law applies to the country's contributions to the budget of the joint administrator of the Joint Development Zone and to the conduct of the country's representatives at such joint administrator. It also requires cooperation with the representatives of Nigeria to make effective in the zone the transparency and governance provisions of the Abuja Joint Declaration issued by President de Menezes and President Olusegun Obasanjo of Nigeria.

The Sao Tome and Principe Oil Fund

A. The National Oil Account

The central feature of the law is the establishment of a national oil fund. The Central Bank is required to establish on behalf of the government an account, the National Oil Account, to be held by an international custodial bank. All oil revenues due the state must be paid directly into the account by electronic transfer. Oil revenues are defined very broadly. In addition to the standard items the definition picks up assets sales, indirect items such as duties or customs fees and the net profits of any government owned oil company. Oil revenues also include all revenue received by Sao Tome and Principe from the Joint Development Zone. The comprehensive definition of income contrasts with the much more limited and much criticized definition applicable to the Chad-Cameroon fund.

To avoid any diversion and to further protect the integrity of the system, amounts due to the government will be considered paid only when received in the National Oil Account. Withdrawals from the account, other than for internal investment expenses, are limited to a single annual transfer to the budget as approved by the National Assembly, and requiring the signatures of four separate officials: the President, the Prime Minister, the Director of the Treasury and Patrimony, and the Director of International Transactions of the Central Bank. As further discussed below, the country is not permitted to borrow against the either the National Oil Account.

B. Expenditure Limits and The Permanent Fund

An amount, the "*Verba Anual*" (Annual Funding Amount), is to be transferred from the National Oil Account in a single transfer to the budget each year. The maximum amount of the Annual Funding Amount is subject to a set of formulas which take account of the various stages of oil exploration and possible production. After oil production commences, the amounts not transferred to the budget are transferred annually to a sub-account, the Permanent Fund. Except for imputed earnings, the monies transferred to the Permanent Fund may not be expended.. The spending limit during production is set so as to accumulate in the Permanent fund sufficient funds to create a national "endowment" that will preserve Sao Tome and Principe's oil "wealth" and continue to support government spending indefinitely at roughly the same level even after the resource is exhausted.

The spending limits also accomplish the important fiscal task of limiting expenditures and increasing savings during periods of high oil prices and providing for the maintenance of spending during period of low oil prices. It thus solves one of the major problems of many oil-producing countries which increase public spending when prices are high but then are unable to maintain the increased level of spending when prices drop, resulting either in the country taking on debt which it may not be able to service or finding itself in an inefficient start-stop mode of development.

For 2005, the initial Annual Funding Amount is determined by the budget process. Thereafter, until there is commercial discovery of oil, the Annual Funding Amount may not exceed 20 percent of the balance in the account as of December 31, 2005. If there is a commercial discovery, the maximum Annual Funding Amount prior to the second year of production is determined by in effect amortizing the balance of the oil account over the period between commercial discovery and the first year of production. Beginning the second year after commercial production, the maximum Annual Funding Amount is set through a calculation which takes account of the country's oil wealth and the size of the Permanent Fund at the time. The calculation of the oil wealth is determined by making a present value calculation for planned production using filed production plans and a 10 year historical average for oil prices. The formula essentially sets a flat spending ceiling for any particular level of discoveries. If total discoveries increase, the formula will result in a corresponding increase in the ceiling. Because of the way various parameters are structured, the resulting permanent fund should be able to maintain the level of real spending.

C. Expenditures

In Sao Tome and Principe political groups felt that permanent limitations on the spending programs of future governments were inconsistent with democratic notions, i.e., parties and candidates in the future should be free to make their own expenditure choices within the ceilings. Accordingly, the law sets out only certain general principles regarding the use of the revenues transferred to the budget. In general it provides for the revenues to be used for poverty reduction, certain priority sectors, and institutional development. Seven percent of the Annual Funding Amount is reserved for the autonomous region of Principe and 10 percent for local governments.

The possibility of providing for direct distribution to the population such as the Alaskan fund provides was included in early drafts of the legislation. In this regard Martin Sandbu of the Earth Institute team suggested a form of direct distribution subject to being "taxed" back by the government. The need to make decisions about the level of taxation would stimulate the type of citizen and government responsibility that is often lacking in resource rich countries. Direct distribution, however, was quickly dismissed by the Sao Tome and Principe lawmakers.

D. Management and Investment Policy

Supervision of the National Oil Account including the Permanent Fund is committed to a committee composed of representatives of the President, the government and the National Assembly, including a representative of the opposition. The committee establishes the investment policies subject to certain statutory guidelines and then is expected to retain investment managers to carry out those policies. The committee is required to apply the "prudent investor rule" as defined in the act. The law provides for a very conservative investment policy during the initial period of the fund.

There are two very central and important restrictions to oil fund investments. First, no investment may be made in Sao Tome and Principe itself or in any entity "controlled directly or indirectly, totally or partially" by any national of Sao Tome and Principe whether or not resident in the country. This is intended to reduce political pressures on the fund's investment policy. It also makes clear that the fund itself is not a "development" fund but an endowment. Development funding is to be determined by the government and the National Assembly as part of the annual budget process.

Second, neither the National Oil Account nor any petroleum resource may be used to secure any borrowing. There is an unfortunate history of borrowing against future oil earnings in the developing world. In principle such borrowing could be used for productive human and capital investment, but that is rarely the experience. Particularly in light of the large amounts that will be otherwise available through the annual funding, borrowing was not seen as necessary to accomplish Sao Tome and Principe's development goals. In prohibiting borrowing Sao Tome and Principe is also following the recommendations of the IMF and other international entities.

This does not mean that the government cannot borrow. The government may engage in borrowing funded by general revenue or revenues from particular development projects, but it cannot encumber future oil production or the funds in the national oil account. Limiting borrowing in this way is an important discipline both for the country and would be lenders. A particularly sensitive period in this regard can occur if there are commercial oil discoveries but oil is not yet being produced. Government borrowing during the period may be appropriate, but it should be tested by the market's willingness to rely on the general credit of the country or the return to a particular project.

Transparency

The activities of the fund are to be fully transparent. In this it joins the growing movement in Africa to make natural resource income public, a movement spearheaded by church and civil organizations and formalized and promoted by the UK government particularly in its Extractive Industries Transparency Initiative (EITI) which establishes a number of minimum standards for reporting resource income. The Sao-Tomean law goes beyond the minimum requirements of the EITI. Instead of providing simply aggregate data to the public, the law mandates public access to information on all payments into the fund on an individual payment basis. Oil fund withdrawals and fund holdings, and all oil payments are to be public.

The Sao-Tomean statute provides that all confidentiality clauses in oil-related agreements, contracts and documents that violate the transparency principle set forth in the law shall be null and void as contrary to public policy. A narrow exception is made to protect proprietary intellectual property with the proponent of confidentiality having the burden to demonstrate its proprietary nature if contested. Payments and financial information relating to contracts may not be withheld pursuant to the proprietary exception.

All information required to be made public under the oil revenue management law must be filed with a to be established public information office, the Public Register and Information Office, which is to act as a central repository of information and makes it publicly accessible. All oil-related information is required to be made public and freely available in Portuguese, in print at the public information office and online on the Internet. Implementing legislation to establish the Public Information Office and the Petroleum Oversight Commission discussed below is currently being drafted.

In connection with the requirement to provide web access, the Columbia group suggested having the custodial bank make available all deposit, holdings, and withdrawal information regarding the National Oil account directly on the web, in the same fashion as account information is made available to private companies and individuals. This would ensure transparency without the need for any governmental intervention. The statute requires web access but without such specificity.

Accountability

To protect the integrity of the fund and to ensure full accountability, the Saotomean law establishes an independent public oversight board, the Petroleum Oversight Commission, to monitor compliance with the law. The Commission includes representatives of government, members of the National Assembly including the opposition, and civil society. The Commission does not include any international representatives. The Commission is not intended to supplant any existing institution, but by monitoring the government's compliance with the law the Commission is expected to strengthen the oil regime. To carry out its functions the Commission is given significant investigatory and administrative powers, among which are the powers to compel the production of documents and information, investigate compliance and irregularities, issue reports, conduct administrative proceedings and participate in enforcement actions as a party.

The activity of the National Oil Account is also subject to two levels of auditing: internally, the national audit chamber will conduct its annual audit, and externally, annual audits must be conducted by independent international auditors to be chosen through a competitive process as prescribed in the law. Audits must be made public by delivery to the oversight commission and the public information office, in addition to various government officials.

Each year the National Assembly will be required to discuss in plenary sessions the state of oil and gas policy and the National Oil Account audit reports. In addition to being open to the public, these plenary session discussions are to be preceded by public discussion sessions with civil society.

Public Integrity

Sao Tome and Principe's Oil Revenue Law requires all oil-related agreements and contracts by statute to include no bribery, public disclosure, and prevailing language

(Portuguese) provisions, as well as a provision conditioning the effectiveness of the agreement or contract on full compliance with applicable government contracts law. Under the law, agreements and contracts shall be construed to include such provisions even if they are not expressly written therein. The anticorruption provision essentially mirrors the OECD anti-bribery convention, and the transparency provisions impose on the private party the same obligations to make contracts and payments public that the law imposes on the government.

The law requires that oil contracts be awarded pursuant to competitive public tenders in accordance with general legislation. In the absence of such legislation – and to the authors' knowledge currently no such general legislation exists – contracts are supposed to be approved by the Petroleum Oversight Commission. This presents a bit of a conundrum since the Petroleum Oversight Commission itself cannot be established until further implementing legislation is adopted.

Finally, the Sao Tomean oil revenue law sets out strict conflict-of-interest standards prohibiting government officials from having interests in oil resources on entities in which oil fund is invested. The law provides for the Petroleum Oversight Commission to also establish conflict of interest provisions.

Enforcement

The law prescribes a range of penalties applicable to violations, of the law. These extend in some cases to the nullification of agreements and documents entered into, in violation of the law. Penalties also include fines and imprisonment in appropriate cases and the disgorgement of any monies and reversion or any improper advantages obtained. The Sao Tomean oil revenue law provides enhanced penalties for both misdemeanors or criminal acts.

Injured parties may appeal administrative decisions relating to the law and such appeals act to stay the action except where a stay would result in "grave" injury to the public interest. There is a presumption of grave injury when an act of the oversight commission is being appealed.

The Joint Development Zone

All of the country's initial oil related revenues will come from the Joint Development Zone. Activities in the Joint Development Zone are governed by the treaty between Sao Tome and Principe and Nigeria and hence were not subject to direct regulation by the oil revenue law. The law can and does, however, control the activities of Saotomean officials acting on behalf of Sao Tome and Principe in connections with activities under the Treaty. Further, the law calls for Saotomean officials to work jointly with representatives from Nigeria to implement the principles embodied in the Abuja Joint Declaration.

The Abuja Joint Declaration signed by Presidents de Menezes and Obasanjo in July 2004 requires all oil contracts relating to resources in the zone and all individual oil company payments to the authorities be made public. The requirement to make payments public is imposed on both the administering authority and the private contracting party. In particular, all oil companies operating in the zone being required to make their payments to the governments public quarterly and annually. In addition the declaration requires that the budget of the administering authority be made public and that the accounts, procurement contracts and the accounts of others operating in the Joint Development Zone be subject to annual public audits. Public means posted and maintained on the website of the zone's administering authority, open to inspection by anyone. Although not yet made public, it is expected that the first production sharing contract in the zone recently executed by ChevronTexaco and its partners will reflect in part, if not entirely, the mandated principles. As of this writing neither the contract nor its transparency provisions have been made public.

Outlook and Next Steps

Even if commercial quantities of oil are discovered, Sao Tome and Principe will not receive significant revenues for five or more years. Yet existing needs must be met, and new problems caused by the prospect of oil are already developing. There are pressures on local prices; unwanted and potentially destabilizing immigration is increasing; all sorts of companies are seeking to negotiate non-competitive arrangements; the budget continues in serious deficit. The next few years are a critical period for Sao-Tomean society as it stretches to strengthen its existing institutions and build new ones to manage its potential good fortune. By establishing new standards of transparency and accountability now, Sao Tome and Principe has taken the first step to assure that oil resources are used wisely for the benefit of the general public and to avoid the "curse" of oil. It must now implement the act, a far harder task than its adoption but one with the potential for great rewards.