



## Grand corruption in the regulation of oil

Farouk Al-Kasim, Tina Søreide, Aled Williams

**U4 ISSUE 2:2008**



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## Abstract

Corruption in the regulation of the oil industry is often referred to as pervasive. It is also considered to be an important element of the 'resource curse', whereby resource-rich countries fail to draw welfare benefits from their natural resources. Theories of the 'resource curse' are important in understanding the underlying challenges facing oil rich countries. Our understanding of how corruption actually influences important decisions in the oil industry is nevertheless limited and policy makers have only imprecise information on the most important areas of risk. This U4 Issue Paper offers an initial exploration of the topic of grand corruption in the regulation of oil. We focus on how and why corruption can distort or prevent efficient regulation of the oil sector, and suggest that, though voluntary initiatives and capacity building programmes are important for addressing corruption, they should not replace establishment of formal state-sponsored regulations. The paper is part of the project 'Corruption in Natural Resource Management' at the U4 Anti-Corruption Resource Centre: [www.u4.no](http://www.u4.no)

# 1 Introduction: the oil industry, corruption and donor countries

Corruption in the regulation of the oil industry is often referred to as pervasive, and cross-country variations in how well an oil industry benefits populations in host countries are increasingly visible. Improved access to information, active journalism and watchdog NGOs have all facilitated international comparisons, and welfare differences between oil rich countries are strikingly evident. Some countries, including Norway, are lauded for their sound management of oil wealth. Others, such as Nigeria and Angola, have experienced negative economic growth despite the development of an oil industry.<sup>1</sup>

Theories of the ‘resource curse’ are important in understanding the underlying challenges facing oil rich countries, and corruption is a key factor in the ‘resource curse’ phenomenon.<sup>2</sup> Our understanding of how corruption actually influences important decisions in the oil industry is nevertheless limited and policy makers have only imprecise information on the most important areas of risk. This U4 Issue Paper provides an initial exploration of how and why corruption can distort or prevent efficient regulation of the oil sector. It focuses primarily on the respective roles of host governments, private oil companies and donor governments, though also touches on other actors and the increasingly dominant role of state-owned, national oil companies (NOCs). We begin with a discussion of emergent trends in the oil industry of relevance to corruption, and go on to provide analysis of corruption risks in the regulatory process. Particular attention is given to licensing arrangements and field development plans. We end with a discussion of potential policies for curbing corruption in regulation of the oil sector, and make some tentative recommendations for donors.

## 1.1 The oil industry: some current challenges

The oil sector is changing rapidly towards both stronger host governments and stronger national oil companies. Private oil companies, including the so-called ‘Seven Sisters’, are less able to influence, or dictate, the terms of operation in many countries, and their financial rewards are being pushed to the margins.<sup>3</sup> According to J. Robinson West, Chairman of PFC Energy: “*The international companies don't run the business anymore*”. *The rule-makers are now the national oil companies. They drive the business.*<sup>4</sup> Despite record-high oil prices, large companies in the sector face considerable uncertainty about their future revenues.

Combined with the changing face of the sector, we observe that the annual growth in petroleum reserves is persistently falling short of anticipated growth in demand. Despite strong awareness of the decreasing volumes of the remaining conventional oil resources in the world, and the necessity of using these resources efficiently, enormous amounts of oil will never reach the surface because extraction in many countries is sub-optimal. The oil companies’ preference for accelerated income tends to maximize early production. This can easily be done at the expense of higher oil recovery which would be possible if the resources were recovered over longer periods and with appropriate recovery measures.

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<sup>1</sup> GDP per capita in Nigeria, in terms of Purchasing Power Parity (PPP), is actually at about the same level as in 1970.

<sup>2</sup> See Kolstad, I. and Wiig, A. (2007)

<sup>3</sup> “The Seven Sisters” are the ancestors of today’s ExxonMobil, Chevron, BP and Shell.

<sup>4</sup> Cited in *Washington Post*, 3 August 2005. PFC Energy is an industry consulting firm.

## 1.2 Regulating the industry

What does this have to do with regulation of the oil industry and corruption or with the role of donor countries? Regulatory frameworks determine the revenues and responsibilities for actors involved in the industry, including the private sector and the government. By defining certain requirements regarding exploration, field development activities, technologies applied, the number of operators, the role of NOCs, and monitoring opportunities, this framework sets the scene for the industry's activities. Regulation determines the opportunities for the sector to function efficiently, and whether this works for the benefit of society at large.

Variations between countries in how well the oil industry functions depend not only on the robustness of the regulatory framework but also on the efficiency and capacity of the regulatory institutions. One explanation for weak sector performance is that some countries lack sufficient human resources and professional competence to regulate such a complex industry. Indeed, a number of donor capacity development programmes, such as Norad's Oil for Development, focus on oil resource management in an attempt to address these weaknesses. Another important explanation is corruption in the sector's regulation.<sup>5</sup>

## 1.3 Why a bribe is more than an unfair benefit

It may appear implausible that a few benefits to a few decision-makers can undermine an entire industry and impede welfare improvements to a whole population. This is, nevertheless, what corruption is often about: relatively small benefits in the personal world of civil servants and politicians that are sufficient to alter the decisions they make as representatives of the state.

The intention behind bribery is to encourage deviation from what would otherwise have been decided, i.e. what would be congruent with the goals of the institution in question, typically a public institution. The bribe represents compensation to the decision-maker for the personal sacrifice of making this deviation, thereby forsaking the ambitions of the institution he or she represents. Following this logic, corruption can undermine any ambition, goal or rule of any institution. The implications for welfare will depend on what ambitions the institution had in the first place, i.e. the benchmark from which corruption encourages deviation. Where a government is benevolent, the ambition is improved welfare, and the benchmark for the deviation (the corruption) will entail a negative welfare effect in one way or another.<sup>6</sup> For the oil industry too, corruption is not simply about how certain decision-makers are rewarded undeservedly, but about the ways in which decisions deviate from what is optimal for society.

Where corruption is relatively common in an oil sector, its consequences can take many forms. There are direct consequences, such as loss of revenues, poor technical standards of operation, sub-optimal oil recovery, premature termination of production in an area, or failure to respect social and environmental standards. There are, in addition, many indirect consequences related, for instance, to capital flight, the design of the tax system, political decisions on resource allocation across sectors and industries, competition effects in the market, income differences and the development of elite groups and power constellations. These consequences invariably trigger serious distortions in the political and social fabric of society. Since tracing these effects back to the oil industry can be challenging, it is often very difficult to verify the indirect consequences of corruption in the sector.

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<sup>5</sup> See [http://www.norad.no/default.asp?V\\_ITEM\\_ID=10094](http://www.norad.no/default.asp?V_ITEM_ID=10094)

<sup>6</sup> See Besley (2006) for a broad analysis of government failure and the relevant political economy literature.

## 1.4 The prevalence of corruption

There are no reliable estimates of the prevalence of grand corruption in the oil sector. There are, however, good reasons to believe that corruption does influence the oil industry. Oil contracts are usually confidential and are not open to public scrutiny. This is still the case, despite various pro-transparency initiatives, such as the Extractive Industries Transparency Initiative (EITI).<sup>7</sup> Contracts are also financially and technically complex, making it difficult to identify irregularities. In addition, they are sometimes embedded within larger geopolitical dynamics that involve a diplomatic *quid pro quo*, where fair competition for operation is not necessarily expected. Several cases of grand corruption in the industry have been brought to court in recent years (see the examples in the box below). Though this is no indicator of actual levels of corruption in the sector, such examples do inform us of some of the mechanisms at play and which actors are involved.

### *Examples of grand corruption in oil*

A 2004 US Senate report detailed how **US oil companies** made millions of dollars in questionable payments to relatives and friends of President Teodoro Obiang of **Equatorial Guinea**, which “may have contributed to corrupt practices in that country”. The report offered a detailed examination of how oil companies operate in an economy where many businesses are dominated or controlled by government officials, their families and other associates. This economic dominance, the report added, resulted in foreign companies having to provide those in positions of authority with “lucrative returns” on oil investments.

*Source: Los Angeles Times, 15 July 2004*

In 2003, American business consultant James Giffen was indicted by US prosecutors on federal bribery charges for channelling over US\$ 78m in payments from **Mobil** and other **western oil companies** to senior government officials in **Kazakhstan**. The payments were reported to have facilitated these companies’ entry into the Kazakh oil sector. They were made not to the government treasury, but rather to bank accounts specified by government officials. US prosecutors asserted that the money was then moved gradually to other accounts or to shell companies, until it arrived in accounts held by Giffen and, allegedly, by the Kazakh President Nursultan Nazarbayev.

*Sources: New York Times, 23 December 2007 & Reingold (2004)*

In 2003, three key executives of the former **French state-owned oil company**, Elf, were jailed for up to five years for their involvement in corruption. The three were among 37 defendants on trial for illegally siphoning off €350m in company funds from 1989 to 1993. Much of this money was paid out in royalties to African politicians in **Angola**, **Cameroon**, **Congo-Brazzaville** and **Gabon**. The payments were aimed partly at guaranteeing that it was Elf - not US or British firms - that gained access to these countries’ oil resources. At one point, Gabon alone accounted for 75% of Elf’s profits.

*Source: UK Guardian, 13 November 2003*

In 2004, the **Norwegian oil company Statoil** was found guilty of bribery and fined US\$ 2.9m for its role in unduly influencing decision-makers in the **Iranian oil and gas industry**. The former director of Statoil’s international development section, Richard John Hubbard, was also fined for his role in the case. Statoil was found guilty under a 2003 law that rendered illegal the agreement it had made with consultants Horton Investment - worth US\$ 15.2m - to secure oil contracts in Iran.

*Source: BBC News, 29 June 2004 & Oslo Aftenposten, 12 September 2003*

<sup>7</sup> See <http://eitransparency.org/>

There is, however, also reason to believe that the problem varies significantly across countries and companies, and that different forms of oil-related corruption have different consequences. These nuances are seldom captured by sources commonly referred to as indicators of corruption in the sector. First, several surveys that point to oil-producing countries as particularly exposed to corruption are based on perceptions, or to some extent on experiential data. Yet we know that very few respondents have first-hand experience of corruption in the sector. The results of perceptions-based surveys can be influenced by a common belief that corruption in the oil sector flourishes, and are not necessarily reliable as indicators of corruption.<sup>8</sup>

Second, the number of cases of corruption is not a robust indicator of the problem's prevalence. This number will seldom represent the actual presence of corruption in a country, since it is heavily dependent on the quality and independence of prosecutors and courts. The number of cases brought to court may also be influenced by a particular focus among prosecutors on this specific sector, since the huge financial transactions involved may tempt potentially corrupt decision-makers.

Third, estimates of prevalence will be blurred by uncertainty about the impact of the last decade's many anti-corruption initiatives in the oil sector. Many players have taken steps to proactively address the problem, and participated in the introduction of serious anti-corruption initiatives such as the EITI and the Global Compact.<sup>9</sup> The impact of these initiatives is still uncertain, though it could be argued that they have already contributed to increased awareness, and have, in some ways, improved business practices and professional standards in the sector.

We are left with one credible source of evidence of corruption in the oil industry: the phenomenon of the 'resource curse'. This is a complex set of political, economic and social factors whereby countries richly endowed with natural resources experience low economic growth and significant welfare inequalities. Corruption is a key element in explaining the 'resource curse'.<sup>10</sup>

## 1.5 'Resource curse' versus foreign influence and aid

Resource rich countries commonly experience low growth rates, low levels of human development, and high levels of inequality and poverty.<sup>11</sup> This paradox is particularly relevant to the oil sector, since a majority of oil producing countries are below the median rank on both the UN's Human Development Index and most of the World Bank's Governance Indicators.<sup>12</sup>

The inability to promote growth and development indicates huge failures on the part of governments in oil rich countries. These failures have many domestic explanations, including the undue influence of power constellations and elites, the prevalence of civil unrest (which may be linked to resource rents), and more clear-cut forms of corruption such as bribery and graft.<sup>13</sup> These are coupled with a tendency among politicians and civil servants to view oil resources as a convenient source of rents for amassing

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<sup>8</sup> For criticism on cross-country perceptions-based corruption indices in general, see Weber Abramo (2007). See Kenny (2006) for a review of estimates of corruption in infrastructure, and Knack (2006) for a comparison of results from perception-based indices and business survey data from Eastern Europe and Central Asia.

<sup>9</sup> <http://www.unglobalcompact.org/>

<sup>10</sup> On the basis of a literature review, Kolstad and Søreide (2008) explain why we have reason to assume that the resource curse is caused primarily by corruption.

<sup>11</sup> See Sachs and Warner (1995), Bulte et al (2005) and Gylfason, (2001a).

<sup>12</sup> For a list of oil producing countries, see Wikipedia: [http://en.wikipedia.org/wiki/List\\_of\\_oil-producing\\_states](http://en.wikipedia.org/wiki/List_of_oil-producing_states); the [UN Human Development Index](#), see United Nations (2007); and the World Bank Governance Indicators, see the [Governance pages](#) at the World Bank web page: [www.worldbank.org](http://www.worldbank.org)

<sup>13</sup> Many books and newspaper articles exemplify how corruption and rent-seeking constellations influence regulation of the oil industry. These often explain or indicate how corruption is backed by foreign firms or governments. For examples, see Yates (1996), Shaxon (2007), and Ken Silverstein's discussion of 'The politics of petroleum' in the *Los Angeles Times*, 13 May 2004.

personal wealth and securing political patronage. According to a former Angolan planning minister: “this is not about production, but about a cake to fight for”.<sup>14</sup>

At the same time, this fight for natural resources must be considered in an international context. Countries that host oil industries are influenced by foreign corporations, and are exposed to pressure from foreign governments and international organisations. Policy advice and aid to poor but resource rich countries has seldom been given out of pure altruism, but has also been influenced by donor countries’ commercial and/or political interests. It is not difficult to imagine how actual or potential conflicts of interest may arise between donor countries’ needs to access oil resources or supply oil-related technology and services, and donor initiatives aimed at improving welfare benefits in oil producing countries. Such conflicts, whether potential or real, may serve to increase the risk of corruption in resource rich developing countries, particularly where institutions are unable or unwilling to enforce regulatory frameworks.

Potential conflicts of interest can be mitigated through open discussion of the motivations behind policy advice. Clearer criteria for success on the part of the donor community for addressing the resource curse would provide a good starting point for discussion and a baseline for assessing the impact of related policies. It is possible to achieve mutually beneficial collaboration between extractive companies, their home countries and resource-rich states, even if there is some variation between who benefits in the short and the long terms. We will return to this issue in chapter three.

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<sup>14</sup> See Shaxon, 2007:215.

## *The Norwegian petroleum industry: a farmer's wisdom?*

In 1969, drilling commenced on Well No. 1 in the Ekofisk oilfield on the Norwegian Continental Shelf. Today, Norway is Western Europe's largest oil producer and the world's third largest oil exporter after Saudi Arabia and Russia. Yet, the country has avoided many of the political, social and economic problems associated with the resource curse, and the so-called 'Norwegian model' of petroleum management is recognised internationally as an example of how to successfully manage large natural resource endowments.

The Norwegian petroleum industry, however, developed under a very particular set of circumstances and in a well-grounded institutional context. By the time of its first oil discovery, Norway was in an exceptionally good position to benefit from its oil resources, with the government able to exert strong influence over their management. The country's previous work related to framing the international Law of the Sea was helpful in clarifying territorial boundaries, thus facilitating serious private sector investment. It also avoided rushing to pass comprehensive petroleum legislation, taking instead a step-by-step or 'wait- and-see' approach. Its first petroleum law (1963) essentially confined itself to clarifying sovereignty of the country's oil. It was not until the Comprehensive Petroleum Law of 1985 - at which point the authorities had gained substantial experience of regulatory practices - that a more all-encompassing legal framework for the industry was introduced.

At an early stage, Norway decided to apply its industrial taxation system to the oil sector with only minor modifications where required. It therefore had no need of developing Production Sharing Agreements, in which it then had little expertise, as a possible form of agreement between government and oil companies. Norway enjoyed sufficient trust in its long standing fiscal system to attract international investors without such agreements. Other key aspects of the Norwegian system included its development of a Petroleum Fund for government oil income and a fiscal rule controlling public expenditure of oil revenues. In an attempt to avoid the effects of the resource curse, the fund created a buffer between net petroleum revenue and its use in the current national economy. It was essentially used to pay off the national debt, and this goal was achieved in 1995.

In some ways the 'Norwegian model' was and still is highly discretionary, with the conditions for and tempo of petroleum operations closely monitored and ultimately decided by government officials. Debate has been increasing, however, on the way Norway's oil wealth is managed, with citizens pointing to below-par health services and infrastructure as reasons for increased public expenditure. It should be noted, too, that the relative strengths of Norway's domestic regulatory system have not prevented cases of bribery involving Norwegian oil companies operating abroad (see the box on page 9).

### *Key periods in Norway's oil industry:*

1958-1969: The pioneering period: establishment of a legal and administrative basis for petroleum activities; evolution of a licensing system.

1970-1978: The growth period: first major oil discovery leads to extensive exploration and rapid growth in resource base; the State Petroleum Administration takes shape and oil-related legislation is developed.

1979-1986: The consolidation period: the Tempo Committee proposes establishment of a Petroleum Fund; development of comprehensive oil-related legislation.

1987-2000: Near maturation period: expansion of oil production and improved rates of recovery in a period of unpredictable oil prices.

*Source: Al-Kasim (2006)*

## 1.6 Uncorrupted regulation of oil: a naïve aim or practically achievable?

Uncorrupted regulation of the oil industry is a win-win situation for both firms and governments, since both theoretically receive increased revenues, more efficiently. If not 100% achievable, uncorrupted regulation is likely close to the reality for many institutions involved in overseeing the sector. Nevertheless, many of the anti-corruption initiatives directed towards firms entail voluntary initiatives and ethical codes of conduct. These may provide efficient anti-corruption mechanisms internally in firms, particularly in relation to their procurement rules. When it comes to the regulation of firms as players in a market, however, voluntary initiatives will seldom be sufficient. Introducing codes of conduct primarily to avoid corruption in competition for contracts can easily be seen as naïve.<sup>15</sup>

The problem is not necessarily caused by those competing for licenses, however. Some oil rich countries experience very challenging impediments to their development, and this is particularly the case where corruption occurs in the political leadership of a country. The question of donor naivety is very relevant in such cases, since most policy advice has concentrated on legal and regulatory reform. Though such reforms are important tools, they will likely be insufficient where opportunistic politicians in *pro forma* democracies alter or circumvent framework conditions according to their personal interests. These cases point to the limited value of formal rules, and indicate that variations in both cases and circumstances challenge the design of donor strategies. The same set of solutions will not apply in all countries and contexts, and tailor-made approaches are likely to be required when offering advice or aid.

Obviously then, this paper does not produce a complete set of solutions, but rather points at certain areas of corruption risk and mechanisms of corruption in oil regulation. We focus primarily on contexts where the government is benevolent, but also discuss cases where basic framework conditions are uncertain due to significant political corruption. We now turn to regulation of the oil industry, with a particular focus on licenses and field development plans.

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<sup>15</sup> See Søreide and Weber Abramo (2008) for a recent discussion of the efficiency of various anti-corruption initiatives.

## *Defining corruption in the context of oil regulation*

There is no single, universally accepted definition of corruption, and academics and advocates have developed a number of useful, but different, approaches. Defining corruption in legal terms is an obvious starting point. In practice, however, uncertainties in how to interpret the law, the variety of laws to be considered in each jurisdiction, and cross-country variations in legal definitions, result in significant grey zones. The most commonly-used definitions for development practitioners are probably those advanced by the World Bank and Transparency International (TI). The World Bank's working definition of corruption is "**abuse of public power for private benefit**". TI takes a broader approach: "**the misuse of entrusted power for private gain**".

To facilitate discussion around corruption in oil regulation, a definition of corruption is required which has relevance to this specific context. Neither the World Bank nor TI definitions appear particularly suited to this purpose, since they do not capture the fundamentality and complexity of corrupt arrangements in the oil sector. The oil industry is usually governed at the highest political levels, and corruption usually involves political representatives at this level. These actors have different opportunities to benefit from corruption as compared to, for example, civil servants. They will not necessarily bend rules in secret, but will rather alter the rules of the game quite openly, or decide on significant exemptions from written regulations. The benefits they obtain through some form of corruption may be far more than a personal bribe, and may be tied to development aid, macroeconomic loans, party contributions, various political and diplomatic *quid pro quos*, intricate arrangements to increase revenues controlled by incumbents, or support of industries where politicians have personal stakes.

A definition of corruption is clearly needed to separate corrupt decisions from this more complex political game. We suggest that a more appropriate definition in the context of oil regulation is "**the manipulation of framework conditions to attain exclusive benefits to individuals or groups at the cost of social benefits.**"

## 2 Corruption in the regulation of the oil industry

### 2.1 Why regulate and why corrupt regulation?

There are several reasons why an oil industry needs to be regulated. Each country owns its oil and gas resources, and permits are needed to gain access to these resources. A government system and appropriate legislation are required to ensure this occurs in an orderly way. Other reasons for regulation relate to technology transfers, the need for security, a requirement for systems to control revenue, and the need for environmental protection. If they are not regulated by law, a licence contract for oil exploration or production will include details related to these considerations, and will usually replace active regulation for the given concession period. Such arrangements can involve considerable corruption risks. Where government officials are coerced into accepting framework conditions embedded within a contract instead of in formal legislation, the regulatory capacity of the state is likely to be diluted. Conflicts arising from varying interpretations of the contract will be subject to international arbitration rather than arbitration in national courts, implying reduced control at national level. Moreover, variations between contracts are likely to reflect the preferences of individual companies, making government monitoring cumbersome. In all cases, regulation of the oil industry involves decisions of great importance to government revenues and company profits, and there are a number of players with an interest in influencing these decisions.

#### *Regulation of Namibia's oil industry*

The Namibian oil industry is regulated via the Petroleum Exploration and Production Act and the Petrol Taxation Act (both 1991). The country operates an open licensing system, where essentially anyone can apply for a concession at any time. The awarding of concessions is done via negotiations overseen by the National Oil Company, which is the technical advisor to the Ministry of Mines and Energy. There are three types of oil licenses in Namibia:

- i) reconnaissance licence
- ii) full exploration licence
- iii) production licence (in the case of discovery)

It is the government negotiating team, chaired by the Ministry of Mines and Energy that determines the issuance of licenses and concessions. However, representatives of several other bodies, including the office of the Minister of Justice, the National Planning Ministry, and the Ministry of Transport and Communication, all have a say in the decision. A team of approximately 10 people - comprising the government negotiating team - across a number of bodies is responsible for the final issuance of a concession.

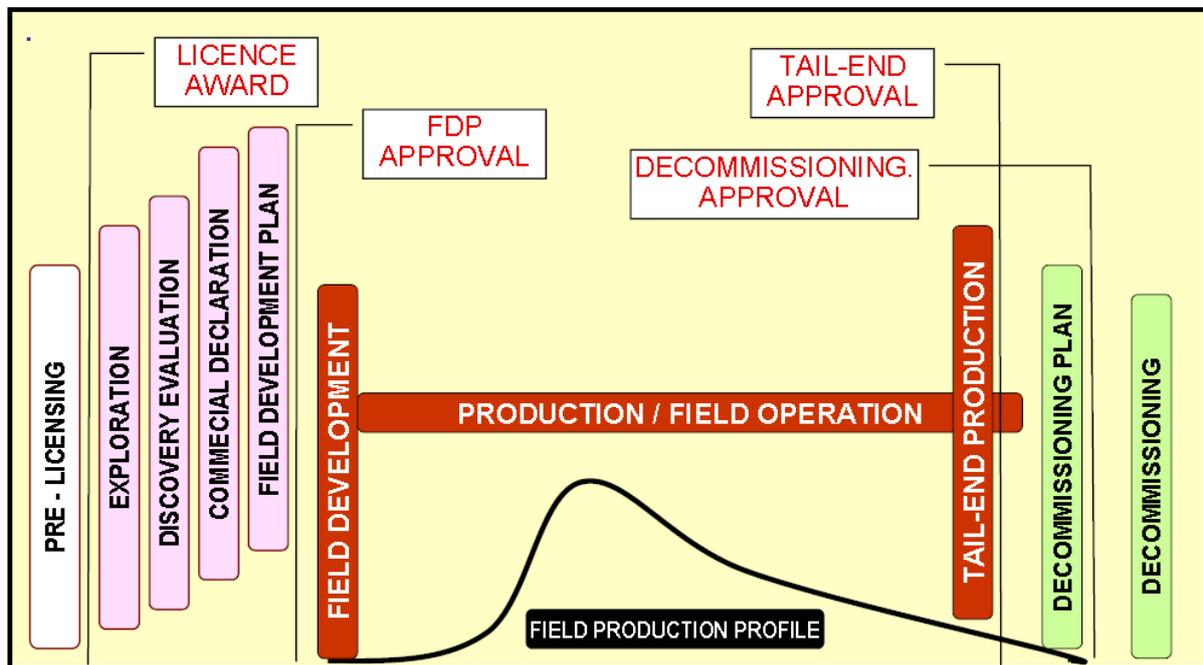
Concessions are, in theory, awarded on a competitive basis in Namibia, but since the country's oil reserves are so little explored, the usual practice is to issue licences on a come-by-come basis. If more than one company is interested in a particular concession block, then applications are reviewed in terms of publicly available criteria. Currently, however, there is around one application a year for 1 or 2 concession blocks.

*Source: Personal interview, Namibian Ministry of Mines and Energy*

## 2.2 Steps in the process: regulating production

The way in which oil operations are regulated varies across countries, as do the steps involved in exploration and production processes. Commonly, regulatory regimes cover a licensing phase, an exploration phase, a production or operational phase, and a post-production or decommissioning phase. Figure 1 illustrates the typical milestones in the regulation of oil operations. Key milestones are the awarding of the licence or concession, approval of the field development plan (FDP), approval of a tail-end plan, and approval of the decommissioning phase. Opportunities for corruption can exist at all stages in this process, as discussed further below.

Figure 1: Milestones in the relationship between government and licensees

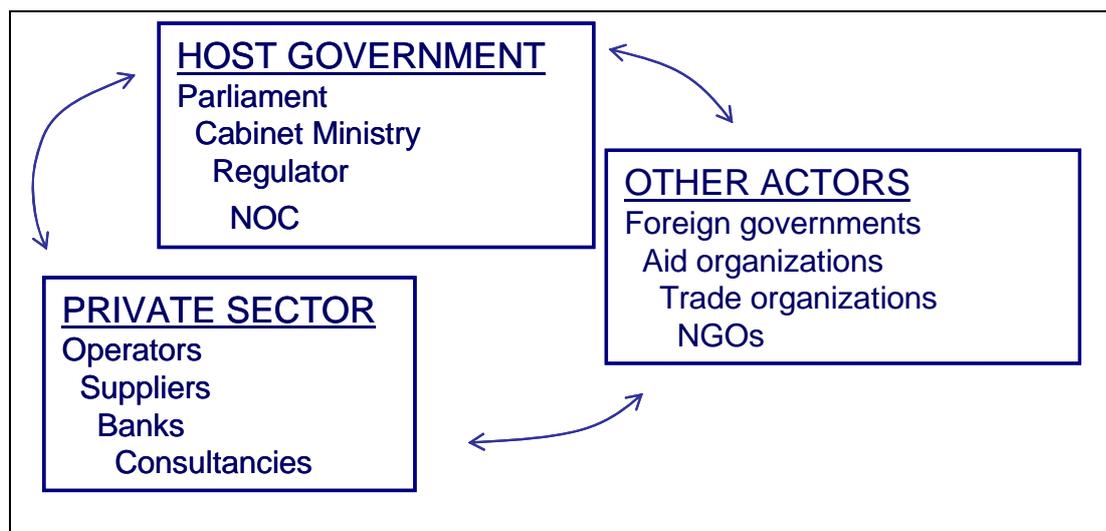


Source: Petroteam AS

## 2.3 The actors and decision-makers

The actors involved in oil regulation and operations, and the relationships between them, present a complex picture. The most important categories of actors are (i) **the host government** of the oil industry, within which key actors include the oil or petroleum ministry, other ministries, various directorates, the NOC, the judiciary and the office of the president; (ii) **private sector companies**, including licensees, joint ventures, consortia, operators, service-oriented contractors, and consultants (iii) **third-party actors**, including the home governments of oil companies (including their donor agencies and departments of trade), NGOs, development banks, commercial banks, and international organisations. Figure 2 presents a simple illustration of these main types of actors.

Figure 2: Actors involved in oil production and regulation



Understanding corruption in oil regulation requires that we analyse how the contacts between these various actors occur, whether they follow formal rules and procedures, and what motivations might underlie their actions. The risk of corruption will depend not only on the actors directly involved in corruption, but also on the propensity of *other actors* to condone corrupt or borderline practices. General tolerance towards discretionary decisions, limited transparency and informal solutions will contribute towards a climate of acceptance of corrupt practice.

## 2.4 Incentives behind corruption

Democratically elected governments will usually be expected to maximise state revenues, including in relation to oil regulation, and improve welfare conditions for society at large. This follows from restrictions on terms of office, whereby voters will tend to re-elect politicians only if their experiences with them are generally positive.<sup>16</sup> In the ‘resource curse’ literature, it is argued that oil resources may alter these democratic mechanisms, since control over revenues can be used to bolster political positions through patronage or to build strong political parties.<sup>17</sup> The opportunities an elite has to benefit from oil revenues also functions as a form of compensation for potentially reduced public support, damaged reputations, and the loss of tax revenues from domestic industry and the population.

<sup>16</sup> This assumes, of course, that voters are to some extent informed about political decisions and their consequences. This will not always be the case when it comes to political decisions related to industry regulation. For more discussion on this, see Besley (2007).

<sup>17</sup> See discussion by Auty (2001) and Woolcock et al (2001).

## *The rise of national oil companies*

Much of the analysis in this paper assumes a traditional view of the oil industry: of international oil companies leading production and, as such, potentially at the front line of involvement in corrupt practices. As world demand for oil increases, however, government-controlled national oil companies (NOCs) are challenging firms such as Royal Dutch Shell and Chevron in the global competition for oil reserves. NOCs are increasingly venturing beyond their home country borders in search of reserves. There are roughly 60 NOCs worldwide, and nearly half of them own reserves outside their home country, or hold ambitions to do so. According to the Washington DC consulting firm PFC Energy, around 77% of the world's 1.1 trillion barrels of proven oil reserves is controlled by governments that significantly restrict access to international companies.

International oil companies (IOCs) and national companies, while sometimes rivals, often work together. In many cases, NOCs lack the money, technology or managerial skills needed to develop large projects and seek to work with bigger firms. But some NOCs have gained enough know-how to begin closing this gap. According to PFC data, more bilateral deals are being made between NOCs, allowing one to operate in another's home country, leaving international firms out of the picture. IOCs often still have a technological advantage and usually operate oilfields more efficiently than their national counterparts. In tenders, however, IOCs will sometimes lose out to NOCs where they are, for example, subsidized by low- or no-interest loans.

The rise of NOCs is linked to governments' desire to more directly control oil revenues, energy for their populations, and the development of new technology. The ties between NOCs and their governments are seldom transparent, however, and several NOCs have significant discretionary authority. They may also be exempt from legal restrictions, for instance on their own procurement procedures. Policy discussion around regulation of oil must recognize that the international oil market is continually evolving, and that NOCs are an increasingly important actor in terms of addressing corruption.

*Partly based on Washington Post article, 3 August, 2005*

Maximising commercial profits is the most obvious incentive for the private sector to engage in corruption. The risk and form of corruption involving the private sector, however, will depend to a large extent on the size of the company. Large firms may seek to reduce political risk or avoid interference with their license concession by, for instance, supporting a ruling regime. Corruption or financial support at this political level has sometimes been defended by those involved as a way of facilitating contact with government officials at lower bureaucratic levels.<sup>18</sup> Smaller companies, on the other hand, are likely to face greater obstacles in bureaucratic systems, to obtain licenses or to clear customs. Accordingly, they will usually be less involved in corruption at higher political levels.<sup>19</sup>

Another indicator of corruption risk is associated with firms' bargaining power vis-à-vis corrupt officials or politicians. A strong (and perceivable) potential for profits may reduce a firm's bargaining power in such contexts since the firm cannot convincingly claim it is unable to afford bribes.<sup>20</sup> This mechanism is uncertain, however, since more profit will also strengthen the firm's ability to handle lower revenues if 'victimized' for not paying bribes, as well as its ability to cover court costs. A high

<sup>18</sup> Personal interviews during survey of Norwegian exporters, see Søreide (2006).

<sup>19</sup> See business surveys by Hellman et al (2000), Batra et al (2003) and Søreide (2006) for data and discussion on how corruption challenges vary between firms of different size.

<sup>20</sup> See Svensson (2003) for a study of what firms in Uganda pay in bribes in comparison to their returns and exit options.

degree of sunken investments in the economy will reduce the firm's exit options and will have a more certain impact on bargaining powers; the more the company invests, the more vulnerable it will be to changing framework conditions in the country, and to corruption.<sup>21</sup>

Similarly, a firm's bargaining power is reduced where time is more valuable to the firm than it is to a (corrupt) decision-maker. The risk of corruption will often be high in relation to regulatory decisions.<sup>22</sup> Bottleneck situations relating to, for example, environmental licensing may be created by government officials to extort bribes from companies keen to begin their operations. Even where they represent important challenges and involve serious consequences, these forms of corruption will seldom be classified as 'grand corruption.'<sup>23</sup>

A company's propensity to engage in corruption also depends on how easily it can obtain benefits, what forms of benefits are entailed, and the structure of decision-making authorities in host countries. The number of individuals involved in key decisions is important to identify risk, with a small number implying fewer people to convince or bribe. Parliaments, for instance, make decisions of the highest importance, including a determination of the basic framework conditions for oil companies. From the strategic perspective of a firm, however, a parliament is not an easy target for corruption since it has so many members. Clear-cut bribery will be far more efficient if aimed at influencing one or two individual ministers, who often hold monopolistic power in relation to certain decisions. The *hierarchical* structure of a government's budget process may also be important to understand the risk of corruption. For instance, von Hagen and Harden (1995) find budget processes to be more democratic and involve greater welfare benefits the more ministers and their ministries are involved in budget preparation and control (as opposed to leaving the main decisions to the finance minister or to the minister of energy or oil).

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<sup>21</sup> Exit is far more costly if the firm leaves or withdraws from a contract before it has covered the cost of investing in the required exploration, equipment and installations.

<sup>22</sup> See Bardhan (1997), Aidt (2003) or Helmann et al. (2000).

<sup>23</sup> See theories of incentives by Shleifer and Vishny (1998) and empirical evidence by Kaufmann and Wei (1999) on how bottlenecks are artificially created with the intention of creating opportunities to demand bribes.

Table 1: Corruption risks prior to operation

Activities		Corruption risks
Preliminary assessment of potential	Prior to the development of an oil industry and petroleum law.	<b>Usually low.</b> Though diplomatic pressure may already be placed on host government by oil companies.
Development of regulatory framework	The set of legal instruments and institutions needed to prepare for and monitor operations, including production.	Important to secure adequate legislation and allocate regulatory functions to competent institutions, and thus avoid political interference in individual cases.
Establishment or granting of role to NOC	National oil companies, often established or given important roles.	Secret transactions and exemptions from ordinary rules in society. Home country support in international tenders may have adverse consequences in the market. Threat to undermine regulatory authority on the pretext of commercial interests. Often used as means of avoiding political accountability when favouring certain oil companies.
Granting of rights	Pipelines, ports, public services, ownership of equipment, technology, data, etc.	Bribery may influence decisions in favour of certain parties.

Table 2: Corruption risks in operational phases

Phases and Activities		Corruption risks
Pre-qualification	Mechanisms of approval decided.	<b>High risk of corruption.</b> Pre-qualification can, conversely, be very important to ensure efficient operation and high recovery rates. Could be used more actively to secure professional business conduct.
Tender, selection and award	Auction to award concessions. Negotiations and contracting. Decisions about local content. Awarding of concessions for exploration only or exploration and production combined.	Procurement related <b>risk is usually high.</b> Procedures are not sufficient to prevent corruption since serious risk is connected to criteria for awards, rules of exemption, or violation of the procedures.
Exploration	The search for oil deposits.	<b>Low risk of corruption.</b> Risk of leniency in accepting insufficiency in meeting work commitment.
Identification of reserves	Precise geological identification of oil reserves. Oil production cannot begin until resources are proven.	<b>Low risk of corruption</b> connected to these geological analyses, although there may be a risk of fraud in the presentation of the results. These data form the basis for negotiations on the FDP.
Field Development Plan (FDP)	Decisions about production profile and cost recovery schemes.	<b>High risk of corruption,</b> either related to its original contents (cost recovery and production profile) or to amendments of the original contents.
Production	Extraction of oil deposits.	<b>Low risk of corruption.</b> There is generally limited regulatory interference at this stage, though greater controls on production could be beneficial in some contexts. Risk of leniency in accepting FDP changes without expert scrutiny.
End phase	Winding up of production.	<b>Low, though there may be some risks</b> associated with decisions about precisely when to stop production and the quality of decommissioning.

## 2.5 Regulatory regimes <sup>24</sup>

Connections between the actors in the oil industry (Figure 2) depend on formal structures, including the organisation of state institutions, legislation, contracts and licensing. Though a well-regulated and predictable environment will facilitate most business operations, thereby reducing the risk of corruption, this is not necessarily what all actors prefer. Weak regulatory environments sometimes prove far more profitable to some private companies - not necessarily because of corruption, but because they provide strong arguments for greater risk compensation and thus higher revenues. They may also provide a more receptive environment for prioritising commercial considerations over the public good in the conduct of operations. Shaxon (2007) describes how a US oil company in Equatorial Guinea struck the most lucrative oil deal in history for a private company, in a context where there was an almost entire lack of established regulatory structures.

Research on corruption provides only limited information on who initiates bribery in various settings, i.e. whether it is a firm that offers bribes or if it is politicians or public officials who demand them. Though difficult to establish, this information can nonetheless be useful to improve the design of anti-corruption initiatives. The relative bargaining powers of different actors will often be easier to establish and, as mentioned, assumptions about these powers can serve as an indication of an actor's propensity to engage in corruption. In order to reduce the risk of becoming involved in corruption, a firm should not solely focus on codes of conduct, therefore, but also consider how it might strengthen its bargaining power vis-à-vis a particular government through technological competence, flexibility (i.e. the ability to withdraw from a market), independence from state subsidies, the size of revenues, or support from home country governments. A company's informal relations (for example, to individual ministers) may sometimes be added to this list and may represent a way of reducing corruption risk. There is no evidence of a direct link, however, between good contacts and corruption.

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<sup>24</sup> Throughout this paper we use the term 'regulatory regime' to refer to the laws, regulations and institutions that govern the oil industry. We note that industry insiders often use the term 'legislation' to refer to both laws and regulations.

## *Corruption and Iraq's draft oil and gas law*

Iraq has one of the largest petroleum resource bases in the world, with potential and proven oil reserves of around 215 and 115 billion barrels respectively. Historically, the country's production has lagged behind its reserve capability and its petroleum facilities have been severely affected following the second Iraq war. In 2003, the country's production sank to around 1 million barrels per day (mbpd), in comparison to a pre-war level of some 2.8 mbpd.

The productivity of the Iraqi oil sector is at considerable risk from corruption. According to the Revenue Watch Institute (RWI), a network of interests exists that is involved in defrauding the Iraqi people of their oil wealth. Problems largely facilitated by corruption include delays in installing meters and the siphoning of crude petroleum and refined products from depots, refineries and pipelines by truck or ship. RWI note that abuse of petroleum resources is inflicting lasting damage on the state apparatus, particularly the Ministry of Oil's relationship with the public.

In this context, the Minister of Oil initiated the drafting of a new Oil and Gas Law aimed at optimising exploration and production operations in the country. The proposed draft law of 2006 has, however, been the subject of significant controversy between different factions, mainly on the grounds of its interpretation of two specific articles of the new Iraqi Constitution. Other critical voices have protested against the mode and scope for foreign company participation allowed under the draft. Extended negotiations between political parties resulted in several further revisions. According to Tariq Shafiq, Chair of Fertile Crescent Oil Company and a member of the original drafting team, the third draft law of February 2007 does not contain sufficient checks and balances "...to cope with Iraq's internal political complications, and [is] more of a façade, leaving the competence of authorities and the processes of the grant of rights open to manipulation by the political forces that prevail..". Crucially for the future of the Iraqi oil sector, Shafiq notes that items have been removed in the draft that are "...fundamental to professionalism, transparency and accountability".

*Sources: Revenue Watch Institute, "Managing Iraq's Petroleum", Workshop Report, Beirut, 8-9 April 2006; Shafiq (2007).*

## 2.6 Licensing arrangements

A licence (sometimes referred to as a concession) is a legal document or contract regarding the exploration for and extraction of natural resources for a determined period of time. In the oil sector, it usually entails the right to conduct exploration, development, production and transportation operations over a defined area, for specified periods and under conditions and requirements outlined in legislation and/or the specific contract.

The many legal details of these arrangements are described in the literature on licensing law and natural resource regulation. Licence agreements vary significantly in their transfer of control and ownership to private firms, the awarded exploitation time, and the revenue shares of private firms and governments.<sup>25</sup> Among the aspects of licence agreements particularly exposed to corruption are the selected area of exploitation, the cost recovery basis, the licensees' share of the profits, the length of operation, rate of production, environmental concerns, end phase commitments, and reporting and control commitments.

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<sup>25</sup> For a broad, legal overview of concessions and natural resources, see Rasband et al (2004).

## 2.7 The awarding of licenses

The risk of corruption is probably greatest during the process of awarding licenses. Such awards are often conducted on the basis of direct negotiations with firms, though auctions following professional auction procedures are becoming more common. Auction procedures are an important means of selecting the most suitable company for production, though the pre-qualification phase is equally important.

Pre-qualification ensures that tender participants deliver serious bids, and that they are actually capable of carrying out the operations in question. Criteria for pre-qualification can be designed so as to single out certain companies, and officials may threaten to do so as a means of extracting bribes. The procedures can also be used to reduce the risk of corruption by setting various anti-corruption requirements or by blacklisting firms that have been found guilty of corruption. This is discussed further in the next chapter.

The design of rules and criteria both for pre-qualification and for the main tender are important to reduce the risk of corruption. They will seldom be a sufficient obstacle, however, and corruption may still occur in various forms. First, it may occur as a *direct but secret violation* of procedures by, for example, providing confidential information to one of the bidders about bids or selection criteria in exchange for bribes. Second, it may occur as a *misuse of rules that allow for legitimate deviations* from set procedures. This may involve, for example, awarding contracts on the basis of direct negotiations with one of the bidders, by falsely referring to extraordinary circumstances or to diplomatic or environmental concerns.<sup>26</sup>

The forms of influence related to these processes vary significantly, and include various honest marketing efforts and grey zone-practices in addition to clear-cut corruption. Via corrupt or borderline practices, firms may influence tender criteria, acquire information that leads to a winning bid, or gain important support at political levels. Firms may even offer bribes prior to operation merely to build commitment to signed contracts.

It should be noted that firms from separate countries competing for the same host country licence will be operating under different home-based legislation, and will therefore face different sanctions when engaging in corruption. This would intuitively lead us to conclude that firms operating under strict domestic legal frameworks - for example, those modified in light of the OECD Anti-Bribery Convention - are less likely to bribe than firms operating under more lax frameworks.<sup>27</sup> Whether domestic legislation is adequately enforced, however, is another matter and the examples of corruption noted on page six illustrate that firms from a range of countries have engaged in bribery.

## 2.8 Operating a license

Decisions about how much of a resource to extract and who has the right to extract it are not necessarily respected by those either granting licences or those receiving them. Violations of licence terms can conceivably include extracting more resources than authorised, extracting resources in prohibited areas, extracting resources other than those agreed upon, duplicating regulatory licenses, misreporting volumes and misrepresenting values in various ways. Bureaucracies are required to monitor oil production and enforce basic regulations and contracts. Yet bribery can still occur in attempts to weaken monitoring efforts, or to avoid sanctions if detected and prosecuted. The main

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<sup>26</sup> For a review of corruption in procurement, see Della Porta and Vannucci (1999), Moody-Stuart (1997), or Rose-Ackerman (1999). Some forms of corruption may seek to exploit a host country's aim to give preference to license applicants with national participation. National companies can sometimes be a façade for local politicians and officials.

<sup>27</sup> The OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions. See <http://www.oecd.org>

corruption risks associated with the operating phase of oil production, however, are connected to the approval and monitoring of field development plans (FDPs).

## 2.9 Field Development Plans

An operator wishing to develop a new field is usually required to apply for consent and to prepare a plan for the field's development. The regulator's scope for influencing the FDP is an important factor in the process of negotiating oil exploration and production licences. There are a number of ways in which oil fields can be developed, and the level and duration of peak oil production vary depending on the characteristics of the field and the emphasis placed on optimal oil recovery. The manner of extraction which is set by the FDP will often reflect the operator's preference for high levels of production as soon as possible. The sooner and shorter the production peak is, however, the greater the risk that less oil will ultimately be recovered from the field. The current world average for oil recovery is around 30%. There is potential for improving this to around 40% on a world-wide basis, though recovery can be as much as 70% in particularly suitable fields under optimal recovery schemes. Efficient cooperation between government and the private sector is a pre-requisite for achieving high rates of recovery, and the FDP represents a key tool for initiating dialogue to achieve improved cooperation.

Once an FDP has been approved, the operator is ideally left to operate the field with only periodic government monitoring to register anomalies that may affect recovery. The government may seek to discuss these with the operator to identify appropriate solutions. Negotiations around the FDP between extractive companies and host governments nevertheless represent the most important risk of corruption in regulation of the sector. The most important elements of the FDP under negotiation relate to cost recovery and to restrictions on production volume. The regulatory basis for optimisation of the FDP determines the framework for these negotiations.

## 2.10 Cost recovery

It will sometimes be difficult to estimate the volume of recoverable oil in a particular field, and operators may face substantial risks associated with exploitation. Rather than seek complete compensation for these risks, most operators serve under a cost recovery basis. This reduces the operators' share of the revenues, while eliminating most of the risk. The operators' revenue can be described as follows:

$$\text{Revenue} = \text{Cost recovery} + \text{Share of profit}$$

The ceiling amount and nature of items that can be included in the cost recovery scheme vary significantly, and this question is an important part of negotiations between regulatory institutions and the operator. It is also a fundamental point in the monitoring of operations by the regulator. Bearing in mind that the percentage share of profit to the oil company is fixed in the contract, there is a risk of corruption associated with regulating how the cost should be determined, since this is of great importance to firms' real profits.

## 2.11 Production profile

The production profile is another important issue during FDP discussions between government and licensee, and relates to the rate of production over the lifetime of the field. It is usually represented by an asymmetric curve with a relatively rapid rise and a gradual slope of decline (as illustrated in Figure 1). The volume of oil under the production curve represents the estimate of recoverable reserves

within the given development plan, comprising of certain investments.<sup>28</sup> Once the FDP is approved, the licensee is committed to perform the development plan unless it can demonstrate that deviations are essential for maintaining the objectives of the plan. As mentioned in the introduction, the marginal rate of return decreases over time and profitability of production becomes negative prior to full recovery. How much oil can be recovered changes with technological developments and with oil prices, however, and the final production profile is not necessarily known when operations begin. The production profile depends not only on reservoir constraints and on the development plan but also on geopolitical issues, conflict prevalence, financial markets, infrastructure development, openness to investment, and the selection of operators.

The planned profile for a given project can therefore be revised with reference to a number of factors. The risk of corruption in relation to poorly justified FDP revisions is significant since government approval of a given revision is essential to company profits. The optimisation of oil actually produced and decisions on depletion rates will depend on regulatory competence and integrity. Since the marginal returns from production decrease over time, an absence of corruption is likely to increase the total volume of oil recovered. Once production is terminated, a field cannot be reopened. Corruption-free regulation prior to and during the period of operation is therefore required to ensure maximum benefits from oil resources.

## 2.12 Renegotiation and amendments

Once production has begun, either the operator or the government may wish to make amendments to the deal and renegotiate the terms of operation. Though renegotiations are less common in oil than in utility licences, they are still relevant since they are often associated with influence-peddling or with corruption. The benefits firms may obtain relate to lower taxes, adjustments to annual licence fees, exemptions from work commitments, amendments to other requirements, or extensions of contracts. In addition, information about opportunities to alter operating terms after operations have begun provide opportunities for winning a tender with what, in reality, would be a low bid.<sup>29</sup>

While renegotiations can sometimes be justified, since not all contingencies can be included in a contract, there are good reasons to expect some level of opportunistic renegotiation, which aims to reduce or eliminate the expected benefits of competitive bidding at an earlier stage in the process.<sup>30</sup> Renegotiation implies a lack of compliance with agreed-upon terms, and the outcome will often imply reductions in expected state revenues. This practice is usually open to broad discretion and can involve corruption or be encouraged by corruption.

Renegotiation is far more common where regulatory governance is weak, or where regulatory bodies do not exist at all. A key factor that influences the incidence of renegotiation is whether the regulatory framework is embedded in the licence contract, rather than in government decrees, regulations or in the general body of law. The opportunities for changing licence terms are stronger where regulation is contract-based. In some countries, firms seek to diminish such risk by investing in 'good contacts'.<sup>31</sup>

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<sup>28</sup> For example: the drilling of wells, installation of surface facilities, introduction of pressure support by the injection of appropriate fluids into the well, and implementation of other improved recovery measures as and when required by reservoir performance.

<sup>29</sup> One oil lobbyist in São Tomé, commenting on a particularly beneficial deal, said "We always understood from day one that there would be, as likely as not, renegotiation", see Shaxson (2007:152).

<sup>30</sup> Guasch (2004) presents a survey of renegotiation of utility concessions in Latin America. He finds renegotiation to be significantly more common when contracts have been awarded on the basis of competitive bidding (i.e. when competition puts pressure on the bids and potential profits), compared to contracts awarded on the basis of direct negotiations (i.e. when firms will be in a better position to negotiate their terms and profits prior to operation). The benefits of competitive bidding for contracts may thus be significantly reduced if renegotiation is widely accepted.

<sup>31</sup> See Wells and Ahmed (2007) for interesting cases of corruption and property rights in foreign direct investment in Indonesia.

In countries with adequate regulatory legislation, petroleum contracts tend to deal strictly with commercial terms, and the scope for revision is thus considerably narrower. On the other hand, host countries should refrain from revision of regulations without consulting stakeholders in the process. For different reasons there will be situations where renegotiation of contracts is the only way to achieve win-win solutions for both parties. Such solutions can only be achieved, however, if the regulatory personnel are competent and the process of renegotiation is transparent and accountable.

### *Bolivia's oil regulatory bodies*

Two entities regulate Bolivia's oil industry: the state-owned oil company **Yacimientos Petroliferos Fiscales Bolivianos** or YPFB, and the **Superintendence of Hydrocarbons**. Until 1996, YPFB was an integrated company with full control over its downstream and upstream process. Since 1997, the Superintendence of Hydrocarbons regulates and controls a section of the oil industry's activities, including oil and gas transport ducts, the natural gas distribution network, commodity prices, refining plant processes, monitoring of compliance with technical and safety standards, and the defence of fair competition. YPFB determines the issuance of licenses through contracts in the sectors of exploration and production. On the other hand, it is the Superintendence of Hydrocarbons that determines the issuance of licenses and concessions for the rest of the activities of the downstream process. In the near future, however, a new hydrocarbon law could again see the YPFB assume full control of downstream and upstream functions.

Two corruption scandals have tainted YPFB employees or former employees in recent years. The first involved alleged secret talks between YPFB's former president and several representatives of the **Brazilian oil company PETROBRAS**, during the negotiation and signing of new petroleum contracts. A second corruption scandal erupted in July 2006 when the then President of YPFB, Jorge Alvarado, approved an allegedly unconstitutional deal between YPFB and the **Brazilian company IBEROAMERICA**. Bolivian Energy Minister, Andres Soliz, accused Alvarado of fraud over the barter deal to exchange crude oil for diesel with the Brazilian company at a price well under the market value. President Evo Morales later replaced Alvarado, one of the most public faces of nationalisation of the Bolivian energy sector.

*Source: Personal interview, Department of Geology, St Andrew's University Bolivia, & Reuters, 28 August 2006, "Bolivia's Morales replaces head of state oil firm", <http://blythe-systems.com/pipermail/nytr/Week-of-Mon-20060828/044529.html>*

## 3 Policy discussion

In recent years, significant attention has been given by government policy makers in host and home countries to corruption in the oil industry, and this may have influenced the practices of some oil firms and regulatory officials. There remains, however, much to achieve when it comes to transparency, fair competition and business integrity. A focus on corruption should not prevent a pro-active approach against the many practices in the political game behind oil production - practices that may not be termed corruption by law, but which may have similar welfare consequences, or which may be used to cloak corrupt practices. Such practices may include low- and no-interest loans, export subsidies, local content provisions that serve the interests of decision-makers, hidden transactions, secrecy about revenues, or secrecy about the details of licences and FDPs.

The definition suggested above: “*corruption is the manipulation of frame conditions to attain exclusive benefits to individuals or groups at the cost of social benefits,*” captures a wide set of practices. It also suggests a common standard of social and economic welfare as the benchmark from which corrupt practice entails deviation. This is a radical definition and one that is likely not to be applicable in a court of law. It underscores, however, the importance of linking the debate around grand corruption to a broader set of issues.

Corporate profits are often perceived to be an important driver of corruption in oil. It appears, however, that governments, via national oil companies, are increasingly important actors in the sector. A public welfare focus is what one would expect from state leaders internationally. What we observe, however, is an extraordinary fight for resources and revenues, which speeds up production levels, reduces transparency, and involves a number of political and diplomatic “weapons”.<sup>32</sup> Grand corruption in the regulation of oil - if understood in broad terms - is a problem driven by governments and their protégé oil companies.<sup>33</sup> Policy debates around the oil sector should therefore note that corruption in oil is mostly steered by those with monopoly on resource jurisdictions. It is further complicated by a variety of regional as well as geopolitical interests.

### 3.1 The development community and the risk of conflicts of interest

The intention behind oil-related aid is to improve governance of the oil industry in developing countries. This is, at least, the most intuitive assumption one can make. Some donor country governments may encounter conflicts of interest when it comes to this ambition, since improved regulation does not necessarily strengthen ‘their’ firms’ opportunities to benefit commercially in the countries in question. The topic of conflicting intentions and interests is particularly relevant for donor country governments with oil interests, including Canada, France, the Netherlands, Norway, the UK and the US. Access to energy and the international politics behind energy prices, however, are priority issues for most governments, and the question of a consistent foreign policy towards oil producing developing countries is therefore relevant for all donor governments and the international development community in general.

Long-term perspectives on the development of domestic institutions, conditions on local content, and moderate rates of oil development may be critically important to reduce corruption risks and ensure welfare-enhancing production. This is a view, however, that contradicts the optimisation of profits for many oil companies, since rapid exploitation and openness towards foreign operators is more consistent with their interests. A slower exploitation rate may also be considered negative to the evolution of oil prices, and will seldom be in the interests of oil importers. The true motivation of

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<sup>32</sup> See Legget (1999) on “the carbon war.”

<sup>33</sup> We include here both international oil firms and national oil companies

trying to influence the governance of an oil-producing country must therefore always be considered critically, including when part of an aid strategy.

Among the likely consequences of a contradiction between aid policy and commercial interests is a tendency for donor governments to operate an imprecise foreign policy towards oil producing countries. A first step towards aid and dialogue on the risk of corruption in the regulation of oil, is thus for donor countries themselves to establish political consensus on this issue, and determine clear criteria for success in their interactions with oil producing countries. Unless a donor country government is able to focus on the importance of welfare improvements in the oil producing country, and patiently tolerate the slow development of regulatory institutions, it should operate openly and primarily as a commercial player, and not hide its commercial intentions behind its aid policy.

Once the issue of commercial interests has been settled, aid strategies should follow more clearly. Since the stakes involved in aid do not relate to competition for access to energy or commercial benefits, but rather to poverty reduction in the countries in question, collaboration between donors should become easier. Collaboration between energy producers is another likely result of clearer goals in relation to donor policy. Better regional collaboration among oil producers reduces the opportunities for commercial players to gain from weak regulatory frameworks. Regional coordination can be important to strengthen bargaining powers vis-à-vis foreign governments, as well as opportunities to share lessons learned.

### 3.2 The oil industry: workable solutions and diplomatic concerns

An analysis of the broader context of the political economy in a country is needed to explain grand corruption in the oil industry. This includes an understanding of the accountability and competence of political leaderships or power structures, democratisation processes, constitutional conditions, the role of the judiciary, the space for political opposition and free speech, and the quality of the media. As emphasised in the introduction, this report focuses narrowly on the oil industry itself and the risk of corruption in decisions relating to the regulation of oil production. We do not offer a complete list of anti-corruption interventions, but point to issues that require greater attention and further development.

The last decade's intense focus on anti-corruption has seen a large number of initiatives and suggested interventions, ranging from ethical training, greater local transparency, monitoring schemes, improved procurement rules, and international conventions with significant legal implications in a number of countries. Here, we concentrate on initiatives likely to have an impact on the institutional environment surrounding the extractive industries. We discuss how workable they are likely to be, and on what basis they may be raised as part of a diplomatic dialogue. This latter aspect is important since initiatives are likely to have little impact unless supported by governments in oil producing countries. The following list of suggested initiatives requires elaboration in detail and should be considered in the context of specific countries.

### 3.3 Regulatory institutions and stronger government capacity

A lack of competence and capacity within regulatory institutions is a main challenge in many countries despite the stream of revenues usually associated with oil production. An important contribution donors can make is to offer training on governance issues relating to each step of the oil production chain. An example of such trainings are the courses offered by Petrad, an institute of the Norwegian Oil Directorate, which focus on petroleum management, administration and technology, and which target representatives of national oil administrations and companies in developing countries.<sup>34</sup> These initiatives appear to be welcomed by many oil producing governments and

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<sup>34</sup> <http://www.petrad.no>

potentially provide a space for dialogue on rather more challenging issues relating to the governance of oil regulation.

### 3.4 Procedures for regulating the industry

Formal rules and regulations are extremely important even if they are being violated and irrespective of political will for reform, or the benevolence of political leaders. If not respected they nevertheless set the stage for what practices should have been, and provide a benchmark for evaluation. Without this benchmark it would not be possible to determine the violations involved and hold people, firms or institutions to account. Where procedures are respected, even to a limited degree, they will usually make corruption more difficult for government officials, firms and other actors.

If not in place, or only partly in place, procedures and rules should be developed for key steps in petroleum operations, from the start-up phase, where a firm arrives in a country to explore and operate a field, to the abandonment phase, where production is no longer financially rewarding. All countries have some level of legislation in place, a first step is therefore to review existing legislation and identify serious deficiencies in the framework conditions and/or deviations between practices and regulations. A few key points related to the tendering process are mentioned here by way of example:

- (i) Procedures relating to **prequalification**, **tenders** and the **selection criteria** behind tenders are particularly at risk from corruption. We do not, however, have enough information about the ability of reformed tender rules to prevent corruption in the awarding of licences. There are numerous ways of cheating on even very structured procedures and many companies consider procurement procedures no obstacle to corruption.<sup>35</sup> One way of reducing the risk of corruption might be to combine strict and **well-defined criteria** on award processes with a limitation on the number of negotiable items for firms (no more than three, for instance).
- (ii) The process of **prequalification** requires attention. In addition to evaluating the technical competence of firms, prequalification procedures can be applied more efficiently to secure fair competition and business integrity. Greater understanding of how these processes can function as a defence against corruption - by introducing, for instance, appeal mechanisms or by allowing them to be subject to international endorsement - are needed.
- (iii) **Discretionary decision-making** will always carry the risk of being marred by corruption. The importance of discretionary decision-making processes should not be underestimated, however, since rules that are too rigid encourage manipulation of the award system (not necessarily due to corruption). A good balance between discretion and rigid rules is extremely difficult to achieve, and should be subject to further research to better inform public policy. The solution is likely to involve some combination of discretion with improved information laws.

### 3.5 The importance of providing information

Public access to information is very limited in the oil industry in many countries. Despite initiatives such as EITI and greater openness among firms about production numbers and revenues, it is very difficult to gather information on important decisions, such as the control of revenue streams and the conditions behind licence contracts. Rather than merely emphasising the importance of transparency to encourage a respect for rules and to build accountability, we should consider incentives from the perspective of those involved in the industry – and consider different pieces of information separately. Elements which are often secret, but which should be public, are the selection criteria behind the

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<sup>35</sup> According to a business survey on corruption (Søreide, 2006)

awarding of contracts, as well as the details of final contracts themselves. In addition, *quid pro quos* between governments, bilateral political negotiations on the awarding of large contracts, and foreign companies' export credit or other subsidies, are seldom accessible.

In seeking access to information about revenues and petroleum rights conditions, we should not forget the impact of information that is already in the public domain. Most important, perhaps, is the information given to firms to underscore what is *not negotiable*. Corruption is part of a game where the goal is to influence decisions, and where the question of bargaining power will often be decisive. The risk of corruption can be reduced by pointing to factors that regulate bargaining power and reduce scope for influence-peddling. Such factors include information about the details of petroleum laws, regulations, model contracts, important directives, and other regulatory frameworks and procedures about information-availability should be encouraged. A corrupt bureaucracy has incentives to refer to such frameworks as flexible and as of less importance than personal contacts. Corruption in the oil industry will thus encourage less transparency about how rules should be understood. A counter-force would be to emphasise the actual presence of the regulations: the clearer the information that can be given to firms and foreign governments about what rules exist and how they should be respected, the lower the risk of corruption.

### 3.6 Building accountable institutions

It is easy to point to the importance of accountability in institutions, yet difficult to make it actually work. Accountability is often presented as a question of ethical choice and its degree a question of motivation among public officials. As part of a reform process, accountability should be viewed more technically, however, as a means for reducing opportunities for public officials to misuse their positions or condone violations of the rules. Each step in the decision-making process can be monitored and reported. Though often avoided, it is possible to link responsibility not only to institutions, but to specific positions. This implies that an identifiable individual is personally responsible if a violation of the rules occurs or if certain goals have not been attained. Despite the importance of defining responsibilities, there will often be significant resistance against this in a given bureaucracy. Most governments keep hierarchies of responsibility blurred, and thereby avoid being held accountable when some form of failure occurs.

Another way to strengthen accountability is to require status reports from those in positions of responsibility and to ask them to defend their choices. This simple means of improving the quality of decision-making is not necessarily applied. At the highest level of the political system, the ministry responsible for the oil industry should report to parliament once a year to explain and defend choices relating to regulation of the industry. Despite the importance of oil revenues and the well-known risk of corruption and other forms of fraud, this is not a common practice. Governments generally allow the responsible ministry and the NOC to operate with broad confidence that the solutions chosen are in accordance with the views of parliament.

A third aspect of building accountability relates to the importance of appeals procedures. Those in a position to note violations when they occur, and those who are the victims of violations - for instance because they lose out on contracts - should be able to appeal without the risk of being sanctioned and, ideally, it should be possible to take the government to court. It is very important that large oil companies react proactively against violations of their rights or against unfair tendering procedures. Prosecuting a government or a NOC can be extremely expensive and difficult. These are nevertheless very important actions to reduce the risk of corruption, and should be encouraged, and perhaps even supported, by the home government of the victimised firm.

### 3.7 How to regulate most efficiently

When it comes to the most effective means of regulation, neither governments nor donors should be under any illusions that there are easy solutions. This is an extremely complex area and there are huge vested interests at stake. According to criminal law literature, the prevalence of unwanted behaviour can be reduced either by *increasing sanctions*, through formal changes in regulations, or by increasing the *risk of detection*, through improved enforcement of existing regulations, which is a practical matter and not a formal procedure.

Economic incentive theory suggests that an agent calculates the expected payoffs of corruption. Specifically, the agent is assumed to gauge the benefits of corruption, such as the size of the bribe or the amount embezzled, versus the risk of being caught and the ensuing sanctions and other market-related losses. Sanctions may include fines, imprisonment, dismissal and associated loss of income, as well as informal sanctions, such as injury to reputation. The agent chooses corruption over honest conduct where, in such a calculation, the benefits outweigh the risks.<sup>36</sup> The implication of this theory is that the level of corruption can be reduced by decreasing the benefits, or by increasing the risks associated with such activity, or by pursuing both strategies.

When it comes to the real world, these suggestions are often very difficult to implement. The factors believed to influence such crime - i.e. the revenues involved, the risk of being apprehended, and the ensuing sanctions - are difficult to regulate. Decreasing the benefits of involvement in corruption is difficult given the secrecy of corrupt transactions. Moreover, a bribe is targeted at the personal economy of the person making the decision, and the amounts involved may be small compared to the financial value of the decision being "bought". Increasing the risks associated with involvement in corruption is also a challenge. These risks are determined by the probability of being caught, multiplied by the consequences thereof. Even when those apprehended can expect to incur very high penalties, the impact on risk is negligible if the probability of being caught is small.

Considering the theories of incentives, voluntary anti-corruption initiatives for the private sector appear primarily to be options for individual agents – who are essentially free to make a choice if and when they find the option reasonable or rewarding. Such initiatives consist mainly of encouragement to act responsibly and tend not to take full account of the factors that more directly influence agents' incentives. Unless they include some form of independent monitoring of managerial processes (such as public procurement, tax collection, customs or license-granting), the results of voluntary initiatives in terms of changing corporate behaviour will be modest.

### 3.8 Initiatives by firms (for internal use), versus for firms (as players in a market)<sup>37</sup>

The more general problem with anti-corruption initiatives can be contrasted with voluntary initiatives initiated internally within firms, where the top management opts to introduce forced compliance systems within the company to reduce fraud and kickbacks. For company employees, these initiatives will often have the same force as laws and externally enforced control mechanisms, and will thus have an impact on their incentives. At least in theory, the prevalence of corruption in a company bureaucracy (for instance in relation to its own acquisition of goods and services in a private market) is expected to decrease as a result. These systems can have an impact on the company culture, depending on how forcefully they are enforced.

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<sup>36</sup> For more explanation, see Andvig and Moene (1991), Aidt (2003), and Bardhan (1997).

<sup>37</sup> This discussion is based on a recent report on anti-corruption collaboration between countries, see Søreide and Weber Abramo (2008).

Whether this impact extends to top management's inclination to participate in corruption in order to win contracts is uncertain. Many of the last decade's corruption cases, including those involving Enron, Siemens, Exxon and Statoil, point to the fact that internal codes of conduct may fall short when it comes to top management and the manner in which it conducts business on behalf of the company. High moral values will not necessarily prevent business leaders from involvement in corruption since their ethical choices will depend on where they place their loyalty, whether on company profitability (including the protection of employees) or the welfare of society at large.<sup>38</sup>

It would be naïve to think that all listed US firms adopt codes of ethics because of some moral imperative. It is more likely that most do so because they must show that their employees and agents were duly informed that they should not bribe. If this requirement is not complied with, the CEO can be held responsible under the Sarbanes-Oxley Act for bribery committed by an agent or employee. In other words, not informing the employees/agents carries a high risk for the actor responsible.

It is also worth noting that corruption is unlawful in most, if not all, countries. A firm's claim, in its code of conduct, that it will not be involved in corruption to win contracts can be seen as a degradation of the law. It is needless to say that we will not rob a bank and, similarly, one should not have to inform others about honest business conduct. While the existence of internal compliance systems within firms is important, the impact of such codes is uncertain when it comes to the way firms gain contracts. To be effective, these procedures have to be supported by external monitoring and enforcement. Voluntary integrity pacts, for instance, are not sufficient to address the problem.<sup>39</sup>

### 3.9 Voluntary initiatives as part of anti-corruption programmes

Voluntary initiatives are sometimes introduced as a response to the difficulties of establishing state-sponsored formal anti-corruption programmes, and in this sense can be seen as second-best solutions. When formal prevention and control mechanisms are not achievable (for political or practical reasons), agents are at least actively encouraged to respect the law. This approach might be an instrumental step towards achieving more formal mechanisms in time, by serving to increase awareness of the importance of anti-corruption. Communication about corruption is often discussed as a significant factor in fostering more honest business practices.<sup>40</sup>

When it comes to protecting markets from the influence of corruption, governments should work towards formal state-controlled initiatives, such as enacting regulations, optimising competitive conditions, enforcing existing regulations, improving monitoring opportunities, allowing investigation units to operate independently, and reducing bottlenecks in the courts' system.

What we observe as a general trend, however, is that many anti-corruption campaigners, donors as well as governments, prioritize voluntary initiatives, without attempting to establish more formal mechanisms. According to Kolstad, Fritz and O'Neil (2007), who conducted an analysis of anti-corruption programs in several countries, the importance of the underlying incentives among agents involved in corruption is very much neglected in anti-corruption campaigns. Limited knowledge about the efficiency of different anti-corruption initiatives might explain this result. A more likely explanation, however, is the relative practical convenience of setting up voluntary initiatives. Such initiatives are far easier to establish than legal enforcement since they require only a limited number of adherents and avoid the far more daunting challenge of changing a country's institutional and

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<sup>38</sup> For discussion of moral values and business leaders' propensity to engage in corruption, see Rose-Ackerman (2002).

<sup>39</sup> An Integrity Pact is a voluntary agreement around a given public tender whereby all public officials and all firms participating in the competition promise to avoid corruption. For a critical assessment of the Integrity Pact methodology, see Weber Abramo (2003).

<sup>40</sup> Hass, Mazzi and Leary (2007) discuss the importance of communication in association with infrastructure projects.

managerial environment. Political factions, firms, agents, and lobby groups almost always lend their vocal support to voluntary initiatives, whereas support for and involvement in in-depth institutional and managerial reform is much harder to come by.

The potential contribution voluntary initiatives can make in terms of bolstering an anti-corruption strategy should, nevertheless, not be underestimated. Our concern is that voluntary initiatives, codes of conduct, self-regulation, and self-imposed transparency, often replace or divert attention from anti-corruption initiatives aimed at the whole of society. The introduction of a range of voluntary initiatives can easily give the impression that 'something is being done' about corruption. An emphasis on voluntary efforts therefore carries the risk that the design and implementation of more vital anti-corruption actions will be delayed.

## 4 Conclusion

Addressing grand corruption in oil regulation is extremely important for drawing welfare benefits from oil resources. There are no easy solutions, however, and donor governments, their oil producing counterparts and other actors, such as private firms, must engage in difficult political dialogue if progress is to be made. Forces that may prevent corruption challenges from being adequately addressed include the growing influence and power of NOCs and the associated fusion between politics and oil. Exploring the many forms of 'legal' corruption in the industry, that often take place at an international level, is an important area for further research. What we can say currently, however, is that attempts to address corruption are more likely to bear fruit where donor governments have determined clear objectives for their engagement with producers and firms, which separate commercial and aid interests. Donor initiatives aimed at training regulators in improving oil governance are important and may act to create a space for policy dialogue on corruption. Voluntary initiatives and codes for the industry should likewise be encouraged, though they should not replace state-sponsored, formal regulation. Indeed, promoting formal procedures for regulation at each stage of petroleum operations should be the underlying aim for donor strategies to address corruption in oil. Over time, a sound regulatory system should be developed that reflects the nuances of the oil sector in a specific country. Particular attention should be given to prequalification procedures, the criteria for licence awards, the renegotiation of contracts, and the drafting of Field Development Plans, all of which are at high risk from corrupt practices. Specific oil-related regulations should be coupled with enforced transparency via the enactment of access to information laws, close monitoring of decision-making processes and the opening up of markets via reform of public procurement systems.

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## Abstract

Corruption in the regulation of the oil industry is often referred to as pervasive. It is also considered to be an important element of the 'resource curse', whereby resource-rich countries fail to draw welfare benefits from their natural resources. Theories of the 'resource curse' are important in understanding the underlying challenges facing oil rich countries. Our understanding of how corruption actually influences important decisions in the oil industry is nevertheless limited and policy makers have only imprecise information on the most important areas of risk. This U4 Issue Paper offers an initial exploration of the topic of grand corruption in the regulation of oil. We focus on how and why corruption can distort or prevent efficient regulation of the oil sector, and suggest that, though voluntary initiatives and capacity building programmes are important for addressing corruption, they should not replace establishment of formal state-sponsored regulations. The paper is part of the project 'Corruption in Natural Resource Management' at the U4 Anti-Corruption Resource Centre: [www.u4.no](http://www.u4.no)