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

Chapter 3 –Practical Challenges of Corporate Governance in Minerals, Oil and Gas Industrys

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3. Overview

Quite apart from the conventional challenges of balancing risks with rewards, boards of minerals, oil and gas companies face additional headwinds that are peculiar to the industries. So, while it is useful to understand the theoretical definition and conceptual framework for corporate governance in general, this is not enough to adequately shed light onto the unique circumstances that confront the boards as they adhere to corporate governance principles. The principles are themselves insufficient to guide governments in the selection and capacitation of board nominees. To achieve this, it is useful to scrutinize the environments, conditions and practical realities under which the industries operate. It is important to examine the environment in and outside the boardroom. It also useful to highlight factors that increasingly influence governance and corporate strategy. I discuss some of these under sub-sections 3.1, 3.2, 3.3, 3.4 and 3.5 below.

3.1. Impact of Global Events on Corporate Governance

Some highly visible corporate events associated with minerals, oil and gas industries have impacted the image and business environment negatively. The events include the collapse of ENRON in 2001, the deep-water oil spill in the Gulf of Mexico in April 2010 and more recently the 2014 indictment of Brazilian politicians in relation to the running of the national petroleum company. Tension between oil producers, the national government and civil society in Nigeria's oil-producing regions and associated human rights challenges in many other parts of the world, add to the negative perception. The advent of conflict minerals and a general increase in illicit trade of high-value minerals and rare earths in parts of the world are other events that damage the image of the industrys. The use of revenue from finite resources to finance prolonged armed conflict in some parts of Africa, Latin America and the Middle East adds to the already tarnished image of the industries. International media headlines on the impact of ill-advised national policies, including resource nationalism and poor fiscal policies leading to economic collapse of countries like Libya, Venezuela and Zimbabwe, reinforce the belief that the industries do more harm than good. More importantly they overshadow the comparatively positive outcomes from the development of the resources in countries like Botswana, Chile and Norway.[1] The boards of directors and executives of companies in these industries are therefore challenged to counter these perceptions, attract finance and reduce the risk of long term adverse effects on investments. Admittedly, these industries are not alone, but brand recognition of leading mining, oil and gas companies is a double-edged sword and often attracts public scrutiny. This benefits companies but also shines the spotlight brighter during times when the companies can ill-afford public attention.

3.2. Increasing Significance of Sustainability in Corporate Strategy

Today most industrys integrate the concept of "*sustainability*" into corporate strategy and deem the merits of doing so self-evident. For most companies the matter is the remit of the board of directors and top executives. But the nature of minerals, oil and gas industries, and the relationship between the business activities and the environment, places these companies in a uniquely challenging position relative to others. Add to that diverse stakeholder expectations and the finite nature of the resources, the strategic considerations become overlaid and quite complex. Considerations range from benefit sharing between corporates, governments and host communities, resource scarcity, conflicting resource needs, environmental protection, reduction of carbon emissions, stakeholder expectations and public mistrust. Corporate leaders recognize that failure to effectively respond

[1] https://resourcegovernanceindex.org/country-profiles

poses financial risk. Successfully embedded into long-term corporate strategy, sustainability policies address these matters innovatively, increase corporate value proposition to suppliers, citizens, customers and employees as well as enhance brand stature. Implemented effectively, the strategies lead to better relations with host governments, reduce public pressure and increase access to the resources and markets for products. Therefore, forward-looking corporate leaders embrace sustainable development principles by making adherence to the principles an integral part of the board of directors' corporate governance marching orders. Two issues have proven particularly challenging for boards of private investors and those of SOEs, namely the Resource Curse and climate change.

3.2.1 Resources Curse

Many problems are beyond the full control of a company's board of directors. However, the boards must play their part and where necessary take the lead. For an example, when it comes to the challenges of the Resource Curse, the importance of transparency and responsible revenue management though central goes beyond just the corporate environment into public policy. One initiative which though far from perfect has helped tackle the issue is the EITI. However the membership is comparatively low as some countries opt out. In this case, by opting to take up corporate membership, the boards of partnerships with host countries can bridge the gap and increase transparency in some host countries. While the boards of these companies do not control national policy, the boards have a duty to ensure that their companies play their part, by promoting the adoption of progressive corporate policies. Ensuring company participation in transparency initiatives improves governance in the external environment and helps engage stakeholders and protect public interest. Turning a blind eye on the other hand perpetuates the problem and weakens the industry's legitimacy at a time when more than ever, companies need to build trust with society.

3.2.2 Climate Change

In the oil and gas industries, the rising voice of environmentalists calling for the reduction of carbon emissions has added significant headwinds. For now, no issue challenges the boards of companies in minerals (coal), oil and gas as much as the question of how to tackle climate change while protecting commercial interests. So strong is the opposition to the industry that, at the insistence of investors, in early 2020, the CEO of Royal Dutch Shell Oil declared the company a utility company (as opposed to an oil or gas company) as what many saw as a first step towards strategically indulging the wishes of his shareholders who were threatening to defund the company unless there was a change of strategic direction away from fossil fuels.

So, as thorny as Resource Curse issues may be, they have the virtue of not calling into question the industry's ultimate viability and right to exist, *per se.* As long as mechanisms can be found to mitigate the tendency towards wrongdoing and leakage of government revenues, Resource Curse associated risks can be mitigated. But climate change is altogether different because the boards of fossil fuel industries must confront their own essential viability, given that production and especially consumption of its core products are incompatible with climate security. Threatened as it is by competitive disruption, (and ever more) punitive regulation and loss of public support, the fossil fuels industry has no choice but to chart a path of shrinkage transformation and ultimately resilience. This is a tough strategic choice for boards but it is particularly counter-intuitive for SOEs of fossil fuel dependent countries. The challenge severely tests any traditional definition of exercising one's duty of care to maximize profits for shareholders, or in the case of SOEs, for the state. It raises several conflicting geo-political questions and economic justice policy considerations. The solution must be led proactively and boldly by the board.

Notwithstanding these challenges, in many parts of the world compliance with sustainability principles is not just an economic and business imperative but it is a question of long-term corporate and national survival strategy. As policy advisor, I observed that in some parts of the developing world, SOEs have been slower to respond. This is in part because they have the protection of state institutions, which hold them to different, if lower standards. Equally, they are funded by the State and do not have to face the demands of Fund Managers and other private industry financiers. In these circumstances, under the false pretext that SOEs are exempt, the board inadvertently abdicates its responsibilities and is not exercising its duty of care. For instance, in Zimbabwe, where the state controls much of the gold mining activities, civils society organization allege lack of transparency as relates to revenue generation and management. They also allege that health and safety accidents are commonplace. A 2015 study by the University of Zimbabwe found that occupational injuries in the country increased from 3 810 in 2008 to 5 141 in 2012, while fatalities almost doubled from 65 to 103 over the same period.[2] Also neglected is the physical environment. A private company wanting to raise finance in the open market would be unable to survive such tragedies. However, in this case SOEs are superficially shielded. More importantly, the companies and boards are short-sighted and fail the most basic test of corporate governance, being exercise of duty of care. These are but a few sustainability challenges associated with the industries.

3.3. Sharing Wealth with Host Countries

Another challenge to corporate boards in these industries which is also growing in strategic importance is the call by shareholders and the public for companies to share the revenue from the development of minerals, oil and gas resources fairly. Specifically, the revenue split between companies and host governments is a matter of significant scrutiny and interest to citizens and civil society. This is especially true with respect to decisions on transfer of payments between subsidiary companies, remuneration of senior executives, distribution of dividend and other revenue streams. Many stakeholders, including shareholders, civil society organizations and the public, advocate equitable and fair sharing of the revenue. Once again, commitment to the two principles of transparency and accountability are part of strategic considerations by corporate boards eager to secure the social license to operate by meeting stakeholder expectations.

Therefore, through disclosure companies can demonstrate good governance as relates to fair distribution of wealth from minerals, oil and gas between investors and host countries. The action reduces risk and stabilizes the business environment. On the other hand, transparent management of public revenue from the resources by governments to better the lives of citizens is proof of accountability and adds to the stability of the political environment. If the membership of the EITI by SOEs is anything to go by here, again they have been slow to respond. According to a 2019 IMF Working Paper on SOEs, corruption by officials using SOEs for personal and political gain is purportedly high.[3] Though not unique to these industries, the significance of these factors is infinitely greater in minerals, oil and gas companies because of the scale of operations, economic

[2] Richard, Makurumidze & Tshimanga, Mufuta & Bangure, Donewell & Gombe, Notion & Fungai, Chinamasa & Takundwa, Lucia & Tapiwa, Magure. (2015). Factors Associated with Occupational Injuries at a Mine. JOURNAL OF APPLIED SCIENCES IN SOUTHERN AFRICA· JASSA. 19.

[3] Governance and State-Owned Enterprises: How Costly is Corruption? by Anja Baum, Clay Hackney, Paulo Medas, and Mouhamadou Sy

impacts and social footprint of the projects. Under the circumstances, an effective board, based on competency and a heightened sense of fiduciary responsibility, is all the more vital.

Of course, the role of the State as investors with seats on the boards of companies in extractives is not limited to SOEs. An even larger number of countries have shares through partnerships with private investors. This is largely due to laws that grant the State the right to equity in extractives projects developed in its jurisdiction. A joint AfDB /World Bank project that mapped all minerals laws in Africa and enables the reader to compare pre-selected clauses shows just how common this legal provision is in the region.[4]

As a result of the legal provisions, in case of third-party development agreements over minerals, oil and gas resources, the State's entitlement to equity is one of the most common non-negotiable conditions for licensing. For instance, in Guinea, the minimum stake by the government is 10% free carried interest but can increase to 35%, subject to specific conditions. In Ghana, the state is entitled to 10% free carried interest for oil deposits and in Botswana the law stipulates the right for the state to purchase 15%, with an option to increase or decrease the shareholding subject to negotiated terms with the investor. In Mozambique, the laws that regulate solid minerals and hydrocarbons not only vest the resources in the state but provide for state participation. Article 8 (1) of the Petroleum Law No. 3/2001 provides that *"the state reserves to itself the right to participate in petroleum operations in which any legal person is involved". (The Mozambique authorities do not stop here, however, but also insist on citizens acquiring equity).*[5]

Many governments perceive equity participation as both a vehicle for extracting greater value and an integral part of their responsibility to steward natural resource exploitation. According to former President Festus G. Mogae of the Republic Botswana, in that country "*the vesting of minerals rights in the state has therefore allowed government to equitably spread services and development across the country*[6]*. Consequently, the government's take in the parlance of trade is now 81% made up of the variable royalty, tax and dividends".*[7]

This pre-condition often also carries with it the right of the State as a shareholder to nominate representatives to the boards of operating entities. So, former President Mogae's statement is correct, though it only addresses fiscal benefits of state equity in Debswana, a 50:50 partnership between that country and De Beers Group. What is not captured in the statesman's remarks is the strategic aspects of the value of the shareholding. Botswana has been capitalizing upon this over the last 50 years through direct influence of decisions of the company's board of directors. But the leadership is fully cognizant of the fact that state equity alone is insufficient to ensure that it reaps the full benefits of the country's diamond wealth. Given the long life of such projects and the ever-changing economic and commercial environments, active involvement in the strategic decisions of the operating entities through the board of directors is therefore another important vehicle for protecting public interest. That said, I will show later in the book how effective execution of this responsibility is easier said than done.

As illustrated by the example of the countries in the preceding paragraph, most of the equity is on a free carried basis. In terms of corporate law, however, once a shareholder, there is no distinction

[4] https://www.aflsf.org/publication/african-mining-legislation-atlas-amla-brochure
[5] *Petroleum Law No. 3/2001 of the Government of Mozambique*
[6] *www.debeersgroup.com*
[7] *A Statement by His Excellency the Former President of Botswana, Mr. Festus Mogae at the African Development Bank's 2008 Eminent Speakers Programme, Tunis*

between the government and the private investor as applies to risk and challenges to the business, some of which I have discussed already. So, it is worth looking at the position of government representatives on boards of these partnerships too. The position of governments is informed by a number of factors and the most important are *percentage of equity*, *level of financial investment* and the corresponding *degree of influence* that the government can exercise through its representatives. In cases where the State is the majority shareholder, these entities are likely to be subject to the same political environment as SOEs. However, in cases where the State is a passive shareholder, with little to no financial investment in the project, the private investor typically performs a dominant role with respect to company culture, corporate governance and strategic oversight. In this case, the state's influence becomes negligible. But this does not mean the State is not exposed to risk or that its representatives should drop their guard as shareholder liabilities can still arise.

An additional important factor in partnerships is the question of which party manages the operations on a day-to-day basis. In case of a minority state interest, in which the private investor also manages the operations of the partnership, the influence of the State lessens. Industry norms and market dynamics, and not the political economy, will have a greater impact on the corporate culture and approach to governance. Corporate governance as relates to ability to raise finance, perceptions of risk, brand visibility and other sustainability challenges will likely influence corporate strategy and decisions of the board. Limiting the impacts of the political economy brings discipline to the boardroom, at least as relates to exposure to financial, reputational and environmental risk.

But the above does not address the importance of having effective State representation focused on meeting the obligations of the State's custodianship of public interest. Nor does it absolve State representatives of their fiduciary duties and the need to maximize the value of the State's equity. But it can mean that the value of a partnership (that pulling collective resources together for mutual benefit) is undermined. It also means that having secured the shareholding thanks to national laws, directors fail to leverage the position of the State because State equity is not an end in itself but rather a means to an end. One of the undesirable consequences of passive State representation is inaction that translates into an incremental opportunity cost to the country through a failure to continuously capitalize on the State's shareholding. For instance, there is nothing to stop the State from growing its stake or putting measures in place to manage the entity over time. But both are unlikely in case of passive shareholder representatives.

To be clear I am not advocating nationalizing assets as has been the case elsewhere. I am acutely aware of the pitfalls of resource nationalization and are merely illustrating a point. In the 1970s, Zambia nationalized its copper mines with disastrous results. At that time, Zambia and Chile were nearly neck on neck in terms of production, revenue and levels of employment. The economy and industry in both countries are dominated by copper mining. Today, Zambia pales into oblivion. Between 2010 and 2019, Chile was the world's largest producer while Zambia had dropped to the 7th position.[8] In Chile, mining accounts for more than 355 000 jobs and in Zambia the figure is only 80 000.[9] Studies show that the role of the Chilean State as a shareholder in mining projects, that of Chile's SOE, Codelco and corporate governance, are major contributors to the gap in performance levels between the two countries.

[8] https://www.statista.com/statistics/264626/copper-production-by-country/

[9] https://sustainablecopper.org/wp-content/uploads/2018/05/ICA-Summary-Document

3.4. Unfulfilled Public Expectations and Other Emerging Issues

Even though companies, civil society organizations and host governments embrace the principle of benefits sharing, in many countries the needs far exceed the economic and financial capacity of minerals, oil and gas projects. This is particularly true in countries where poverty and population growth rates are on the rise. Under these circumstances, disproportionate public expectations for geological resources to alone address poverty, unemployment and inequality present a challenge. These factors makes success difficult for boards trying to govern corporates responsibly by meeting the needs of multiple constituents while faced with the reality of limited resources. In the industries in question, this is a constant source of tension and preoccupies a significant part of the efforts of boards seeking to strike the right balance between the expectations of financiers, shareholders and citizens. In the next chapters I offer a view on ways to achieve this and the role that can be played by representatives of the private industry and governments as a collective voice of reason.

3.5. Negative Public Narrative

Corporate boards must also wrestle with a continuously negative public narrative. There are several reasons for this, including issues raised under item 3.3 and 3.4 above. Proximity of the projects to poor communities and increasing levels of urban unemployment that are frequently contrasted with the scale of financial costs of projects, (which is erroneously deemed indicative of financial wealth of corporates), are only a few of the main reasons. Though the belief that large projects are by definition lucrative is not always correct, the perception does add to the unusual strategic challenges that the boards of minerals, oil and gas companies must grapple with. The outcome is a need for a unique lens through which directors must view their roles and the difficult conditions under which boards increasingly must lead their companies. More serious is that the sentiments make corporate governance and the job of the board of directors of companies in these industries even tougher.

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