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Policy Brief

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Establishing a National Oil Company in Lebanon

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Executive Summary

This brief reviews possible roles for a national oil company (NOC) in Lebanon and their appropriateness at various stages of development. Specifically, it addresses the optimal timing for creating an NOC; the role it can effectively play in the pre-licensing, exploration, development, and production phases; and what governance frameworks can keep an NOC in check. The brief concludes that the establishment of an NOC presents real governance risks. While various processes and rules can mitigate these risks, such measures depend on strong political leadership. Without them, it will be difficult to hold the process to a higher standard.

Introduction

Most emerging oil and gas producer countries eventually face the question of whether to create a national oil company (NOC). For some, the need arises when the sector is well established, but for others the question emerges before discoveries are made. There is no universally optimal time for the establishment of an NOC. Rather, the balance between risk and reward for the state evolves over time, with financial risks to sovereign funds declining as a resource base becomes larger and as petroleum sector skills grow. With a more firmly established petroleum sector, there are greater financial and human resources to commit to operations. But as this brief will show, there are also governance risks to consider when establishing an NOC. Whether these types of risks grow or decline over time depends on the strength of institutions and quality of political governance.

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In addition to the issue of timing the establishment of an NOC, there is also the question of what role it will play. Before engaging in the creation of an NOC, it is critical to have a clear answer to the question, 'Why have an NOC?' The government should consider what NOC role would be most useful, realistic, and affordable. It should also anticipate how that role would complement or hinder what other state institutions and private sector companies are doing (or planning to do).

This policy brief does not recommend a specific NOC model, nor does it advise for or against the creation of an NOC in Lebanon. Rather, it narrows down the options for NOC roles appropriate in the early stages of development of a resource. Societies and governments must examine what roles an NOC could usefully and effectively play in their country. Ultimately, if sufficient benefit to Lebanon cannot be established, the idea of creating an NOC should be questioned.

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For the sake of discussion, this brief presumes that Lebanon will award licenses and that discoveries will be made and produced. In reality, the political and market backdrops may not be favorable to the rapid development of the country's resource base. The absence of leadership and political paralysis stalled the licensing round for three years. Michel Aoun was elected president of Lebanon in October 2016, ending more than two years of deadlock relating to the presidential vacuum. But parliamentary elections are around the corner and the political leadership may not hold strong enough to provide needed direction for the oil and gas sector to take off. Meanwhile, the oil price has fallen to a lower, new norm, bringing many exploration efforts to a halt—especially in areas presenting higher political and/or geological risk. Of course, there is never an assurance of discoveries. Exploration is a very high-risk enterprise and discoveries in a neighbor's acreage offer no guarantees in other countries. It is important to recognize the possibility of the petroleum sector hitting a dead end or advancing at a glacial pace—especially when dedicating resources to the creation of new institutions for the petroleum sector.

Possible roles for a Lebanese NOC

Indeed, when there are scarce financial or human resources, strategic decisions must be made. As will be shown, the risks and rewards associated with each role change substantially over these phases, which makes a sequenced approach, involving incremental changes as the geological situation evolves and as capacity grows, very useful.

Beginning with the pre-licensing and exploration phases, the creation of an NOC in Lebanon is not warranted. An NOC would have little to do and the Lebanese Petroleum Administration (LPA) has proven very capable in oversight of the sector. The governance of the sector would not benefit from the introduction of a new organization. Moreover, existing legislation does not sanction its establishment since the Offshore Petroleum Resource Law states that an NOC could be considered 'when necessary and after promising commercial opportunities have been verified.'

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Following commercial discoveries, an NOC could be legally established and mandated with an upstream role. It could manage or hold minority stakes on behalf of the government, provided a provision is made at the licensing stage for back-in state participation. However, there are risks (and some benefits) tied to an NOC with an upstream focus in the development phase (the one to five years during which the oil companies determine how they can commercially produce oil and/or gas they have discovered).

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For one, a new NOC would not have the required skills to review operators' technical decisions and audit costs. It would therefore be risky to task such an NOC with managing state equity interests in licenses (modeling the

Norwegian NOC, Petoro, or a concessionaire-NOC). It should therefore have limited (or no) oversight responsibilities over operations.

If an NOC is created with a more commercial upstream mandate, it would not have an oversight role in the sector, but would act as any commercial oil company in Lebanon with the comparative advantage of a carried equity stake in some (or all) licenses. Here again, it would not have established skills and its technical contribution to operations would be limited. But limited skills do not bring additional risks to the state, provided these operators are carefully monitored by the LPA. One area of concern is finance, however. If the NOC's share of the development costs is not carried to production, it will be a challenge to raise the necessary finances. Consequently, such an NOC will need to provide financial markets with a robust strategy and sound financials.

That said, there is some value in the creation of an upstream NOC at the development stage, namely, that it will have years to build its skills before production starts and can learn with foreign oil company operators how to manage a complex project.

Another option during the development phase would be to create an NOC to take on a downstream role, in view of facilitating the creation of domestic markets and infrastructure to bring offshore gas to shore. This role could be beneficial to Lebanon, which relies heavily on energy imports to meet domestic demand. But it also presents significant risks if an NOC is not guided by a clear government strategy for economic development and industrialization and if transfer prices are not market based (as cheap energy inputs would benefit some companies and not others and would be a disincentive for foreign oil company investors). The state should also consider that the private sector is dynamic and capable in Lebanon and investments in infrastructure to gather and process gas from offshore facilities could be made by local private companies and supported by an enabling environment for investment (e.g., fiscal incentives, clear policy and pricing signals, early information on the petroleum project's expected supply).

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The main risk of establishing a company is that it would become a bloated state-owned enterprise, doing favors for the ruling elite and providing no benefit to the country. This would come at the expense of the state budget because an NOC is unlikely to make a profit from its downstream business and is certain not to make a profit from its upstream role before production begins. The creation of a modest NOC at the development phase should therefore only be considered if it can be designed to stay lean and focused, if financial controls are put in place to mitigate the risk of it developing into a vehicle for patronage, and if the state's back-in participation can be negotiated at favorable terms to Lebanon.

At the production phase, an NOC could be established to take on any of the above roles, as well as marketing the state's share of oil or gas and maximizing 'in-country value'. An NOC could rely on a share of petroleum revenues for its expenditure, which means it would not have to be a burden on the state budget. But it would be reducing the 'state take' (share of revenues from production going to treasury) and the government should consider carefully what NOC role is beneficial to the country in relation to other state goals. The ambition or scope of an NOC's mandate would also have to be guided by the size of the resource base and the capacity of the state to hold an NOC to account. In early production, many countries have let unrealistic expectations of oil revenue flows shape their decisions about NOCs' future roles. With greater revenues, NOCs grow in capacity and states must build their own capacity to hold them to account.

NOC Governance

In all cases, particular care should be given to the governance framework for an NOC. A well governed national petroleum sector sets clear roles, responsibilities, and goals for institutions involved in the sector, enables each institution to perform its role, provides clear and transparent information, and has accountability processes that ensure each institution is held to account for its performance.

In Lebanon, roles are broadly clear at present, as the LPA is tasked with licensing and monitoring operators. The introduction of an NOC into the system would have to be carefully managed by giving the company a mandate that is clearly delineated to avoid functional overlap with the LPA and clear oversight processes. An NOC cannot be accountable without a clear mandate and oversight structure.

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Beyond the allocation of roles, there should be clear goals. From their comparative studies of fifteen NOCs, David Victor, David Hults, and Mark Thurber concluded that the goals a government sets for its NOC (explicitly or not) are 'the single most important explanatory of NOC performance.' NOCs whose government allow them to focus on their commercial oil and gas mandate perform better. The second key element in determining NOC performance is consistency in government-NOC interactions. Governments should provide consistent goals and direction for an NOC and present a unified system of control for the sector, which reduces uncertainty and gives an NOC a longer planning.

At present, the lack of political leadership has left the sector paralyzed. Government instability is ranked as the most problematic factor for doing business in Lebanon. The country ranks in the seventh percentile globally for political stability. The introduction of an NOC without clear political direction would certainly lead to governance failures. It may become the pet project of some powerful figures, promoting special interests, rather than the public good. For this reason, it is preferable to delay the establishment of an NOC until a higher threshold of political leadership and broad-based consensus can emerge to guide and control it.

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Building Capacity and Ensuring Transparency and Accountability

Enablement is a key challenge for most emerging NOCs, as they lack funds to develop their skills. They need to build capacity and technical skills to take on more meaningful roles in the upstream, moving from passive, financial carried, minority equity holders to more active, commercial players with operations. Conversely, when access to funding is not sufficiently controlled, they spend too much on capacity-building.[1] It is therefore important to provide NOCs with a clear financial model that enables them to accomplish the mandate they are given and that incentivizes them to control costs.

Another common problem that prevents NOCs from carrying out the role assigned to them is interference in their operations and decision-making. Commercial decisions are frequently influenced by political interference. In Lebanon, an NOC would face particular challenges in terms of staffing decisions, which would likely impact its performance. Lebanon's confessional system is based on a formula allocating political and administrative positions to confessional communities. It should therefore be expected that the membership of the board of directors of an NOC would be determined through drawn out haggling between political parties, with the possible nomination of members who are not sufficiently qualified or independent from political masters. Only political leadership pushing for high standards of professionalism and independence

The efficiency of the company's operations will also likely be affected by the practice of patronage and nepotism

1 NOCAL of Liberia for instance spent $54,794 per employee per year on training in 2014.

at an NOC would prevent this outcome.

The efficiency of the company's operations will also likely be affected by the practice of patronage and nepotism. There is a high risk that political expectations that an NOC could be a cash cow (though it will, in fact, be a cost center for many years if created before production begins) will lead to demands on management to hire more nationals. Staffing decisions and (though it is often forgotten) salary determination should be made through a transparent meritocratic process. Professionalism, performance, and meritocracy are values that can be reinforced through corporate culture. The attitude of the state is key to enabling a strong, commercial corporate culture to take root.

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Strong reporting, based on clear and independently audited accounts, is critical. In Lebanon, there is a capacity to keep accounts, but the practice has been patchy. National scores on the strength of auditing and reporting standards are moderately good (in the 54th percentile globally), but transparency of government policymaking scores very poorly (7th percentile) and corruption is one of the top factors inhibiting business. According to the World Bank's Governance Indicators, control of corruption suffered a sharp downturn from 2005 to 2006 and has stayed stubbornly low since then.[2] Recent moves to adopt the Extractive Industries Transparency Initiative (EITI) would bring higher standards of disclosure and transparency to Lebanon. These primarily targeted foreign oil company payments to the state, but now also require disclosure of NOC transfers to the treasury (and vice-versa) and NOC quasi-fiscal expenditures.

2 http://info.worldbank.org/governance/wgi/index.aspx#reports.

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However, the EITI process does not shed light on the type of corruption that could thrive: Procurement. The risk of corruption in procurement grows once (if) Lebanon reaches the development and production stages. At those stages, an NOC's ambitions and commercial activities may grow, leading it to take on project management responsibilities as an operator of a field or a processing facility. In this role, procurement decisions would present opportunities for corruption and cronyism. Also, if exploration and production licenses are awarded to oil companies that are not listed in OECD-based stock exchanges, they will not fall under the same burden of legal responsibility regarding corrupt practices. They may be more amenable to paying bribes or to awarding procurement contracts on the basis of political connections. NOC interactions with those companies would present increased risks for corruption (similarly for the LPA).

Exposing corruption, in whichever form it takes, would be essential to mitigating or preventing corruption, but would be risky for a whistle blower. He or she must be legally protected from punitive measures by superiors (a whistle blower law can provide such protection) and the rights of whistle blowers must be protected by an independent judiciary. Lebanon ranks poorly in terms of judicial independence in the Global Competitiveness Index (117^{th} rank out of 140 countries). Corporate culture in an NOC, supported by corporate messaging signaling a zero-tolerance policy regarding corruption and procedures for (anonymous) assessment and reporting, can provide some internal controls.

Plainly speaking, corruption can thrive when co-workers and clients are friends or owe each other favors. Patronage increases that tight-knit community in which it is difficult to challenge bad practice or crimes. Introducing processes for meritocratic hiring and promotion is recommended. But an NOC may also benefit from the introduction of outsiders. In order to benefit from an external perspective, Saudi Aramco has maintained a percentage of foreign staff in the company (14%). It also has foreign members on their board of directors: A former chairman of Royal Dutch Shell and Anglo American plc, a former managing director of the World Bank and Chief Executive Officer of the International Finance Corporation, and a former chairman of BG Group plc and chairman and CEO of Schlumberger Ltd. These external voices provide a degree of benchmarking for the company vis-à-vis external corporate standards. They also limit group think and cronyism.

The willingness and interest of oversight bodies to carry out their mission depends, once more, on signals given by the political leadership, but also on the professionalism of the agency

Accountability processes can only be effective when roles of all organizations involved in the petroleum sector are clear and when those responsible for oversight are capable enough to detect good and poor performance. It is therefore crucial, for the sake of accountability processes, that the state is capable and interested enough to audit a company for its financial and operational performance. The bodies responsible for auditing an NOC should have the skills necessary to do so, which includes a capacity to understand what the costs of an NOC should look like. The capacity to do so involves an understanding of petroleum sector activities and sufficient experience to compare NOC costs to other companies of similar size in the petroleum sector. The willingness and interest of oversight bodies to carry out their mission depends, once more, on signals given by the political leadership, but also on the professionalism of the agency. Clear performance benchmarks can support the accountability processes; and the company leadership should be held accountable for meeting or failing to meet those benchmarks.

Lebanon could see improved governance standards with a partially listed NOC. A listing on an OECD stock exchange would be most appropriate, considering the small size of the Lebanese capital market, though some shares can be reserved for Lebanese citizens. Even a listing of a minority equity stake of the company can increase transparency across the company's accounts because it will require higher, external disclosure requirements and will add a layer of accountability by bringing in private shareholders. If some of the shares are offered to Lebanese citizens, the process may increase their sense of ownership of the company, and thus encourage them to hold the company to account. A more accountable NOC is a better managed NOC.

Conclusions

This policy brief reviews possible roles for a new NOC in Lebanon and their appropriateness at various stages of development. It highlights an evolving balance of risk and reward concerning the establishment of an NOC, with potential benefits increasing in the production phase, for example, when an NOC could be called on to market the state's share of oil and gas. Potential rewards also increase when an NOC can draw on more technical capacity and experience to fill its ranks. Similarly, risks decline over time because the chances of a successful outcome of petroleum projects are greater in the production phase than in the development or exploration phases.

The quality of governance and the relationship between a state and NOC are among the greatest (if not the greatest) determinants of a successful NOC

Perhaps most importantly, risks decline when the quality of political governance increases. The quality of governance and the relationship between a state and NOC are among the greatest (if not the greatest) determinants of a successful NOC. Today, the political-economy of Lebanon could enable patronage and cronyism to grow in an NOC. This could lead an NOC to make strategic decisions and contract suppliers for political rather than commercial gain and could hinder meritocratic hiring and promotion in the company, producing an ineffective company.

But this outcome is not a foregone conclusion. The LPA has notably managed to establish itself as a technically competent body, scoping out a degree of independence from political favors (in spite of its board members being nominated on the basis of confession by the Council of Ministers). It has sought to craft a professional organizational culture. Various processes and rules could also help an NOC establish itself as a commercial center of petroleum skills, but it is important to emphasize that the application of these good governance principles requires strong political support. Without a leadership committed to these principles, it will be difficult to drive a process to a higher standard.

An NOC's role, its workforce, and its budget can expand with the size and maturity of the resource base and also with the ability and will of state institutions to hold it to account for its performance

An incremental approach to the establishment of an NOC is useful in an emerging producer country. An NOC's role, its workforce, and its budget can expand with the size and maturity of the resource base and also with the ability and will of state institutions to hold it to account for its performance. A Lebanese NOC could therefore be established with a modest role and keep lean and focused once (if) the thresholds of commercial discoveries and strong political leadership are met. Over time, when production revenues allow it to access finance, its role can expand to respond to state priorities. This expansion in ambition will need to be guided by a strategic view of national development goals and met by growing state capacity to hold an NOC accountable.

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About the Policy Brief
A Policy Brief is a short piece regularly published by LCPS that analyzes key political, economic, and social issues and provides policy recommendations to a wide audience of decision makers and the public at large.

About LCPS
Founded in 1989, the Lebanese Center for Policy Studies is a Beirut-based independent, non-partisan think-tank whose mission is to produce and advocate policies that improve good governance in fields such as oil and gas, economic development, public finance, and decentralization.

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