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U4 BRIEF

Reforming corruption out of Nigerian oil?

Part one: Mapping corruption risks in oil sector governance

Oil dominates the Nigerian economy and generates the vast majority of government revenues. At the same time, Nigeria is perceived as one of the world's most corrupt countries, and significant levels of corruption are said to exist within its oil sector.[1] The complex and largely opaque operations of the oil industry make it difficult to establish exactly how, when and to what extent corruption takes place. This U4 Brief attempts to shed light on how public sector institutions governing the Nigerian oil sector permit the existence of corruption. Six areas of corruption risk are addressed: the awarding of licenses; the awarding of contracts; bottlenecks and inefficiencies; the role of bunkering; the exportation of crude; and importing refined products. The Brief is the first in a two-part series, the second of which addresses policies and programs that aim to stem corrupt practices in the Nigerian oil sector.

Oil in the Nigerian context

Nigeria is sub-Saharan Africa's largest oil producer with reserve levels that far exceed those of its neighbours. While only the 11th largest producer globally, Nigeria's international importance arises from its high quality crude, accessibility to Western markets, continuing exploration potential, and absence of resource nationalisation trends apparent in other oil-producing states. In 2007, oil earnings comprised 85 percent of government revenues and 99 percent of export earnings.[2] While the Nigerian government has earned over US$ 400 billion in oil revenues since 1970, standards of living have declined. Nigeria's massive population, estimated at between 120 and 150 million, faces conditions as harsh as the continental average.[3]

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Oil wealth also fuels the instability, corruption, and patronage-driven politics which characterise governance in the country. Emblematic of these negative governance trends were the 2007 elections. Following eight years in office, President Olusegun Obasanjo handed over power to Umaru Yar'Adua through elections which were resoundingly condemned by observers. Despite these challenges, some reform has advanced since the 1999 reintroduction of civilian rule. Obasanjo appointed a highly skilled team of technocrats which implemented banking and insurance sector reform, accelerated the prosecution of top officials for corruption, stabilised the currency, paid off the foreign debt, and improved budgeting procedures and transparency.[4]

Which public bodies govern the oil sector?

Four government institutions run Nigeria's oil industry affairs:

The **Nigerian National Petroleum Corporation (NNPC)**, Nigeria's national oil company, controls a large range of upstream and downstream activities. It has over 9,000 employees and its expansive functions include the operation of 12 subsidiaries, among them refineries, petrochemical plants, and oil trading companies. The most crucial subsidiary is the National Petroleum Investment Management Services (NAPIMS) which acts as the industry's concessionaire, entering into contracts with oil companies on behalf of government. Given the size of its personnel, budget, and mandate, and its high share of industry expertise, NNPC is the lead government actor in the sector.

The **Ministry of Petroleum** (known for a period as the Ministry of Energy) technically oversees NNPC and leads oil sector policy-making. Apart from the final months of Obasanjo's administration, the President has served as the Minister of Petroleum since 1999. The Minister of State for Petroleum, a junior-level minister, exercises some influence but limited unilateral authority. At the time of this publication, Yar'Adua had recently announced the appointment of Rilwanu Lukman as Minister of Petroleum.

Along with the top leadership of NNPC, the **President and his top advisors** form the inner circle of oil sector decision-making. The President, who has also served as Minister of Petroleum, plays a direct and decisive role in oil sector operations. To assist in this endeavour, Presidents Obasanjo and Yar'Adua both appointed two senior advisors on petroleum matters who exercise a great deal of authority while acting on the President's behalf.

The **Department of Petroleum Resources (DPR)** is the industry regulator. Until 1988, DPR existed as a unit within NNPC, creating the untenable situation of the regulator being subordinate to the industry's largest player. While they now operate separately under the Ministry of Petroleum, NNPC retained some regulatory functions. DPR's mandate includes the allocation of oil blocks, the collection of royalties, the enforcement of sector regulations (safety, environment, gas flaring, etc.), and other technical oversight tasks.

A number of criticisms have been raised regarding the ability of this set of actors to effectively execute their functions. Weak DPR capacity, NNPC intrusion into regulatory and policy-making functions, lack of NNPC oversight and accountability, and weak incentives for efficiency and performance generally top the list.

How is the upstream sector organised?

The majority of Nigeria's oil production is governed by **six large joint venture (JV) arrangements**, with NNPC as the majority shareholder, controlling between 55 and 60 percent of assets. Western oil companies serve as minority shareholders and operate the fields. The earnings of both partners derive from the sale of their respective shares of crude production. The operator then pays a royalty (collected by DPR), based on the amount of production, and Petroleum Profits Tax (PPT, collected by the tax agency) on its earnings. NNPC and the oil company split the operating costs associated with exploration and production. NNPC has consistently struggled to pay its share of operating costs forcing it to enter into a string of loan arrangements with its company partners.

In the 1990s, Nigeria shifted towards offering **Production Sharing Contracts (PSCs)** for offshore blocks in order to stimulate deepwater exploration, diversify the sector's corporate participants, and avoid the problematic cash-call system. PSC production rose from 106,000 barrels per day (bpd) in 2001 to an estimated 595,000 bpd in 2008, and could double again by 2010.[5] In comparison, the total average production in 2007 was 2,2 million bpd. In a PSC, the operator incurs all risk as it puts up the funds for exploration and production activities. If and when production begins, the oil is divided into "cost oil" and "profit oil". Cost oil goes to the operator so they can recoup their investments. Profit oil is split between the operator and NNPC at a proportion set in the contract. In addition, the operator pays PPT on its share of profit oil as well as royalties based on production. PSCs result in a lower average take for government than JVs.

Where are the corruption risks located?

Within the complex interactions which constitute Nigeria's oil sector, several areas stand out as possible loci of corruption.

Awarding upstream licenses

Governments of most oil-rich countries directly allocate the highly valuable licenses to explore and produce oil. Without well-regulated award procedures, such transactions represent possible opportunities for corruption. Nigeria's Petroleum Act gives the Minister of Petroleum full authority over the allocation of licenses for the exploration, prospecting, and mining of oil. There are, therefore, no legally mandated processes or oversight mechanisms for the allocation of blocks. During military rule, most licenses were awarded on a discretionary basis by the head of state. Upon taking office in 1999, President Obasanjo revoked eleven of the blocks given to senior military officers and their allies by the previous military government just before its departure.

Ostensibly to end such practices, Obasanjo set out to make Nigeria's oil block bid rounds more competitive and transparent. For the first time, government publicly advertised the available blocks and selection criteria, and disclosed the various bids received. However, each of the major bid rounds conducted by DPR in 2000, 2005, 2006, and 2007 suffered serious shortcomings. Companies were forced into partnerships without explanation, signature bonus deadlines were unevenly enforced, and bid round qualification standards inconsistently applied, all to the advantage of certain companies. Some of the more egregious violations involve the award of preferential "first refusal" rights to companies which promised to make power sector investments. A number of these companies lack the capacity to accomplish such tasks, and most of these investments have yet to materialise. In 2008, probes into the bid rounds by the Presidency and by the House of Representatives uncovered these manipulations and resulted in the suspension of DPR's director and the revocation of several blocks.[6]

Awarding contracts

Oil sectors also involve the award of numerous large-scale contracts, primarily to oil service companies. In principle, it is the operator company which awards these contracts. However, the Nigerian government retains a high degree of control over such transactions. In JV operations, NNPC approves all contracts or expenses over US$ 1 million. For PSCs, NAPIMS approves anything over US$ 250,000. Former NNPC executives and industry experts stated in interviews that these thresholds are considered extremely low by industry standards and inflate government involvement in contract decision-making.[7]

> *"the bottleneck around reviewing contracts ensures that top officials remain the gatekeepers of the industry"*

Several recent prosecutions under the U.S. Foreign Corrupt Practices Act (FCPA) reveal how corruption can infiltrate contracting procedures. For example, in 2008, Albert Jackson Stanley of Kellogg, Brown and Root, a US oil service company, pled guilty to paying around US$ 180 million in bribes to NNPC, the Petroleum Ministry, and other government officials. This was to secure four contracts, together worth over US$ 6 billion, to build liquefied natural gas facilities. Case documents illustrate how aspiring contractors used fake consultancy firms to channel payments to government, manipulated their own company's financial systems to acquire extra cash, and distributed payments to representatives designated by those at the highest levels of government.[8]

In addition to receiving bribes, government officials can benefit from procedures that favour companies in which they have a financial stake. For instance, senior political leaders reportedly manipulated tenders to benefit Intels Nigeria Ltd, a large logistics company, for their private gain.[9] Alternatively, officials can give preference to companies owned by their allies, and then seek repayment through other business deals or political favours.

Bottlenecks and inefficiencies

Oil and oil service companies frequently confront costly delays and inefficiencies in their dealings with Nigerian state institutions. Though they do not constitute corruption per se, such delays create the motive and opportunity for "greasing the wheels", or paying bribes to speed along procedures. Three examples illustrate these kinds of inefficiencies:

First, oil companies must gain approval and a visa for each expatriate worker they employ. The US Government identifies the ensuing delays as a barrier to trade.[10] Second, importing goods and equipment involves port and customs delays. In 2007, the US Department of Justice investigated over 12 oil service companies (including industry heavyweights Schlumberger and Transocean) for allegedly bribing Nigerian customs officials via a third-party company.[11] FCPA investigations provide evidence of long-suspected practices: high-level jobs in customs and the port authority are widely perceived as immensely profitable for the officials who hold them.[12]

Lastly, contracts and other expenditures above a low threshold require NNPC approval. Most contracts are subject to a three-tier approval process consisting of NAPIMS, the NNPC Group Executive Council, and the NNPC Board, with larger awards also requiring Federal Executive Council approval. The average time for the review of contracts is 24 months, while the global industry average is closer to six to nine months.[13] This bottleneck ensures that top NNPC officials remain the gatekeepers of the industry. Protecting this arrangement often contradicts profit maximisation within the national oil company. As a result, its functions remain inefficient, politicised, and susceptible to capture by individual interests.

Bunkering

Bunkering is the theft of crude oil directly from pipelines, flow stations, and export facilities. Most sources quote around 100,000 bpd lost via bunkering in Nigeria, a quantity equal to the entire oil production of Cameroon. Some estimates, however, run as high as 600,000 bpd.[14]

It is widely perceived that both government and oil company representatives are complicit in bunkering activities. Groups of well-armed young men typically execute the pipeline sabotage, but their activities are overseen by powerful figures.[15] Other methods of bunkering (e.g. the loading of more crude than is reported onto export vessels) would likely require some level of official complicity.

Bunkering inflicts serious costs. It lowers the amount of crude Nigeria exports, thereby reducing the revenues which accrue to the state. The security risks and damage to equipment associated with bunkering dissuade investment into onshore exploration and production. More perversely, bunkering provides a steady stream of funding for the militancy movements and corrupt syndicates responsible for destabilising the Delta region. Buying arms, paying militant forces, and bribing officials become easier with readily available cash at hand.

Exporting crude and importing refined products

Each year, NNPC issues "lifting" or export contracts to international oil trading companies, several NNPC-affiliated companies, and a few foreign governments. The traders buy the crude from NNPC at market price and sell it on to refineries and other buyers worldwide. Similarly, NNPC also awards licenses to import refined petroleum products such as petrol, kerosene, and diesel.

These export and import transactions yield high levels of fungible returns, and the lack of transparency surrounding them creates considerable opportunities for corruption. Following a pre–qualification process for the licenses, it is not clear how winners are selected or how much the contracts are worth. Press reports allege that officials regularly receive payments by the companies involved.[16]

Nigeria's four refineries, due to persistent mismanagement, produce only around half of their combined potential capacity of 438,000 bpd.[17] As a result, Nigeria imports the majority of the refined petroleum products used by its population. Petrol and kerosene prices are subsidised by the government. Proponents of the subsidy argue that it represents the only tangible benefit of oil wealth for most Nigerians. On the other hand, the subsidy and weak market regulation create enormous distortions and opportunities for corruption. Distributors import refined products at the international market price, and sell them on the Nigerian market at the subsidised price. An NNPC subsidiary reimburses these companies for the difference. These payments are often delayed for months, creating incentives for the companies to induce government payments.[18] The subsidy www.U4.no

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also allows for other high-profit rackets. Allegedly, distributors collect the subsidy reimbursement on imported products, or buy them from Nigerian refineries at the subsidised price. They then re-import the same products so as to receive the subsidy refund again or sell them for much higher prices on the black market or abroad.[19]

Corruption, revenues and future prospects

Corruption, either involving public sector actors or enabled by their weakness, constrains the Nigerian oil industry's earning potential by misallocating funds and contracts, rewarding inefficiency, and permitting the theft of oil. Oil-related corruption also harms the national interest by increasing the amount of wealth available through illicit means. This problem, however, should be neither conceived of nor tackled in a vacuum. A perfectly managed oil sector will do little to further national development if the resulting revenues are mismanaged or lost due to corruption.

The management and allocation of oil revenues require much greater oversight than is presently the case. Government and companies allocate some oil earnings to the Niger Delta Development Commission (NDDC) and the Petroleum Technology Development Fund (PTDF). Serious accusations of fraud have surrounded both institutions in recent years. NNPC, which earns revenues through a number of its subsidiaries, is subject to unusually limited budgetary and expenditure oversight. However, beyond these specific challenges, the utility of oil revenues depends on the wider practices of budgetary planning, execution, and oversight at the federal, state, and local levels of government.

Reducing oil sector corruption and improving the quality of oil revenue expenditure remain great challenges. Nigeria exhibits characteristics of the "rentier state": the driving logic of governance is the allocation of resources and opportunities in ways that strengthen the position of those in power. Such a system, operating over decades, creates seats of wealth and influence which depend on these distributional patterns for their continued existence. Reforms that advance due process, transparency, and oversight threaten this state of affairs. The second Brief in this series will describe efforts to reform the existing system for regulating oil in Nigeria, the obstacles faced by reformists, and how external actors might boost their chances at success. ■

Further reading

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