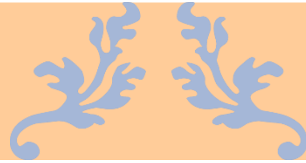

CORPORATE GOVERNANCE -BOARDS OF PARTNERSHIPS AND STATE OWNED ENTITIES IN MINERALS, OIL AND GAS INDUSTRIES."A PERSONAL PERSPECTIVE BY SHEILA KHAMA"

Chapter 1 Overview of Governance in Minerals, Oil and Gas Industries

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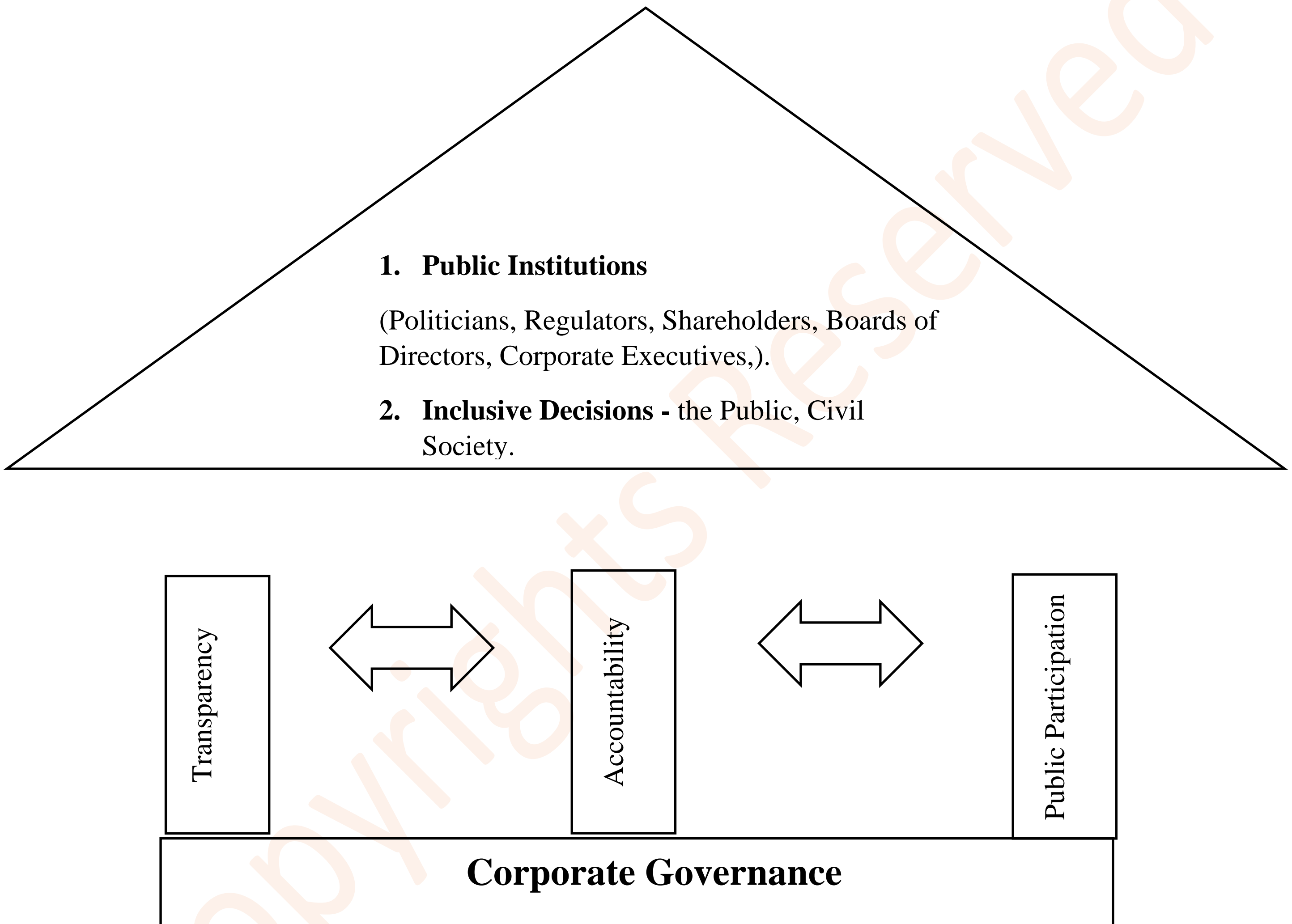
1.1.Principles of Good Governance

The three corner poles of governance - namely "*transparency*", "*accountability*" and the "*public voice*" - are my springboard as I delve into the importance of corporate governance in extractives. Applied consistently, the three offer a firm foundation for good governance of minerals, oil and gas resources. Given the target audiences of this book, corporate governance is the perfect intersection between public policy and governance of resources projects in which the state has an investment. *Diagram 1* maps this relationship between the principles of good governance and corporate governance.

Diagram 1: *Foundation, Structure & Pillars of Good Governance*



1.2. Why Governance in Minerals , Oil and Gas?

In mining, oil and gas industries, factors that heighten the importance of good governance are *responsible stewardship*, *protection of inter-generational value*, *maximizing current value*, *duty of care to citizens* and *containment of risk of unintended consequences.* I discuss these below.

Responsible Stewardship: In the context of minerals, oil and gas resources development, the importance of responsible stewardship is underscored by a number of issues. To start with, based on the principle of

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"accountability", the role of the State as the custodian of a country's resources wealth makes good governance a panacea. Entrusting the State with protection of public interest without first ensuring that national leaders respect this principle, is self-defeating. Equally, the State's custodial role, among others, assumes the ability and willingness to subject its agents to public scrutiny through transparent and accountable institutions as well as competent and responsible office bearers. In the absence of such clear rules of engagement, the ability of the public to monitor and validate adherence to these principles is hampered.

Maximizing Current Value: One of the most important roles of the state is to decide who develops mineral oil, and gas resources through licensing. The public reasonably assumes that, in licensing third parties or in undertaking exploitation of the resources, the State's foremost objective is to maximize value for the benefit of citizens. Public scrutiny ensures that licensing, negotiations and public investment decisions indeed reflect the views and interests of the public by confirming with the principle of value maximization. For instance, this provision assumes that the State's adjudication of resources development through licensing is driven by the need to engage the investors that are most capable of optimizing value and that the State has no other subjective consideration. By being transparent about the criteria and processes for licensing, and by subjecting themselves to public scrutiny, governments therefore enable citizens to assess their effectiveness and provide the public with necessary assurances that their interests are not compromised.

Protection of Inter-Generational Value: The finite nature of minerals, oil and gas resources places a premium on the notion of intergenerational value. As such, a major factor in ensuring good governance of minerals, oil and gas resources is the principle of sustainable development. This is to say, the importance of meeting the development needs of current generations without compromising social, environmental and economic needs of future generations. This is not possible unless those regulating and managing the projects embed this principle into day-to-day decisions, including but not limited to the rate and timing of extraction of the resources, investment of revenue from the projects and protection of the social and physical environment impacted by the projects.

Pursuit of Economic Justice

The notion of economic justice is defined as *'the idea that the economy will be more successful if it is fairer: that prosperity and justice go hand-in-hand rather than in opposition to one another'*.[1] On thinking about the importance of governance in minerals, oil and gas industries, I was drawn to this concept. But it was not so much the economists' view of the economic world order that intrigued me. Instead it was the idea that prosperity and justice go hand in hand. It occurs to me that companies cannot be indifferent to the plight of those in their midst and hope to prosper in the long-run. Because in many countries minerals, oil and gas resources are the hand that feeds the nation, it is also inconceivable that the governments that preside over the development of the resources can do so without due regard to this concept. It is inextricably linked to good governance, custodianship and wealth sharing. It links interests of communities, corporates and governments and is an essential safeguard for good governance.

Duty of Care to Citizens*:* Among others, acting in the best interest of others and ensuring that there is no harm done is premised on the assumption that those charged with the responsibility of making decisions relating to the resources understand the fundamentals of the industries. In this respect, good governance requires that representatives of the State have some understanding of what happens upstream, midstream

[1] *Tom Kibasi , What is economic justice – and why does it matter?* Director of the Institute for Public Policy Research, September 6, 2017

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and downstream of the resources value chain. For instance, a clear sense of where economic value lies in the chain and the ability to verify chain of custodianship for taxation and other purposes is particularly important for the State to avoid potential revenue leakage. From the perspective officials representing the state in boardrooms, these matters are integral to corporate strategic decisions and require a certain knowledge and alertness. Without this, state representatives risk under performing including being unable to recognize and capture incremental value. More importantly and as custodians, the representatives cannot confidently give the public assurances of adequate "*duty of care"*.

Containment of Risk of Unintended Consequences. The involvement of the State in the affairs of any company attracts additional scrutiny and potential criticism beyond the immediate corporate environment. Any decisions by the State can have a negative impact on the business of the companies the state is associated with. Avoiding such unintended consequences requires constant awareness of the impact that state decisions and actions might have on national resource wealth. Minerals, oil and gas companies (State-owned or not), are particularly vulnerable to this risk.

Because of this factor, brand visibility and the global nature of commodity trading, national companies can get caught in crossfire of international geo-politics. Companies affiliated with the state are vulnerable to risk of sanctions, as has been the case in the oil-rich country of Venezuela. Though the troubles in that country are rooted in multiple issues, it is hard to argue that poor governance and a failure to ring-fence Venezuela's state owned oil company from national and international politics is part of the challenges facing the country now and during the period leading to the crisis that began in 2010. According to OPEC, the country has the world's largest proven oil reserves yet that has not been enough to guarantee its citizens access to life's basics.[2] Venezuela's current economic and social demise is the clearest proof that resources wealth that is not accompanied by good governance cannot save a country and its people.

Under such circumstances, in addition to the risk of international sanctions, based on public perceptions of lack of good governance on the part of either a SOE or a country's political leaders, consumer groups can organize to boycott retail products downstream of the value chain. When this happens, the result is a potential decline in demand that renders the licenses immaterial and the deposits economically sterile. For governments and private investors, good governance is therefore a long-term business case. It is not surprising then that increasingly enlightened and forward-looking companies place these principles at the core of corporate strategy. For their part, shareholders and financiers increasingly demand that boards of directors act to contain such risk based on the concept of sustainability. In many respects, it is the recognition of unintended consequences that bad political decisions can have on corporate performance that the world owes the growing importance of Environment, Social and Governance (ESG) ratings.

1.3 Lessons From Global Trends

Over the last three decades, the subject of good governance of minerals, oil and gas resources has been elevated by global trends. These have added to the importance of good governance. I discuss a few of these in the paragraphs below.

Increased Access to Information – thanks to the internet age and social media, decisions made by boards of companies can and often are immediately and readily available to stakeholders. This empowers the public and enables it to demand accountability with greater speed and credibility than previously possible.

Lack of Trust in Governments and Companies – has led to a loss of moral authority on the part of the State as custodian and the companies that develop the minerals, oil and gas resources leading to a trust

[2] https://www.opec.org/opec_web/en/data_graphs/330.htm

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gap. This growing lack of trust in governments and companies is illustrated very well by the annual survey of results conducted by the Edelman Barometer (see Diagram 6).

Rise of Civil Society Organizations – have unleashed multiple global initiatives and coalitions devoted to holding governments and companies to account for their individual and collective actions. The plethora of civil society initiatives in minerals, oil and gas industries is particularly evident. A significant number of them advocate good governance through transparent licensing regimes, revenue collection and management as well as responsible protection of social and physical environments. This momentum challenges the actions of companies and has progressively found its way into corporate boards influencing strategies of many companies. Companies whose boards have not responded timeously and effectively risk adverse reputational and financial outcomes, including difficulty in raising finance and poor performance in stock markets as investors increasingly make a direct link between poor governance and perception of corporate risk.

Case 1:BP Deepwater Horizon Oil Spill.

The 2010 BP oil spill in the Gulf of Mexico is a stark reminder of the challenges facing corporate leaders in an environment of informed and diverse stakeholders. According to the American Society for Engineering Education, "the April 20, 2010 Deepwater Horizon oil rig explosion was an engineering and environmental tragedy that led to the loss of 11 human lives and has had far-reaching environmental and economic impacts, the full extent of which is difficult if not impossible to calculate. In 2015 the explosion continued to impact those 11 individuals' families; it continued to have a far-reaching emotional impact on the 115 men and women on board at the time of the catastrophe; scientists are still evaluating the environmental impacts of both the oil dispersion throughout the gulf and the oil dispersant used to curtail the spill at surface depths. Simultaneously, gulf business owners, particularly those who rely on gulf waters for their livelihoods, continue to struggle. This novel and far-reaching real-world disaster is particularly salient for use within engineering curricula due to its inherently complex interplay of *ethical issues* and the *broad scope of stakeholders impacted* by the initial disaster and its aftermath".

While the magnitude of adverse environmental impacts is unprecedented, the sustainable development challenges associated with development of minerals, oil and gas resources are common, because of the diversity of interests and expectations for the company to respond to these. Faced with this scenario, BP's management and board were faced with the challenge of having to balance expectations of employees, environmentalists, businesses reliant on marine life, the media, shareholders, CSOs and a range of regulatory requirements. Many case studies have already been written and will no doubt continue to be documented to debate the question on how well or not the company managed the crisis. This is not the object of this anecdote. That said, what we know is that the incident was very costly and that:

- BP set up a US$20 billion fund to cover the costs of claims from residents expected to be affected by the oil spill,
- BP set up a US$500 million Gulf of Mexico Research Initiative. It was set up as a 10-year initiative, with BP supplying US$50 million a year in funding to discover how the Deepwater Horizon explosion affected the environment and also its effects on human health,
- BP agreed to donate all revenue from recovered oil from the Macondo well to Restoration Gulf Coast, a program created by the National Fish and Wildlife Foundation,
- In addition, BP is paying $5.5 billion in civil Clean Water Act penalties and nearly $15 billion more for environmental damage and

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assorted claims by local and state governments along the Gulf Over a 16-year period,

- Even with this, a US federal judge still approved a whopping US$20.8-billion settlement.

These amounts constitute the largest environmental civil settlement ever in the US and are additional to BP's settlement reached with individuals and businesses for another US$7.8 billion. There are many lessons to be learnt from the company's response. Michael MacMasters suggested that BP should have undertaken the following actions to minimize the damage:

- "Issue regular, frequent progress reports
- Control the pictures
- Be transparent,
- Display empathy as a concerned corporate entity comprised of authentic people diligently making a good-faith effort to solve the problem
- Stop lobbying for environmental waivers"

McMasters' views notwithstanding, the magnitude of financial cost and reputational damage to BP is undeniable. For many companies, it is enough to collapse the business. Yet, from a sustainability perspective, we can expect that the cost to companies who find themselves in such a situation is likely to rise in a manner consistent with public views and perception of damage to the environment and regulatory standards. It is not surprising then that corporate boards invest time and energy strategizing to contain such risk. In the end, preventative measures are better and retroactive actions are a poor substitute. They offer little comfort to investors, suppliers, environmentalists and other industry critics.

Source:

Abstract: An Ethics Case Study in Environmental Engineering, American Society for Engineering Education, 2016.

Michael McMasters; BP Deepwater Horizon Crisis - A Case Study, Published on May 31, 2015

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Response from Public Institutions and CSOs*:* While the public has been consolidating its position and demanding greater transparency and accountability for custodians and developers of minerals, oil and gas projects, international organizations and academic institutions have not been indifferent to public sentiment either. In response, many have been at the forefront of efforts to direct the conversation in a structured, informed and objective manner. The UN Global Compact supports companies to do business responsibly by aligning their strategies and operations with ten principles. The Natural Resource Charter (NRC) outlines tools and policy options designed to avoid the mismanagement of diminishing natural riches and ensure their ongoing economic value. The Extractive Industries Transparency Initiative (EITI) offers a global standard to promote open and accountable management of extractive resources. The Equator Principles provide a risk management framework to financial institutions for determining, assessing and managing environmental and social risk in projects.

Call for Responsible Investing*:* Fund managers and other shareholders understand fully the negative consequences that failure to comply with principles of good governance can have on corporate performance. Hence, they spend time scrutinizing companies for compliance as a pre-condition to investing. Shareholders in minerals, oil and gas companies pay close attention to the actions of executive management of their companies and host governments, especially as relates to transparency, the environment and human rights. Investors are increasingly applying non-financial factors as part of the process of assessing and identifying material risks, as well as business growth opportunities. The ESG standards are one of the pushes for this and ESG investing is the latest benchmark and guiding principles for financiers and investors. While agreeing on a single rating and reporting standard has eluded ESG, no one argues with the importance of compliance, much less the risk of ignoring it altogether. This has clearly added to the corporate governance momentum. In the last ten years, and as a direct consequence of failure to abide by these principles, the shareholders of BP and Rio Tinto forced the CEOs of the two companies to resign.

Anti-Corruption Laws*:* In 1977, the Jimmy Carter administration in the United States passed the Foreign Corrupt Practices Act (FCPA). FCPA is a United States Federal law that prohibits U.S. citizens and entities from bribing foreign government officials to benefit their business interests. The FCPA is applicable worldwide and extends specifically to publicly listed companies, employees and other agents in the corporate hierarchy. Following amendments made in 1998, the Act also applies to foreigners engaged in corrupt practices in the U.S. itself. Members of the OEDC and the UK followed suit with similar laws targeting different sectors. When one adds onerous listing requirements, the burden of responsibility on boards of directors of companies increases significantly. But, while focus has been on private and listed companies, state-owned entities and partnerships dare not drop their guard because they too are subject to the same investing and financing standards. Indeed, the commodities they produce are subject to the same consumer scrutiny and choice.

These are but a few of the global trends that add to an already vast array of issues the boards of minerals, oil and gas companies have to contend with. It is not only a long agenda but it is also a constant moving target that requires vigilance. State-owned entities or governments in partnership with others will succeed or fail in part based on how they fare in the space of corporate governance.

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