

GOOD GOVERNANCE GUIDELINES

for Lebanon's Oil and Gas Sector



June 2018

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Forward

What really matters is achieving a lasting, positive development outcome in Lebanon. This has eluded most oil and gas producer countries thus far. This is largely because of the resource curse, which makes it difficult for other sectors to compete with oil and gas exports. The high rent generating oil and gas activities distract policy-makers and investors— even before discoveries are made. They also create intense competition in the political space for rent capture.

Good governance can improve development outcomes. At its core, it is about rules, customs and expectations that focus policy-makers on making good decisions for the long-term prosperity of the country. The Good Governance Guidelines that follow review and challenge the rules that oversee the sector in Lebanon and, critically, serve to inform the public about policy options and set its expectations at the right level. An informed citizenry that expects good decisions is a key piece of the governance puzzle.

Valerie Marcel
Associate Fellow at Chatham House
Member of LOGI advisory board





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On behalf of the Lebanese Kubernaou Center – LKC,
Julien Courson
Managing Director

 **List of Abbreviations**

Council of Ministers: **CoM**
Exclusive Economic Zone: **EEZ**
Exploration and Production Agreement: **EPA**
Extractive Industries Transparency Initiative: **EITI**
Kuwait Investment Authority: **KIA**
Lebanese Oil and Gas Initiative: **LOGI**
Lebanese Petroleum Administration: **LPA**
Member of Parliament: **MP**
Ministry of Energy and Water: **MoEW**
Ministry of Finance: **MoF**
Multi-Stakeholder Group: **MSG**
National Oil Company: **NOC**
Natural Resource Charter: **NRC**
Natural Resource Funds: **NRF**
Offshore Petroleum Resource Law: **OPRL**
Parliament: **PL**
Petroleum Activities Regulation: **PAR**
Sovereign Wealth Funds: **SWF**
Strategic Environmental Assessment: **SEA**
Tender Protocol: **TP**
United Nations Economic and Social Commission for Asia and the Pacific:
UNESCAP



This report provides an exhaustive assessment of the governance processes and practices adopted to date in the elaboration of a framework for management of the oil and gas sector in Lebanon. It reviews progress regarding ten key areas of decision-making and foundations required for managing resources to prosperity, highlights positive practices, and suggests practical recommendations for improvement. The report covers Lebanon's activities from 2010 to 2018 in the aforementioned areas:

1. General Principles of Good Governance
2. Developing a Clear and Comprehensive National Oil and Gas Strategy
3. Establishing a Legal and Institutional Framework for Resource Management
4. Determining a Framework for the Allocation of Exploration and Production Rights
5. Obtaining Beneficial Ownership Information
6. Designing Fiscal Regimes
7. Setting up Natural Resources Funds
8. Creating and Defining the Mandate of a National Oil Company
9. Implementing Local Content
10. Paying Attention to the Environment

The following are key takeaways about sector governance in Lebanon in relation to the subjects tackled in each chapter. It identifies achievements when comparing with international best practices, as well as where there is room for improvement.



On Good Governance

Current Situation in Lebanon:

The presence of subsoil resources is not in itself a sufficient condition for achieving economic growth and sustainable development.

While a panoply of factors influences the successful development of the sector, poor governance can significantly hinder policy-making and impede economic growth and sustainable development outcomes.

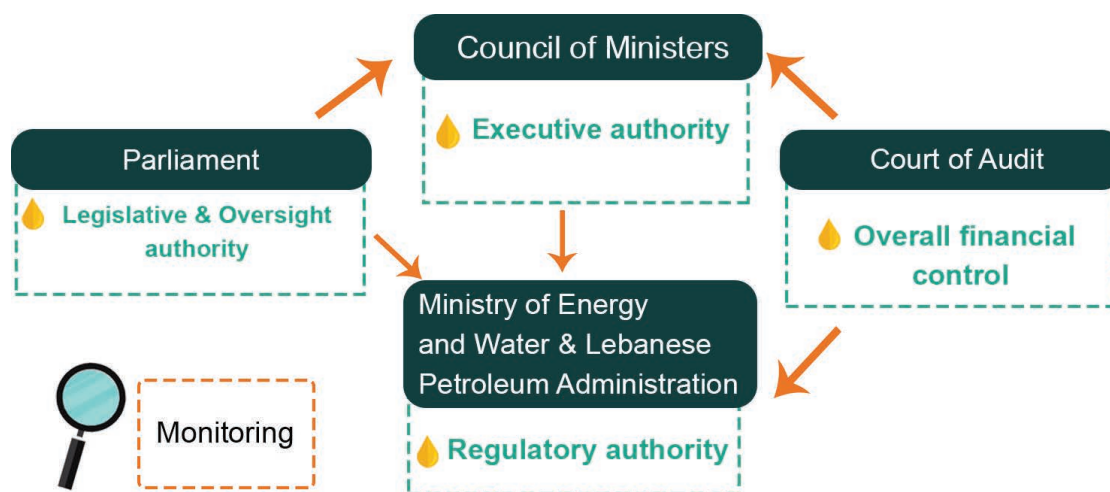
Lebanon has been consistently performing poorly on the World Governance Indicators (WGI) ranking below world average. In the last five years only, it has ranked on or below the 50th percentile on all six indicators.

The Lebanese state has made initial positive “good governance” steps by declaring its commitment to principles of good governance and transparency and its intention to join the Extractive Industry Transparency Initiative (EITI).

Recommendations:

The Lebanese government should elaborate an action plan to improve the overall quality of governance so as to reap the potential benefits of the petroleum sector and move towards economic growth and development.

Civil society should advocate for Lebanon’s full accession to the EITI through the formation of a Multi-Stakeholder Group (MSG) that would be fully engaged in EITI implementation.



On the Importance of an Inclusive and Comprehensive Oil and Gas Strategy for Lebanon

Current Situation in Lebanon:

The Lebanese government has developed components of a sector strategy. For example, it has overseen the elaboration of a sound institutional and legal framework and conducted seismic surveys to identify prospects. However, Lebanon's maritime borders remain contested, which represent a potential loss of significant revenue and benefits in addition to political and security instability.

However, there is no official and comprehensive strategy outlining how the Lebanese state intends to develop the oil and gas sector in Lebanon.

While legitimately trying to promote the potential benefits of future oil and gas revenue for Lebanon, officials have failed to manage public expectations from the sector by overestimating benefits at a time when commercial discoveries have not yet been made.

If public expectations are not reigned in, Lebanon may not eschew the "Presource Curse."

Four draft laws were submitted to parliament in November 2017 for the establishing of a national oil company, a sovereign wealth fund, and a directorate of petroleum assets, and for regulation of onshore oil and gas exploration causing controversy

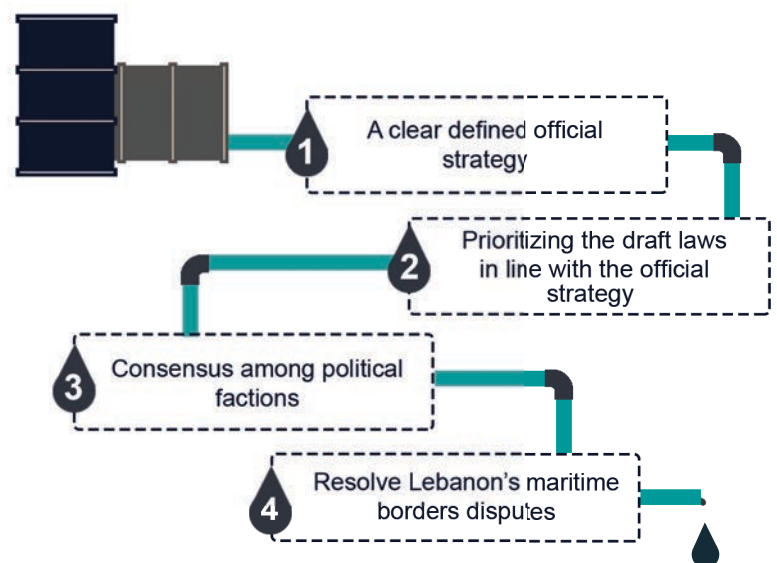
Recommendations:

The Council of Ministers (COM) should elaborate and publish a comprehensive and inclusive national strategy for oil and gas sector governance that is inclusive to ensure buy-in from all stakeholders, civil society included.

Lebanese officials need to align popular expectations with resource-related policy-making and developments to avoid any Presource Curse scenario.

The Lebanese parliament should prioritize the proposed draft laws in line with a national petroleum strategy.

The Lebanese government should pursue third-party mediation to settle maritime disputes.



Legal and Institutional Framework

Current Situation in Lebanon:

The legal framework for natural resource governance is comprised of a set of instruments that include the constitution, legislation, regulations, and contracts.

The Lebanese parliament and the COM have established the legal foundations for the oil and gas sector.

Institutional decision-making for Lebanon's resource governance is built mainly around three governmental entities: the COM (Policy Making/Executive Authority), the Ministry of Energy and Water-MoEW (Regulatory Authority), and the Lebanese Petroleum Administration-LPA (Regulatory Authority/Consultative). The Lebanese parliament also plays legislative and oversight roles.

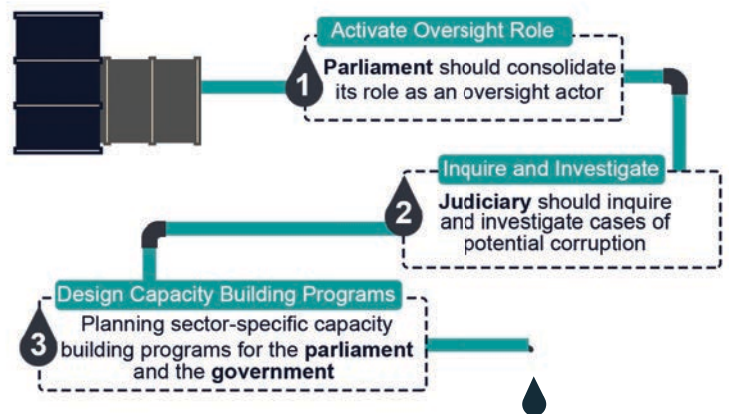
In Lebanon, the sector-specific legal architecture and institutional framework reflect good governance traits. However, within a wider context, these become the victims of rule of law challenges. The First Offshore Licensing Round 3 years delay and the passiveness of the judiciary about allegations of corruption are examples of this vulnerability.

Recommendations:

The parliament should consolidate its role as an oversight actor as per the mandate conferred to it by its bylaws.

The judiciary should inquire and investigate cases of potential corruption.

With the election of a new parliament, and the upcoming formation of a new government, sector-specific capacity building programs for the parliament and the government ought to be undertaken.



On Allocation of Exploration and Production Rights

Current Situation in Lebanon:

International best practices favor competitive bidding, which reflects principles of fair competition, transparency, openness, value maximization and equal treatment of investors.

The Lebanese state adopted a competitive bidding process in prequalification, bidding evaluation and awarding.

The allocation of rights process was stipulated by the Offshore Petroleum Resources Law, assisted by a sequence of ministerial decrees, including Petroleum Activities Regulations, Tender Protocol, and Exploration and Production Agreement.

In practice, there was one single source offer for blocks 4 & 9 that were benchmarked to similar scenario. On December 14, 2017, the CoM approved the awards of two petroleum licenses for exploration and production in blocks 4 and 9 for the consortium made up of Total S.A, Eni International BV and JSC Novatek.

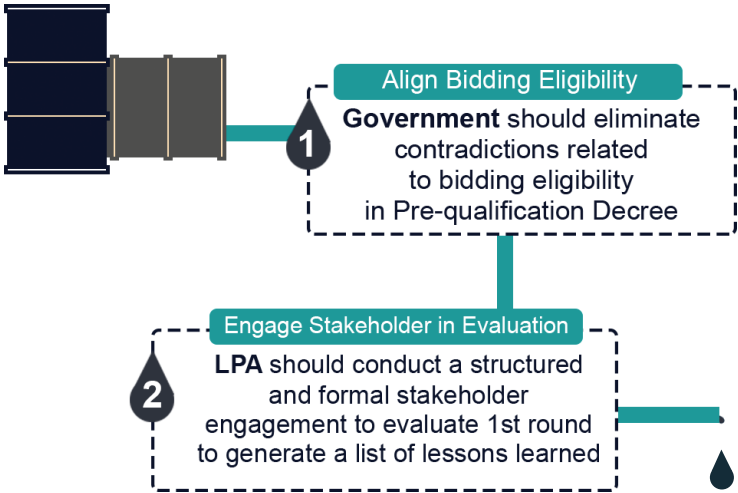
The most dubious element of the pre-qualification decree is article 3.3 that allows for at least one company within a group to prove that it is able to meet the eligibility criteria set forth by the decree. This provision contradicts article 7.4 of the same decree that prevents qualification of any application that doesn't meet the eligibility criteria.

Recommendations:

The Lebanese government needs to evaluate, through a consultative process, the process through which rights are allocated to ensure that Lebanon reaps the benefits of competitive bidding.

The government needs to re-evaluate the pre-qualification decree and assess the relevance and implications of article 3.3.

Before launching the second licensing round, the LPA should conduct a structured and formal stakeholder engagement to evaluate feedback from the first round.



Beneficial Ownership

Current Situation in Lebanon:

Annex 1 of the Pre-Qualification Application Form pertaining to the Prequalification Decree requires any company wishing to submit an application to the LPA for assessment of its eligibility to participate in the bidding round to declare the identity of any shareholder who holds above 20% of the total company's shares. It is the only legal provision that tackles a partial aspect of beneficial ownership at this stage.

A petroleum register draft decree tackling beneficial ownership is underway and will supposedly complement the draft law on "Strengthening Transparency in the Oil and Gas Sector".

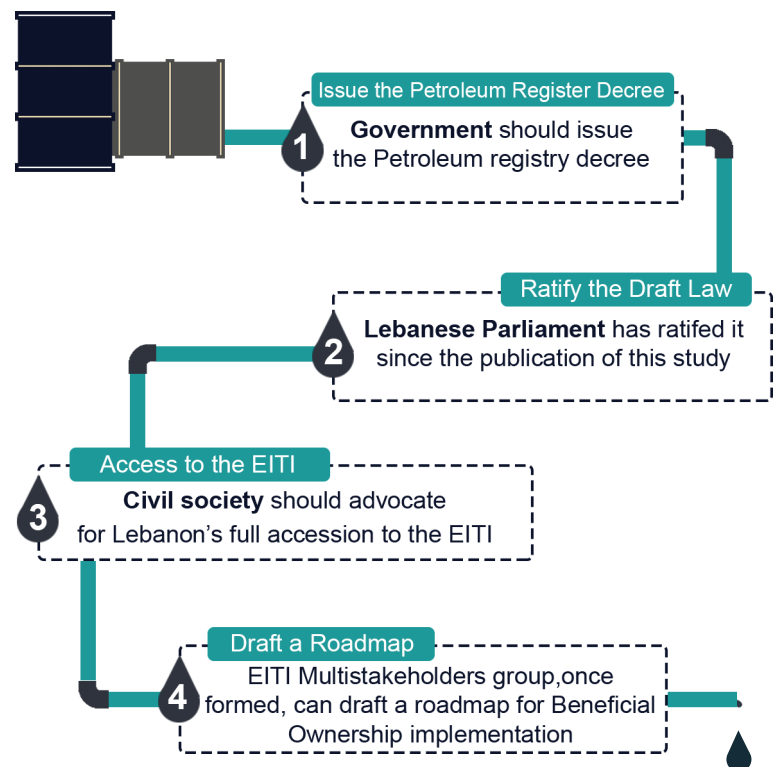
Lebanon's intention to join EITI is an opportunity to put into practice a roadmap for the realization of beneficial ownership.

Recommendations:

The Lebanese government should issue the Petroleum register decree as soon as possible.

The EITI's MSG, once established, should consider drafting a roadmap for the enforcement of beneficial ownership.

The Lebanese parliament should ratify the "Strengthening Transparency in the Oil and Gas Sector" draft law, which will contribute to increasing the transparency of the sector.



Fiscal Regime

Current Situation in Lebanon:

Lebanon's fiscal regime includes royalties, cost recovery, and production sharing between government and extractive company, plus income tax on the company's share.

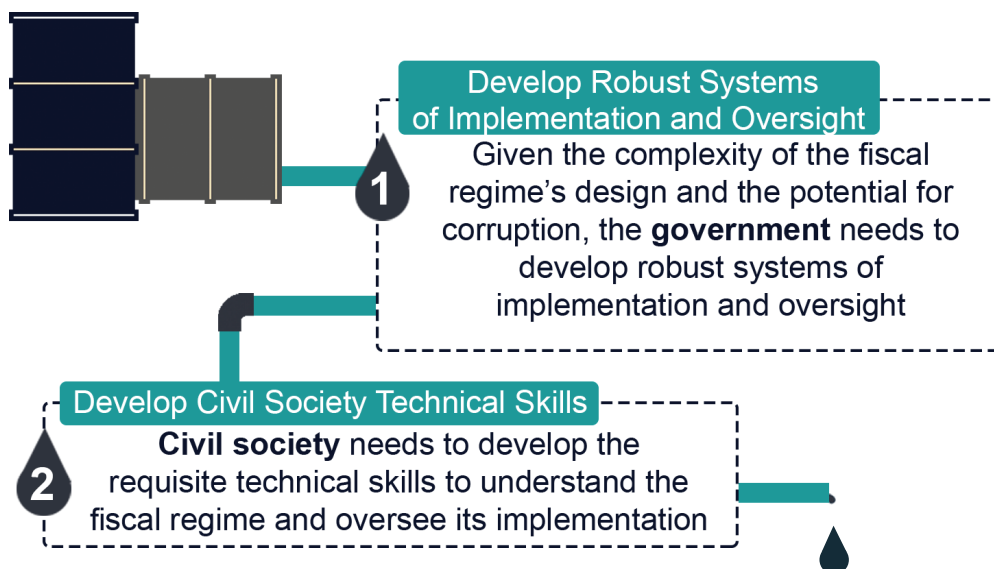
With a combination of fiscal tools, one refers to, not one fiscal regime, but a fiscal arrangement composed of a wide array of fiscal instruments, similarly to many countries worldwide.

The fiscal regime in Lebanon was designed to allow the state to minimize its share of risks and costs and maximize its share of revenues, while simultaneously appearing attractive for extractive companies, and adjusting for changes in the market.

Recommendations:

Given the complexity of the fiscal regime's design and the potential for leakages, the Lebanese government needs to develop robust systems of implementation and oversight.

Civil society needs to develop the requisite technical skills to understand the fiscal regime and oversee its functioning.



Natural Resource Funds

Current Situation in Lebanon:

Good governance of NRFs requires a clear policy objective, appropriate fiscal rules, adequate clear investment constraints, an effective institutional structure; strong independent oversight bodies; and high degrees of transparency.

Currently, the Lebanese government has two sources of revenue from the sector: (1) the application fees paid by companies to participate in the first offshore licensing round; and (2) the sales of seismic data to interested companies. Those revenues are deposited in a Central Bank account under the authority of Minister of Energy and Water, and the Director of Tripoli and Zahrani Facilities.

In November 2017, MPs Yassine Jaber and Anouar El Khalil submitted a draft law to the parliament for the establishment of a Sovereign Wealth Fund in Lebanon (LSWF). The draft law took a fast route legislative track after the creation of a joint parliamentary committee to discuss and review the law.

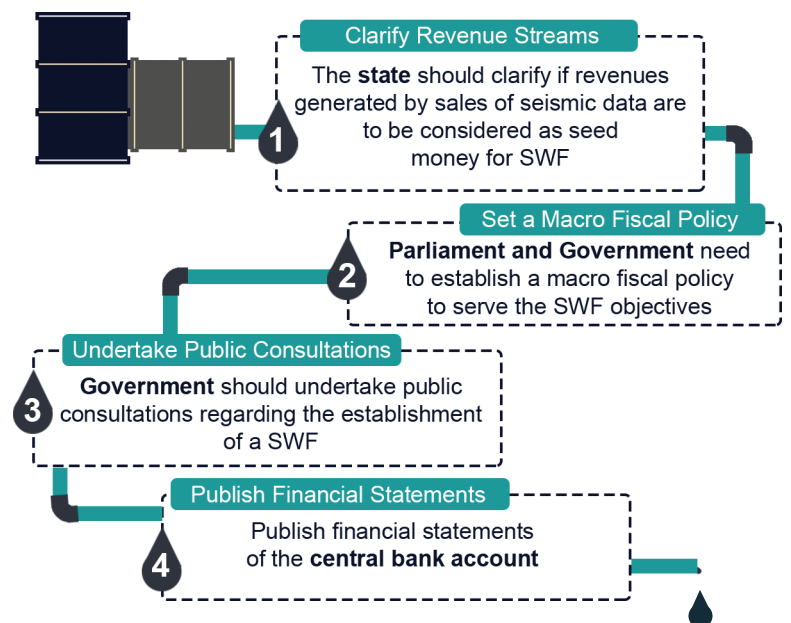
Recommendations:

The government needs to elaborate a macro fiscal strategy and a national development plan to serve as the basis for SWF objectives in the draft law.

The government should seek to undertake public consultations and stakeholder engagement for the establishment of a SWF, and should carefully account for loopholes that may instigate a “Presource Curse” scenario.

The Lebanese state should classify the revenue streams already generated from application fees and seismic data sales and clarify if those revenues should be considered as a seed money for the SWF.

Financial statements pertaining to those revenue streams should be published on annual basis.



National Oil Companies

Current Situation in Lebanon:

Article 6 of OPRL states that only when necessary and after commercial opportunities have been verified can the COM establish a national oil company. However, a draft law to establish a NOC has already been submitted by parliament members.

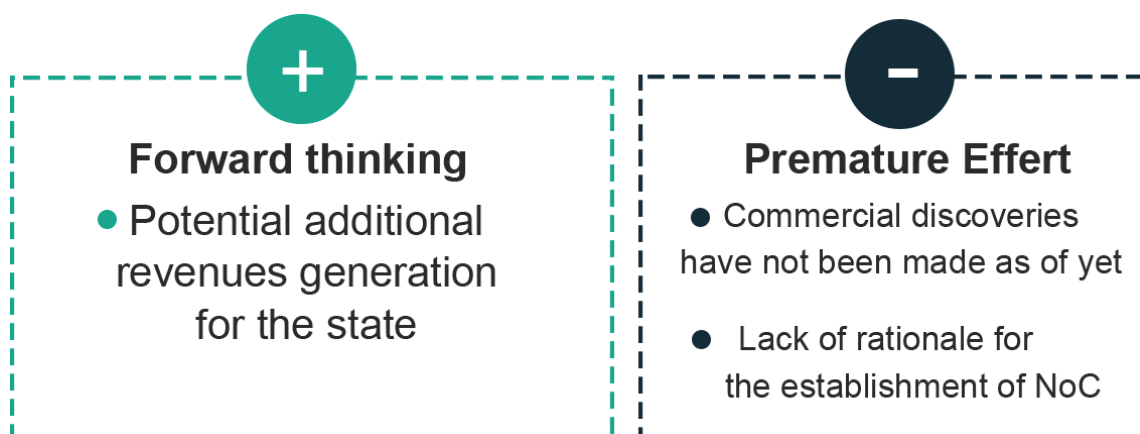
On November 2017, MPs Michel Moussa and Ali Osseiran submitted a draft law for the establishment of a Lebanese NOC. The draft law on NOC took an unorthodox fast-track process after the creation of a joint parliamentary committee to discuss and review the law.

By effect of article 6 of the OPRL, any discussion around an NOC is premature as long as commercial discoveries have not been made.

This move is difficult to assess without a published background paper justifying the rationale of the draft law and the basis on which the suggested model was adopted.

Recommendations:

The Lebanese Parliament should ensure stakeholder engagement in the establishment of a NOC, and similarly to the SWF draft law, it should carefully account for elements that may lead to a “Presource Curse” scenario.



Current Situation in Lebanon:

The Lebanese Offshore Petroleum Resource Law and the Petroleum Activities Regulations contain provisions that safeguard local content interests by giving preferential treatment standards regarding quality, price and performance.

The Exploration and Production Agreement (EPA) sets an 80% quota of Lebanese employees on the right holders.

The EPA includes a clause that binds the operator to select Lebanese entities for procurement of products, even if the local prices exceed the international prices by a 5 percent margin for goods or 10 percent margin for services.

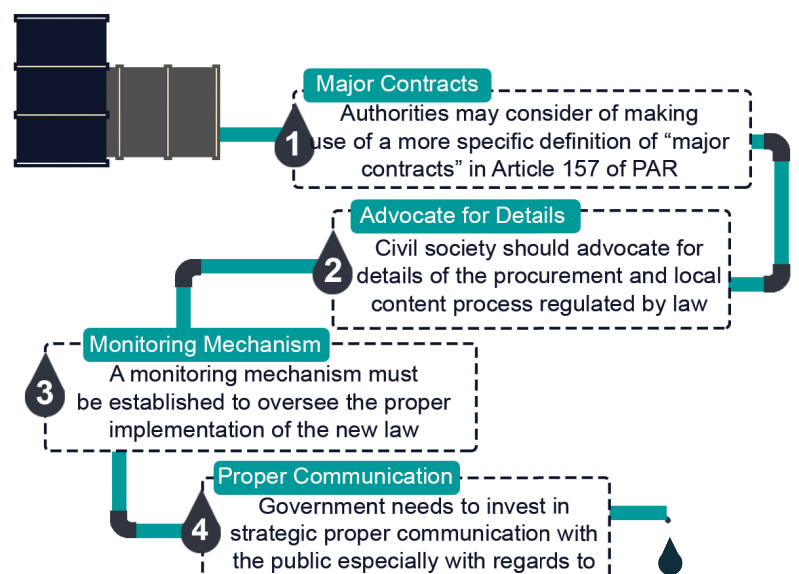
As per the EPA, companies are supposed to assign a budget to train public sector personnel of at minimum \$300,000 per year with a 5% increase mandates each year until the beginning of production phase.

Recommendations:

Lebanese authorities should mitigate vagueness around “major contracts” by making use of a more specific definition of “major contracts” in Article 157 of PAR, such as by using threshold values, which specify a value above which contracts should be subject to public tender.

Civil society should advocate for details of the procurement and local content process regulated by law, and that a monitoring mechanism be established to oversee the proper implementation of the new law.

The Lebanese government needs to invest efforts in strategic communication with the public and in managing people’s expectations especially about job opportunities.



Current Situation in Lebanon:

International best practices in the industry, recommend developing a “Strategic Environmental Assessment (SEA)” in relation to oil and gas activities.

A SEA provides the government with a methodical process for evaluating the overall benefits and costs of petroleum exploration and production activities.

Article 7.2 of the OPRL explicitly recognizes the importance of carrying a SEA.

In 2014 the Lebanese government published the 2012 SEA version report that fell short from being an effective tool for risk mitigation, mainly due to lack of information.

Within the process of updating the SEA, as stipulated by Legislation on Environmental Protection, a series of consultation workshops are being organized by the Lebanese Petroleum Administration for the SEA Study Update for the oil and gas sector in offshore Lebanon.

Recommendations:

The government and the LPA need to be more proactive in trying to account for environmental risk mitigation, especially given the lack of health and safety legislation in the oil and gas sector, the need for a more comprehensive national contingency plan, the issue of data deficit, and the need for an effective infrastructure for waste management infrastructure.



Executive summary

As Lebanon delves into the exploration phase of its offshore oil and gas sector, it is critical that both policymakers and the public be cognizant of the governance needs and imperatives of the sector, especially given the benefits Lebanon could reap from the sector. Given the significant progress made in the last couple of years on the development of the sector- including the signature of the first offshore oil and gas exploration agreements -the need to institutionalize good governance is more pressing than ever. In fact, international experiences clearly illustrate the positive correlation between good governance and deriving large growth and development dividends.

In practice, it has been proven that the existence of subsoil resources is not in itself a sufficient condition for achieving economic gains and sustainable development. In fact, for the development of the sector to yield positive results, the quality of governance needs to improve. Although Lebanon's government has, in principle, declared its commitment to the principles of good governance and transparency and made public its intention to join the Extractive Industry Transparency Initiative (EITI)--a standard by which oil and gas information is published--, 2017 World Bank World Governance indicators show that the country needs to drastically improve the overall quality of governance.

Perhaps the most visible discrepancy is the absence of an inclusive, consensus-driven oil and gas national strategy setting the government's policy for the development of the oil and gas sector and integrating it within the country's overall economic vision. The formulation of a national petroleum strategy ought to be guided, first and foremost, by the principle of inclusion, comprehensiveness, attention to the long term, and an account for sector uncertainty, as the development of an oil and gas sector is rather a lengthy process that extends through decades and rotations of government. Therefore, it is important that decisions about the governance of this sector can sustain changes in government and that policy-making be coherent and built on long-standing consensus.

While expectations from this nascent sector have significantly risen, government officials have failed to align the political discourse with expectations. Indeed, heightened expectations are tied to an uncertain reality about the commercial viability of the underground prospects.



That said, elements of a strategy can be derived from existing legal instruments governing the sector, especially the Offshore Petroleum Resource Law (OPRL), and the application decrees of this law represented in the Petroleum Activities Regulations (PAR). These legal instruments together with the Lebanese Constitution, the Tender Protocol (TP) decree and the Exploration and Production Agreement (EPA) translate to a coherent legal framework, involving the Council of Ministers (CoM), Parliament, Ministry of Energy and Water (MoEW), and Lebanese Petroleum Administration (LPA). Regardless, real implementation challenges endure especially where parliamentary oversight and judiciary investigation and accountability are concerned. Moreover, the law-making process at parliament level remains ambiguous. Despite the imperative for Parliament to pass an overarching law that strengthens transparency in the oil and gas sector, the National Oil Company and Sovereign Wealth Fund draft laws have taken precedence. This reflects confusion as to what is needed to run the sector efficiently and transparently.

On another note, the conceptualization of allocation of rights in the oil and gas sector mirrors international best practice. Nonetheless, the LPA may benefit from a structured and formal stakeholder engagement to evaluate the first offshore licensing round before launching the second licensing round. Initially, Lebanon was expected to reap the benefits of a competitive bidding process for rights allocation, however, the rights were allocated by the CoM based on a benchmarking exercise done by the LPA given that there was a single source offer per block.

A particular attention however needs to be given to the prequalification decree, more specifically to article 3.3 which allows companies that don't match the qualification criteria to participate to the bid should they partner with eligible companies.

As for the fiscal regime, Lebanon's legal framework embodies its core features. While there are distinct and internationally recognized types of fiscal regimes, Lebanon has opted for a hybrid version, borrowing elements from both concessionary and production sharing regimes. This is believed to allow the state to minimize its share of risks and costs and maximize its share of revenue, while simultaneously adjusting for changes in the market and appearing attractive to extractive companies. However, the complexity of the design requires robust systems of implementation and oversight that are attuned to the Lebanese context.

Another issue that requires attention from the government is the question of beneficial ownership. Since Lebanon is dealing with international companies and encouraging Lebanese companies to participate as subcontractors on the basis of local content requirements, it is important that the state and the public be aware of who controls the management and the profit of any company participating in the sector (whether right-holder or subcontractor).



A draft decree on the Petroleum Register tackling beneficial ownership is currently under preparation, together with the draft law on “Strengthening Transparency in the Oil and Gas Sector” in Lebanon that includes provisions in the same vein. In addition, Lebanon’s declared intention to join EITI represents several opportunities, one of which is to put into practice a roadmap for the realization of beneficial ownership within the oil and gas sector in Lebanon.

The Offshore Petroleum Resources Law (OPRL) stipulates that revenues from the sector are to be placed in a sovereign wealth fund—one that could be established by a draft law submitted by parliamentarians Yassine Jaber and Anouar El Khalil in November 2017. The uncertainties regarding the country’s macro fiscal strategy and the absence of a national development plan reinforces the need for inclusive law-making that engages stakeholders, including the public—and this applies to determining a sovereign wealth fund’s objectives’ and the best way to implement them. Currently, the Lebanese government has only two sources of revenue from the sector: (1) application fees paid by companies to participate in the first offshore licensing round; and (2) the sale of seismic data to interested companies. These revenues are deposited in a Central Bank account under the authority of Minister of Energy and Water and the Director of Tripoli and Zahrani Facilities. However, it is unclear whether these revenue streams are considered to have been generated from oil and gas exploitation and therefore should constitute seed money for a sovereign wealth fund.

Furthermore, financial statements reflecting application fees and sale of seismic data need to be published on annual basis in the interest of good governance and transparency.

The establishment of a national oil company (NOC) presents similar legal ambiguities. Article 6 of OPRL states that “When necessary and after promising commercial opportunities have been verified, the Council of Ministers may establish a national oil company.” However, a draft law for the establishment of a NOC, organizing the corporate governance of a future NOC, was rather hastily submitted by parliament members well before the striking of any commercial discovery. Although the purpose of the law is not necessarily to establish a national oil company immediately, here again, consultations and well-thought out legal assessment are needed.

1. The “value that an extraction project brings to the local economy beyond the resource revenues” (Natural Resource Governance Institute, 2015)

2. The Strategic Environmental Assessment, commonly known as SEA, is an evaluation of the likely environmental and social impact of introducing and developing oil and gas activities. The SEA process also allows governments to recognize environmental restraints, potential effects, cultivate adequate solutions, and enables accurate communication of information to stakeholders. (Lebanese Oil and Gas Initiative, 2017)



Furthermore, the Offshore Petroleum Resources Law (OPRL), the Petroleum Activities Regulations (PAR), and the Exploration and Production Agreement (EPA) contain provisions that safeguard local content interests by providing preferential treatment standards regarding quality, price, performance and a mandatory quota of Lebanese Labor. It is especially important to manage the expectations of the Lebanese public about future employment opportunities in the sector. Lebanese authorities are advised to legally flesh out the process of procurement and local content and instill adequate powers for monitoring and implementation in an effort to counter the vagueness around the definition of “major contracts” in Article 157 of PAR by relying on threshold values for example, which sets a value above which contracts should be subject to public tender.

Bearing in mind the high environmental risks and concerns associated with oil and gas development activities, and taking into account the framework for updating the Strategic Environmental Assessment-SEA, the government and the LPA need to be more proactive in accounting for environmental risk mitigation, especially with regards to the absence of health and safety legislation in the oil and gas sector, the need for a more comprehensive national contingency plan on oil spill, the issue of lack of data and information, and the need for an effective infrastructure for waste management .

Finally, while recognizing the efforts made to instill good governance practices in the development of the oil and gas sector in Lebanon, some measures should be taken into consideration should the Lebanese state want to better consolidate best practices in the sector as highlighted in the different paragraphs above. In fact, Lebanon has an important opportunity with its new parliament, and government to be formed in 2018 to rectify the gaps and risks that remain unaddressed. LOGI hopes that this report provides a balanced review of the good practices already adopted and the areas for improvements in Lebanon’s nascent oil and gas sector with the hope its recommendations are highly considered by the decision makers, and supported by influencers and citizens alike.





Methodology

This report presents itself as a general, user-friendly tool that explains the systems and processes essential for the development of good governance natural resource frameworks. The report touches upon as many aspects of resource governance as may be relevant to Lebanon, whilst assessing the sector's progress on the basis of international standards and best practices. The report seeks to go beyond the identification of best practices and interpret the application of these practices in the Lebanese context, providing constructive recommendations where necessary.

The report relies on primary and secondary data collected through desk research and interviews with MPs Anwar Al Khalil, Joseph Maalouf, Mohamed Kabbani, and Nabil DeFreige, the Lebanese Petroleum Administration (LPA) officials; Mr. Walid Nasr, Mr. Assem Abou Ibrahim, and Me. Gaby Daaboul, as well as a focus group attended by members of the Lebanese Coalition for Good Governance in Extractive Industries, a network of 13 NGOs formed in March 2018 to promote transparent management of the sector.

A literature review of existing resources on good governance practices along the oil and gas decision chain—which illustrates the process of converting resources into development—was derived from diverse references, including the Natural Resource Charter (NRC) (second edition, 2014), the Resource Governance Index (RGI) 2017, the Chatham House Guidelines for Good Governance in Emerging Oil and Gas Producers 2016, and World Bank Extractive Industries Source Book. Every chapter in the report examines one aspect of sector governance, mirroring the NRC decision chain. This handbook also seeks to build upon reports published by Lebanese Oil and Gas Institute (LOGI) on sector transparency. However, it neither includes an in-depth review of the environmental impact of oil and gas exploitation, nor one of the transparency in the sector, given that LOGI has already published reports on those very issues.

At the end of each chapter, a table summarizes the main takeaways on Lebanon's current situation and highlights achievements on the basis of international best practices, while simultaneously identifying room for improvement.



Chapter 1

Natural Resources and Economic Growth



Chapter 1

Natural Resources and Economic Growth

Lebanon could be sitting on potential hydrocarbon reserves, that may or may not be commercially viable (The Economist, 2013). In the current context, Lebanese citizens' perceptions of the nascent oil and gas sector seem to teeter between hope and skepticism, and even apathy, much of it stemming from the mistrust in the government's ability to manage future resource revenues.

Despite an existing wealth of knowledge about natural resources management, which Lebanese policymakers can draw upon, the challenge of establishing and managing this sector is daunting not only because of the high risk of failure, but also because of the lengthy timeline associated with the exploitation of these resources. The mere discovery of oil and gas does not translate into resource wealth, or economic growth and development. Moreover, the experience of resource rich economies¹ indicates that their growth, when it happens, has been considerably slower than resource poor ones (Gylfason & Zoega, Natural Resources and Economic Growth: The Role of Investment.)

Studies have furthermore debunked the nexus between resource wealth and economic development, providing evidence against the notion that resource wealth leads necessarily to economic development. Indeed, one of the biggest frustrations of international economic development is the “resource curse” (Natural Resource Governance Institute, 2015,) or “paradox of plenty” whereby abundance of resource wealth actually manifests itself as poor development outcomes—poverty, inequality and misery—and less democracy in countries with significant resource wealth. As demonstrated by Gylfason and Zoega in table 1.1 below, countries with the largest shares in resources often produce the smallest economic growth.

1. The International Monetary Fund (IMF) considers a country rich in hydrocarbons and/or mineral resources if it meets either of the following criteria: (i) an average share of hydrocarbon and/or mineral fiscal revenues in total fiscal revenue of at least 25 percent during the period 2000-2005 or (ii) an average share of hydrocarbon and/or mineral export proceeds in total export proceeds of at least 25 percent.



Natural Resource Dependence and Economic Growth							
	Growth of GNP per Capita per Year 1965 -1998, Adjusted for Initial Income (%)						
Share of Natural Capital in National Wealth (%)	$\leq -3\%$	$-3\% < x \leq -2\%$	$-2\% < x \leq -1\%$	$-1\% < x \leq 0\%$	$0\% < x \leq 1\%$	$1\% < x \leq 2\%$	$3\% <$
$x \leq 5\%$	Jordan	El Salvador South Africa	Guatemala Morocco		Austria Belgium Denmark Egypt France Greece Italy Portugal Spain	Japan Mauritius	Korea
$5\% < x \leq 10\%$	Benin Ghana Haiti	Honduras Jamaica Kenya Peru Zimbabwe	Argentina Costa Rica Panama Philippines	Columbia Dominican Chile Brazil Rep. Mexico Pakistan Sri Lanka Sweden Trinidad Tobago Tunisia	Norway Ireland Finland	Malaysia Thailand	Botswana China
$10\% < x \leq 15\%$	Nicaragua Malawi Mozambique	Congo The Gambia	Bangladesh Namibia Uruguay	Australia Paraguay	Canada	Indonesia	
$15\% < x \leq 20\%$	Cote d'Ivoire Senegal Togo Venezuela	Burkina Faso Burundi Nepal Papua New Guinea	Ecuador New Zealand	India			
$20\% < x \leq 25\%$	Mauritania Rwanda	Cameron					
$25\% < x \leq 30\%$	Sierra Leone						

Table 1.1 Natural Resource Dependence and Economic Growth

As an example, natural resources make up around 30% of Sierra Leone's national wealth, and yet between 1965 and 1998, the country suffered from an overall negative national per capita economic growth (-3%). Similarly, Sweden's natural resources comprises between 5% and 10% of its national wealth, but its average national economic growth is negative.



On the other hand, positive experiences of some resource-rich countries, including Norway, Botswana, and Chile indicate that, even though unique challenges abound in natural resource management, governments are able to make policy decisions that help avoid some of the negative effects of resource management and harness resource wealth for growth, development and political stability.

Why Governance Matters?

Clearly, the existence of sub-soil resources is not in itself a sufficient condition for achieving economic growth and sustainable development. A transformational process needs to take place, and countries bestowed with natural resources face the challenge of “getting it right” every step along the way. Why is it then that some countries are able to benefit from these resources and reach their full potential while others are not?

Daniel Kaufmann, president of the Natural Resource Governance Institute (NRGI) and former director of global programs at the World Bank Institute, stresses on the importance of governance in harnessing natural resources:

The extraction of oil, gas and minerals is one of the most politically, socially and economically complex undertakings in development ... It has contributed to one of the most fundamental challenges in human history— climate change. It has produced trillions of dollars in revenues. These vast sums of money contrast cruelly with the poverty of many countries where resources are found— .8 billion people live in poverty in the scores of countries assessed in this index. The empirical evidence is clear: changing this dire situation requires improving governance— the institutions, rules and practices that determine how company executives and government officials make decisions and engage and affect citizens, communities and the environments they inhabit.”
(Natural Resource Governance Institute, 2017).

Evidently, for countries who wish to raise the prospects of success in transforming natural resources into economic growth and sustainable development and avoid the “resource curse,” attention to the quality of governance is of the utmost importance. On that note, the “Extractive Industries Source Book” explains that with “important indicators of good governance, once they are in place in a country [improve] the chances... or achieving the desired outcomes: poverty reduction, a more equitable distribution of benefits, better protection of rights, greater retention of value, protection of the environment, and a strong economy. With bad governance, such improvements are highly unlikely” (Cameron & Stanley, 2017.)

Simply put, it would appear that a country’s inability to benefit from this potential “blessing” is a direct factor of the quality of its governance.

The Characteristics of Good Governance

The term “governance” broadly refers to “the process of decision-making and the process by which decisions are implemented” (Sheng, 2009.) This definition incorporates: the actors responsible for making the decisions, the process they follow, the decisions taken, and their effective implementation.

To talk about good governance means to subject these components to a quality assessment. A great deal of efforts has been put into defining and understanding good governance, although most seem to have some characteristics in common as elaborated by the United Nations Economic and Social Commission for Asia and the Pacific (UNESCAP, 2018) and summarized in Box 1.1:

1. Participation of stakeholders: can be direct or intermediate, has to be organized and informed, and requires freedom of association and expression and a vibrant civil society.
2. Rule of law: Good Governance requires a fair legal framework that is enforced impartially, and that yields full protection of human rights. This is only possible with the existence of an independent judiciary and an impartial upright police force.
3. Transparency: means that information is freely and easily available and accessible to those who will be affected by decisions. And that these decisions follow the existing rules and regulations.
4. Responsiveness: Good Governance requires that the institutions and processes available are able to serve stakeholders in an efficient and timely manner.
5. Consensus oriented: indicates that good governance should seek to mediate among different interest in society towards a broad long-term consensus on the best interest of the community. This requires a deep understanding of the historical, cultural, and social contexts.
6. Equity and inclusiveness: depends on all members feeling concerned rather than excluded from society, and that is mainly achieved through fostering opportunities to improve their wellbeing.
7. Effectiveness and efficiency: require and institutional and structural framework capable of generating results that meet the needs of society through an efficient use of resources.
8. Accountability: is a cornerstone for good governance. It cannot be enforced without transparency and the rule of law, and should address all actors in society from governmental institutions to the private sector, and civil society.

Box 1.1 Good Governance Characteristics



When it comes to good governance, there is no one size fits all. The model and quality of governance will depend fundamentally on the local context of a country, specifically on the institutional structures and mechanisms for oversight already in existence. Governance should also account for the particularities of the different sectors of the economy and the specific modus operandi by which they are guided. Consequently, the particularities of the extractive industry render the goal of achieving good quality of governance in the oil and gas sector even more challenging.

The natural resources sector governance refers to the system for making and implementing decisions concerning the exploitation of a nation’s oil and gas resources. the structural and hierarchical organization of the sector, its decision-making and communication processes, the policies and objectives governing its activities and the regulation of those activities(Glada Lahn, Marcel, Mitchell, Myers, & Stevens, 2007.)

Accumulated experience in oil and gas sector governance reveals a collection of guiding principles and best practices for taking advantage of opportunities in the sector to improve development; these have been formalized and organized under the Natural Resource Charter (NRC,) illustrated in Figure 1.1. The charter is organized as precepts along a decision chain that would enable the transformation of subsoil resources into sustainable development, in addition to a set of good governance practices along the chain (Natural Resource Governance Institute,2014).

The Natural Resource Charter Decision Chain

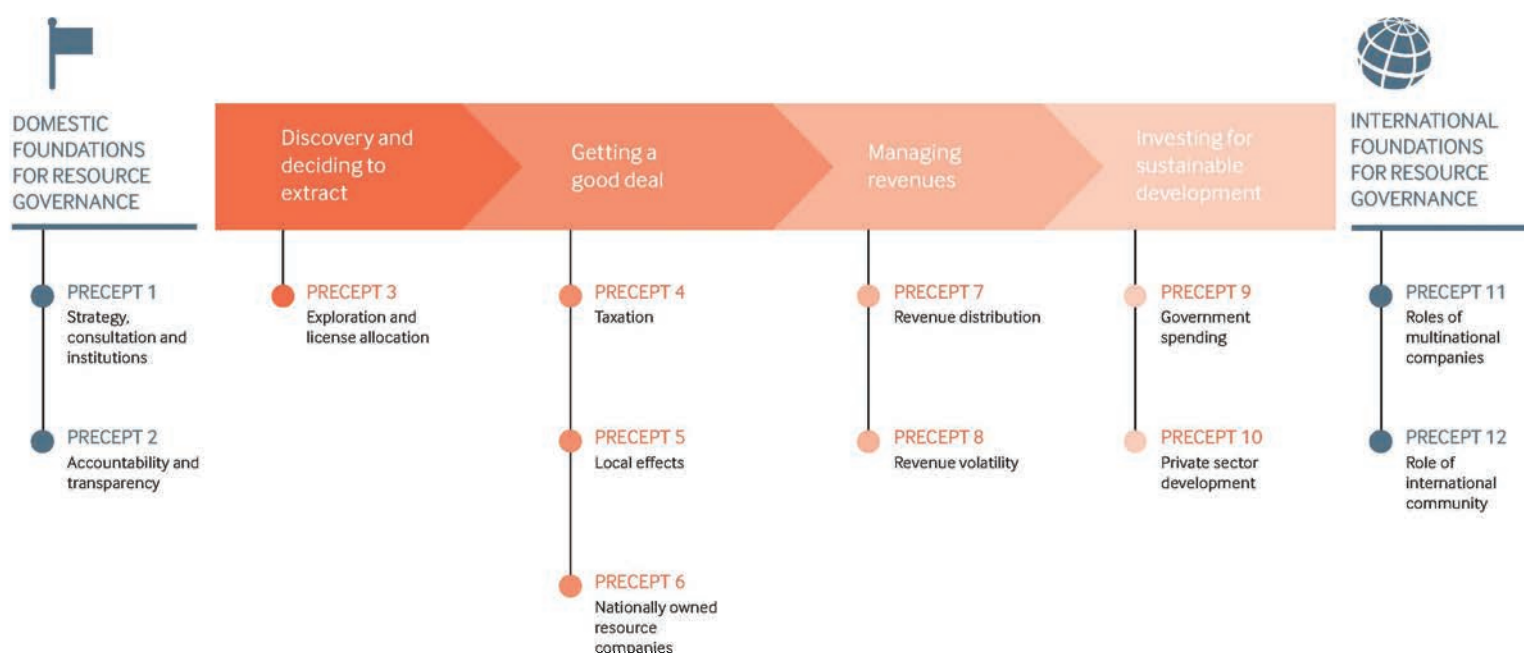


Figure 1.1 Natural Resource Charter Decision Chain

The stages of this decision chain begin with the decision to extract (or not to extract) and tackle such questions as how to allocate rights of exploration and production, how to generate revenues and additional benefits, and how to manage the generated revenues from the sector. The decision chain is most helpful when viewed as a coherent and interdependent framework, rather than a set of stand-alone decisions. Since every step in the chain builds on what has been done before it, one poor decision limits the impact and efficiency of what comes after it. For instance, a country would not be able to invest its resource revenue at full potential, if it did not take necessary measures to instill efficient mechanisms for revenue management beforehand, or if it did not properly allocate rights for exploration and production.

Good Governance in Lebanon

Kaufmann stresses the importance of governance and anticorruption policies in general. In an interview, Kaufmann points to research that proves that countries can derive a very large development dividend if they were to improve their overall governance standards (Center for International Private Enterprise, 2008.) He explains how a mild improvement in governance can, in the long term, increase a country's income per capita threefold, and reduce infant mortality and illiteracy.

Lebanon belongs to this new generation of countries that wish to develop their natural resources potential and can benefit from the knowledge available to establish a profitable oil and gas sector. However, the sector does not exist in a vacuum. To what extent does the country provide an enabling environment for the sound development of the sector? How can Lebanon's governance track record so far influence future resource management prospects?

As Kaufmann states, "governance is not the only thing that matters for development (...). But when governance is poor, policymaking in other areas is also compromised" (Center for International Private Enterprise, 2008.)

To help governments improve their governance performance, the World Bank put forward the Worldwide Governance Indicators (WGI) as part of a long-standing research project to develop cross-country indicators of governance. This project condenses the characteristics of governance in three main areas and relies on two indicators for each as presented in Box 1.2:



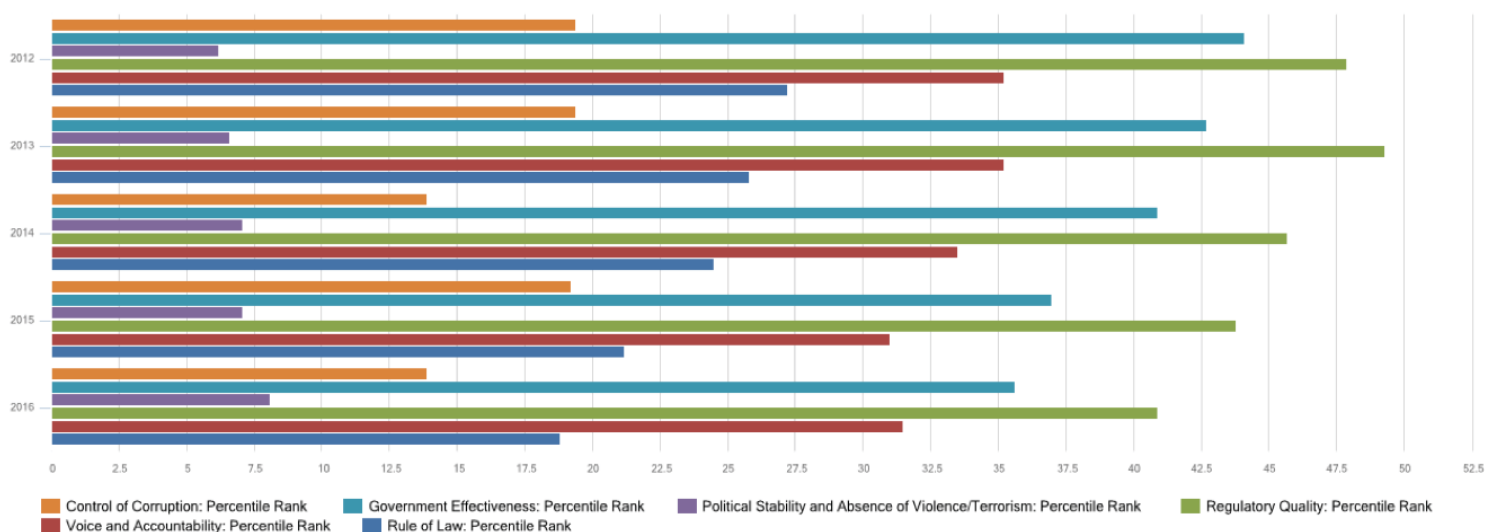
- 1) The process by which governments are selected, monitored, and replaced:
 - Voice and Accountability
 - Political Stability and Absence of Violence/Terrorism

- 2) The capacity of the government to effectively formulate and implement sound policies:
 - Government Effectiveness
 - Regulatory Quality

- 3) The respect of citizens and the state for the institutions that govern economic and social interactions among them
 - Rule of Law
 - Control of Corruption

Box 1.2 World Governance Indicators (WGI)

Lebanon faces governance challenges in almost every sector of its economy. Figure 1.2 reveals that when compared with rest of the world, the country has been performing very poorly on the World Governance Indicators (WGI), consistently ranking below world average (on or below the 50th percentile on all 6 indicators) for the last 5 years.



Country : Lebanon
Source: Worldwide Governance Indicators

Figure 1.2 Worldwide Governance Indicators - WGI Lebanon

The Lebanese state represented by the MoEW has declared its commitment to the principles of good governance and transparency in the sector as well as its intention to join the Extractive Industry Transparency Initiative (EITI). Given the state's weakness in areas of corruption and rule of law, the implementation of strong and effective governance will be even more challenging.

On Good Governance

Current Situation in Lebanon:

The presence of subsoil resources is not in itself a sufficient condition for achieving economic growth and sustainable development.

While a panoply of factors influences the successful development of the sector, poor governance can significantly hinder policy-making and impede economic growth and sustainable development outcomes.

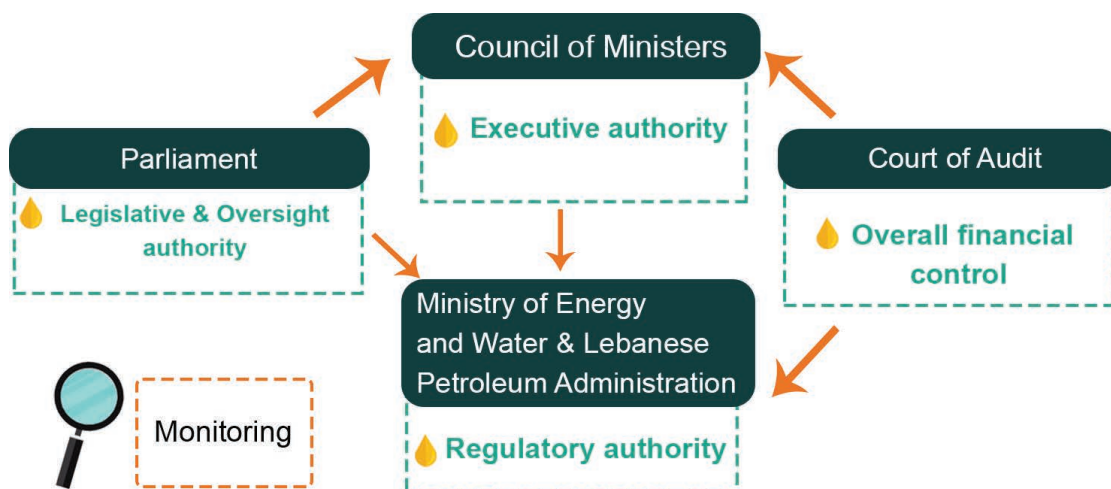
Lebanon has been consistently performing poorly on the World Governance Indicators (WGI) ranking below world average. In the last five years only, it has ranked on or below the 50th percentile on all six indicators.

The Lebanese state has made initial positive “good governance” steps by declaring its commitment to principles of good governance and transparency and its intention to join the Extractive Industry Transparency Initiative (EITI).

Recommendations:

The Lebanese government should elaborate an action plan to improve the overall quality of governance so as to reap the potential benefits of the petroleum sector and move towards economic growth and development.

Civil society should advocate for Lebanon’s full accession to the EITI through the formation of a Multi-Stakeholder Group (MSG) that would be fully engaged in EITI implementation.





Chapter 2

Update on the Oil and Gas Sector in Lebanon



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Update on the Oil and Gas Sector in Lebanon

This chapter provides a general overview of the lifecycle of an oil and gas sector, where does the Lebanese oil and gas sector currently stand, and what are the impending milestones.

Developing an extractive sector requires a chain of exploration and production activities that extend over several decades. Five main thresholds that can be distinguished in the long-life cycle of a hydrocarbon field (IFP SCHOOL, 2014):

- Field discovery:** Exploration wells are drilled to check if the identified prospect does indeed hold hydrocarbons. The drilling is typically several kilometers deep.
- Field Evaluation:** An economic assessment is performed to estimate the initial volume of oil and gas in the reservoir, construct production forecasts, and estimate the development costs.
- Field development:** A field development plan is established accounting for all aspects of the activities, including number of wells to be drilled, type and cost of installations, recovery techniques, etc.
- Field production:** Can extend over a time period that varies between 15 to 30 years and may be stretched up to 50 years or more for “giant fields.”
- Field abandonment:** Occurs when the hydrocarbon production rate becomes non-economical or when the extraction of the reservoir stops yielding economic revenue.



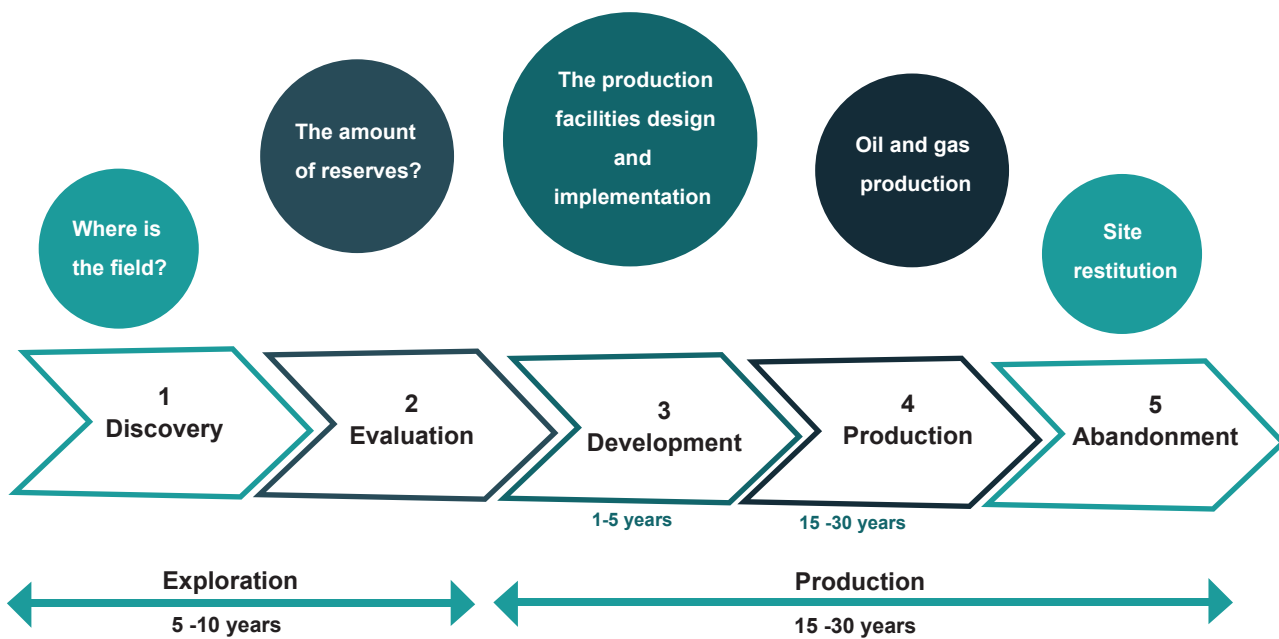


Figure 2.1 Hydrocarbon lifecycle – IFP School - 2014

With Lebanon on the verge of becoming an oil and gas producing country, it is important to identify the country's position in terms of the roadmap outlined by the figure above. October 12th, 2017 marked an important milestone for Lebanon. Three companies, Total S.A, Eni International BV, and JSC Novatek, grouped in one consortium, participated in the bid round on block 4 and block 9. Upon the results of the evaluation, negotiations on the technical offer took place between the consortium and the MoEW together with the LPA.

On December 14th, 2017, the Council of Ministers approved the awards of two exclusive petroleum licenses for exploration and production in blocks 4 and 9 for that consortium. This became the effective date for the Exploration and Production contract to enter into force, setting a clearer roadmap for the sector (Sukkarieh, 2018).



January 2018	Consortium establishes a legal presence in Lebanon	Article 8 of PAR and article 6 of EPA
	A management committee is established to represent each company in the consortium, as well as a representation for Lebanon that would be appointed by the MoEW and the LPA.	Art. 16.1 EPA
End of January 2018	Both EPAs (block 4 and block 9) are signed. Work commitment guarantees (40 million USD) for each block) are made to safeguard the interest of the state in case the consortium fails to fulfill minimum work as per EPA.	Art.9 EPA
February 2018	Exploration plan is submitted to the LPA and the MoEW (within 60 days) This plan details the first exploration phase that includes surveys and the drilling of exploration wells of blocks 4 and 9 that the consortium should complete by 2019.	Art. 7 EPA
	The work plan and budget are submitted	Art. 13.3 EPA
April 2018	Exploration plan is approved if consistent with criteria of the EPA within 60 days of the submission. (The decision must be explained to companies either way)	Art. 7.7 EPA
	The day for approving the exploration plan marks the beginning of the 1st exploration phase (3-year)	Art. 7.1 EPA
June 2018	Recruitment and training plan is devised	Art. 20 EPA
End of June 2018	The update to the Strategic Environmental Assessment is completed	
December 2018	The current term of the LPA Board of Directors expires	

Table 2.1 Roadmap for the Petroleum Sector in Lebanon 2018

On April 2018, MoEW Cesar Abi Khalil announced that the preparation for a second licensing round has started (Barrington, 2018). Currently, there are five important resource-related laws being submitted for ratification by parliament (Salman T., 2018), namely:

- Strengthening Transparency in the Oil and Gas Sector draft law, submitted by MP Joseph Maalouf, to integrate transparency measures across the petroleum sector value chain and the sector's governance. The final version is ready for voting by parliament.



- Onshore Petroleum Resources draft law to set up the scope of onshore petroleum activities, including exploration, development, production, decommissioning, ownership of resources, methodology for land expropriation, and the participation of the state.
- Sovereign Wealth Fund draft law (SWF) to establish a SWF for the management of sector revenues. The draft law, after submission by MPs Yassine Jaber and Anouar Al Khalik was transferred for discussion under a joint parliamentary committee.
- Petroleum Asset-Management Department draft law to establish a new department under the Ministry of Finance (MoF) with two major functions:
 1. Assist MoF in designing an investment mandate for the SWF that will remain subject to approval of the CoM and the parliament.
 2. Audit participating companies to ensure the proper collection of taxes.
 The draft law was submitted by MPs Yassine Jaber and Anouar Al-Khalil. This draft law is slated for review by the parliamentary joint committee.
- National Oil Company (NOC) draft law to organize the NOC’s governance structure, and the state’s participation in the sector. This draft law, after submission by MPs Michel Moussa and Ali Osseiran, was transferred for discussion and is reviewed by a joint parliamentary committee.

	Submitted by	Legislative Stage
<i>Strengthening Transparency in the Oil and Gas sector</i>	MP Joseph Maalouf	Awaiting transfer to parliament vote
<i>Onshore Petroleum Resources</i>	MP Mohammad Kabani	Awaiting transfer to parliament vote
<i>Sovereign Wealth Fund (SWF)</i>	MPs Yassine Jaber & Anwar Al Khalil	To be reviewed under Parliamentary Joint Committee
<i>Petroleum Asset-Management Department at the Ministry of Finance</i>	MPs Yassine Jaber & Anwar Al Khalil	To be reviewed under Parliamentary Joint Committee
<i>Lebanese National Oil Company (NOC)</i>	MPs Michel Moussa & Ali Osseiran	To be reviewed under Parliamentary Joint Committee

Table 2.2 Summary of the Submitted Draft Laws

To date, 2018 has been an essential preparatory year for Lebanon with regards to developing its nascent oil and gas sector. Although drilling will not begin until 2019, it is important to lay down solid foundations for good sector governance. These laws are currently at the initial stages of the legislative process and will be reviewed by the new parliament.





Chapter 3

On the Importance of an inclusive and comprehensive National Oil and Gas Strategy for Lebanon



Chapter 3

On the Importance of an inclusive and comprehensive National Oil and Gas Strategy for Lebanon

Farouk El Kassim, the “Iraqi who saved Norway Oil”(Sandbu, 2009) famously stated that “the first step in developing an oil and gas sector is to decide what a country really wants to do with the oil or gas if it finds it. In other words, a country needs to set its objectives and formulate an oil and gas policy.(Lebanese Center for Policy Studies, 2014)”

In fact, the formulation of a national petroleum strategy ought to be guided, first and foremost, by the principle of inclusion, comprehensiveness, attention to the long term, and an account for sector uncertainty (Natural Resource Governance Institute, 2014). Indeed, the development of an oil and gas sector does not happen overnight; it is rather a lengthy process that extends through decades and rotations of government. Therefore, it is important that decisions about the governance of this sector can sustain changes in government and that policy-making be coherent and built on long-standing consensus. Moreover, strategy design needs to be based on the involvement and participation of a “critical mass of informed citizens”(Collier & Venables, 2011, p. 17)who, together with legislators, journalists and other civil society actors, monitor the implementation of this strategy and holds the government accountable.



Is There a Lebanese National Oil and Gas Strategy?

In 2007, the CoM attempted to address this fundamental matter by creating a committee tasked with drafting the oil and gas policy(Daaboul, 2018). With the formation of a new government in 2008 under the supervision of Minister of Energy Alain Tabourian, a drafting team affiliated to the MoEW--including public servants from Ministry of Environment and Ministry of Finance--, capitalized on the work of the previous committee to draft a law based on the draft “hydrocarbon policy” written by the latter(Daaboul, 2018).

In 2009, MoEW Gebran Bassil sent a draft law to the CoM(Daaboul, 2018). In parallel, current parliament member and former Minister of Finance Ali Hassan Khalil submitted a different draft proposal to the parliament. This led to the creation of joint parliamentary committee during which both draft laws were integrated, and the parliament voted on the Offshore Petroleum Resources Law (OPRL) on August 24th, 2010(Daaboul, 2018). The CoM thereafter issued implementation decrees through the Petroleum Activities Regulations (PAR) in 2011. The law allegedly encompassed the core elements of the country’s oil and gas policy.



On November 28th, 2017, House Speaker Nabih Berri called for a joint meeting for six parliamentary committees to discuss four draft laws that had been submitted to parliament, namely the draft law for establishing a national oil company, the draft law for establishing a sovereign wealth fund, the draft law for establishing the directorate of petroleum assets, and the draft law for Onshore oil and gas exploration (Maalouf, 2018). This motion stirred divergent reactions among the ministers and parliamentarians of different political factions (De-Freige, 2018).

Conflicting reactions as to whether to support Berri's move revealed a lack of consensus on a national oil and gas strategy for the sector. In fact, the country's draft oil and gas policy was never publicly shared and thus not subjected to scrutiny. These events underlie the country's vision for the sector or lack thereof. The question that arises in this regard is to what extent does Lebanon actually have an inclusive, comprehensive strategy supported by a longstanding consensus among all political factions?

By establishing an oil and gas legislative framework, Lebanon put in place, early on, certain elements of a strategy for the sector. However, in a focus group conducted with the Lebanese Coalition for Good Governance in Extractive Industries², it became clear that no formal or structured measures had been taken to consult stakeholders outside government and parliament (Coalition, 2018).

Promising elements of the strategy relate to the conduct of seismic surveys for the more accurate identification of oil and gas prospects, although Lebanon's maritime borders are still ambiguous and the subject of disputes with neighboring countries is unresolved yet (Middle East Strategic Perspectives, 2018). The entirety of Lebanon's offshore has been traversed by 3D seismic surveys and 80% by 2D seismic surveys; efforts that improve the accuracy of data about the existence of resources (Nash, 2014).

The results of these surveys reveal that Lebanon has good prospects that would improve the country's negotiations position with oil and gas companies, but also provide companies with a better idea of how to conduct petroleum activities once contracts are signed.

2. The Lebanese Coalition for Good Governance in Extractive Industries is a network of NGOs aiming at consolidating good governance in the Oil and Gas sector in Lebanon through monitoring and awareness raising.



Another reassuring feature is the legal and institutional framework. The OPRL and the PAR cover strategic decisions, such as rights allocation and the establishment of a sovereign wealth fund, as well as the institutional structure. In fact, the OPRL, the PAR, and all the relevant decrees and contracts are a partial manifestation of a sector strategy.

A clear and publicly announced strategy was prepared and launched for the first Offshore Licensing Round which led to the signature of two Exploration and Production contracts in 2018. The Lebanese legislation includes provisions about local content, quality, health, safety, and environmental policies. Those are also core components of the country's overall hydrocarbon strategy.

However, although these components provide a general strategic direction, they do not provide a full picture. Indeed, to this day, there is no single document that discloses a well-articulated national strategy to the public, including how and if, once produced, the oil and gas produced is going to be consumed in the internal market, where the gas is to be exported, a sales and marketing strategy, analysis of the impact of the sector on the economy and development, etc. While there are partial answers to the above questions, it is clear that the existing information does not constitute a clearly defined, comprehensive, and official strategy, nor are there any signs of attempts to elaborate on such a strategy in the spirit of inclusiveness, engagement, and buy-in.

According to the OPRL, both the CoM and the MoEW have a role in setting the sector strategy. While the MoEW is in charge of raising propositions to the CoM, the CoM has the responsibility of assessing, discussing and approving this proposition (Lebanese Petroleum Administration, 2017). Therefore, given the absence of consultation that accompanied the creation of the OPRL and the PAR, and the continued lack of consensus on the direction of the sector, the duty to elaborate a comprehensive, inclusive, and consensus driven strategy for the country's petroleum sector, falls on the shoulders of the upcoming government. This is both a need and an opportunity to lay the foundations of sustainable management of petroleum activities especially with a constellation of important milestones at the sector's horizon (see Chapter 2 Update on Lebanon Oil and Gas.)



Although progress has been made with regards to the sector's strategy, the need for consensus and full disclosure are undeniable, especially given the four draft laws that were recently submitted to parliament.

"Would you tell me, please, which way
I ought to go from here?"

Alice inquires

"That depends a good deal on where you want to get to"
said the Cat

"I don't much care where"
said Alice

"Then it doesn't matter which way you go,"
said the Cat

This exchange taken from Alice in Wonderland is instructive in that: the roadmap for the development of the hydrocarbon sector in Lebanon "depends a good deal on where Lebanon wants to get to," and a great deal on full formal disclosure to all relevant stakeholders. This is perhaps one of the most essential conditions for good governance.

Public Consultation and Stakeholders' Engagement: An Ally for the State, a Right for the Public

International experience teaches us that the inclusion of public stakeholders in governance, strengthens good governance practices and facilitates the process of effective policy making (Natural Resource Governance Institute, 2014.) With Lebanon's high ranking (143/180) on the Corruption Perception Index (Transparency International, 2018,) and amid an environment etched with public mistrust of officials in charge, communication and inclusiveness become an asset in the hands of the state and a right in the hands of the public, especially within the process of setting up a national oil and gas sector strategy.

Public consultation and stakeholders' engagement are thus tools that enable more transparency and provide a way to promote debate, collect information, as well as share information, consolidating inclusion of all stakeholders, and adding value to strategies, policies, and laws (OECD Studies on Public Engagement, 2009.) This explicit and direct exchange of information would enable the state to better manage its own expectations and that of the sector and can successfully avoid what is nowadays called the "Presource Curse" as explained in the below section. To date, there has been no sign of the establishment of formal and structured stakeholder engagement processes.



Public consultations, a process involving stakeholders affected by the issue at hand, have not been undertaken to date. However, it is worth noting that the LPA organized on April 26th, 2018, the First Consultation Workshop on the update of the SEA on the upstream offshore oil and gas (Nasr, 2018.) Another matter that could be relevant for a public consultation process is the revenue management issue (SWF,) or how Lebanon is going to use the potential revenues generated through the extraction and production of oil and gas.

Resource Prophecy, Resource Curse and the Importance of Managing Expectations.

“We have nothing, so let’s agree that anything we do find belongs to everybody”. These were the words of Botswana President, Ian Khama when touring the country and managing public expectations about newly discovered mineral wealth. Botswana’s unassuming mindset of “We’re poor and therefore we must carry a heavy load,” distinguished it from its African neighbors contributing to an approach and outlook that made it into one of the richest countries in the region (Collier, 2013.)

Natural resources are usually perceived as correlated to wealth and richness. Discoveries or their prospects tend to increase public spending as soon as news about them emerges. Kenya’s public sector demand for an increase in wages only a month after the government announced oil findings is a case in point. Although the exploration of Lebanon’s offshore resources will require no less than 10 years to produce revenues, high public expectations could drive the government to over spend and borrow, taking a further toll on the country’s budget.

In a recent research paper to the IMF, it was found that, following oil discoveries, growth systematically underperforms the forecasts made by the IMF. For certain countries with weak institutions, the “discoveries have even led to significant growth disappointments, compared with pre-discovery trends” (Cust & Mihalyi, 2017.)

As it turns out in many cases, economic growth begins to underperform long before the first drop of oil is produced, and one of the reasons behind this underperformance is that people’s expectations skyrocket when their government mentions this commodity, what we are referring to as the “Resource Curse.”



Managing Lebanese public expectations has not been successful. In fact, while trying legitimately to promote the importance of this nascent sector, Lebanese governmental officials failed to align the political discourse with expectations management. During the last eight years, several statements and positions from officials in charge of the oil and gas file have contributed to heightened expectations through messages exaggerating the expected outcomes the sector is going to yield (Chatham House, 2018.) Moreover, the fast tracking of the review and eventual implementation of NOC & SWF draft laws can also lead to the establishment of institutions early on that would increase public expenses with a negative effect on growth, making Lebanon a potential candidate for the “Presource Curse” Club. Again, the drafting of a comprehensive and inclusive strategy can highly contribute to an effective management of expectations.

Better Late than Never

The First Offshore Licensing round ended with the signing of two exploration and production contracts over blocks 4 and 9. Amid political disagreements about the development of the sector, the elaboration of an inclusive and comprehensive national petroleum strategy can serve as a platform to bring together different political factions and provide the basis for consensus, a critical condition for benefiting from the oil and gas potential “blessing.”

Therefore, it has become of utmost importance for the Lebanese state to adopt a judicious yet pragmatic strategy for the sector, while prioritizing the strategic effort of effective communication and inclusiveness with the public to reduce the asymmetry of information and manage expectations efficiently.

“A successful strategy not only requires an understanding of the economics, but also an appreciation for accountability, the structure and capacity of government institutions, and the relationship with civil society (Natural Resource Governance Institute, 2014.)” In other terms, the elaboration of a good strategy depends on the underlying system of governance in which it is anchored.



On the Importance of an Inclusive and Comprehensive Oil and Gas Strategy for Lebanon

Current Situation in Lebanon:

The Lebanese government has developed components of a sector strategy. For example, it has overseen the elaboration of a sound institutional and legal framework and conducted seismic surveys to identify prospects. However, Lebanon's maritime borders remain contested, which represent a potential loss of significant revenue and benefits in addition to political and security instability.

However, there is no official and comprehensive strategy outlining how the Lebanese state intends to develop the oil and gas sector in Lebanon.

While legitimately trying to promote the potential benefits of future oil and gas revenue for Lebanon, officials have failed to manage public expectations from the sector by overestimating benefits at a time when commercial discoveries have not yet been made.

If public expectations are not reigned in, Lebanon may not eschew the "Resource Curse."

Four draft laws were submitted to parliament in November 2017 for the establishing of a national oil company, a sovereign wealth fund, and a directorate of petroleum assets, and for regulation of onshore oil and gas exploration causing controversy

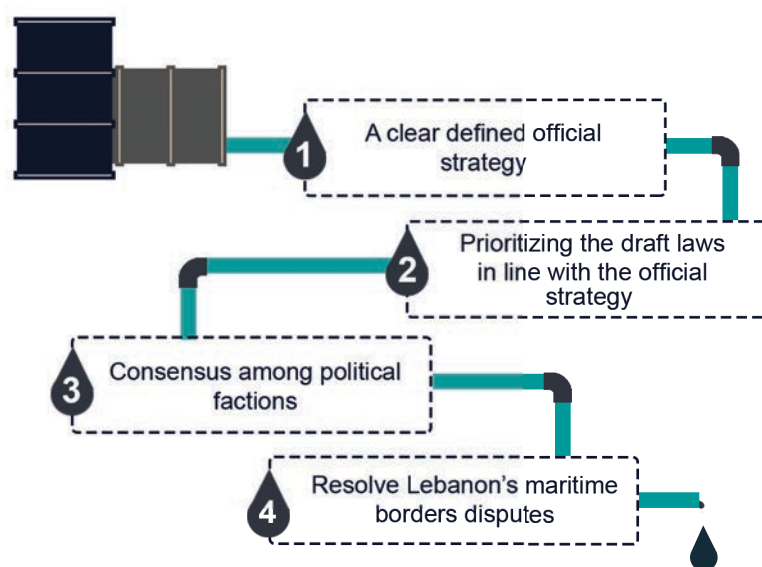
Recommendations:

The Council of Ministers (COM) should elaborate and publish a comprehensive and inclusive national strategy for oil and gas sector governance that is inclusive to ensure buy-in from all stakeholders, civil society included.

Lebanese officials need to align popular expectations with resource-related policy-making and developments to avoid any Resource Curse scenario.

The Lebanese parliament should prioritize the proposed draft laws in line with a national petroleum strategy.

The Lebanese government should pursue third-party mediation to settle maritime disputes.





Chapter 4

Legal and Institutional Framework



Chapter 4

Legal and Institutional Framework

The governance of resource revenues occurs within a system and led by stakeholders who are in charge of making and implementing decisions about the management of these resources. This system is administered through a legal framework that sets forth the rules, rights and obligations of companies, governments, and citizens. What are the main constituents of this framework and how do they function? How is the legal framework for the oil and gas sector in Lebanon designed? Who are the institutional bodies responsible for the implementation of this legal framework?



On the Legal Framework

The legal framework that governs the resource management rests within a broader set of rules governing the organization of the state and economic activities. This framework differs from country to country and is composed of a set of instruments that include the constitution, legislation, regulations, and contracts (Natural Resource Governance Institute, 2015.) These “legal instruments”-- often referred to as legal hierarchy-- vary in importance and function. Moving from the bottom of the pyramid to the top as illustrated in Figure 3.1, each instrument becomes increasingly detailed or specific, and more easily amended (decrees, contracts) versus the Constitution at the top.

To understand the role of and function of the legal framework in resource governance, think of the situation of an orchestra with no conductor, where musicians are playing without notes leading to, most likely, and disappointing performance. Just as conductor and music notes provide guidance and coherence, and ensure the quality of the performance, so is the legal framework an essential component of the governance of the sector.

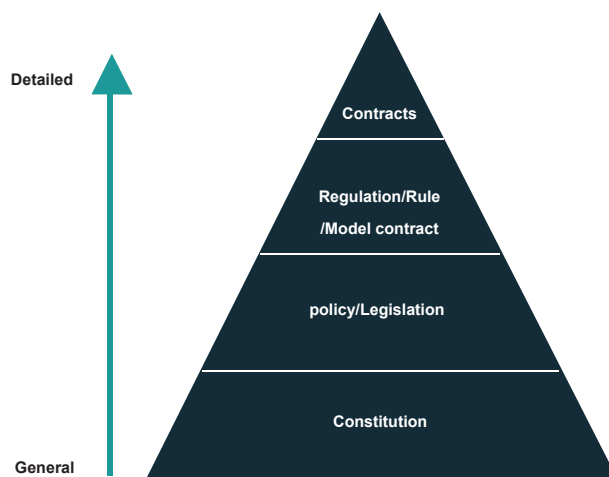


Figure 3.1 Legal Hierarchy



Each of these instruments has a function and role within the legal framework.

The constitution is the foundation of the legal framework. It provides general guidance about the system of governance and the relationship between the state and its citizens. Although it does not necessarily establish specific rules for the sector, it can contain guidelines on the governance of natural resources, such as mechanisms for checks and balances, ownership of natural resources, the legal processes within the country, labor laws, and environmental standards.

Policy and legislation are concerned with establishing and implementing the general policy for the sector, incorporating the state's strategy. A vital component of good governance, policy crystalizes the roadmap for all the applications that follow. Ideally, policy is expressed in a legislation that specifies the how this policy is implemented and who are the authorities responsible for the implementation.

Decrees and regulations are usually issued by the CoM and can be understood as the tools used to enable the implementation of legislation by providing additional details on the law they are associated with.

A contract is the legally binding agreement between two or more parties. In the natural resource sector, contracts are the tools with which the state grants the right to explore or extract natural resources to companies by laying out the rights and responsibilities of both parties. These contracts can take several forms depending on certain characteristics, such as the levels of control granted to the foreign company, the fiscal regime (which will be elaborated in later chapters,) and levels of involvement by the state.

Some have suggested that countries with more expansive laws and regulations are more successful at managing effectively their oil and gas sector. They propose that a developed legal framework would leave less room for negotiations in contracts, which would facilitate monitoring and accountability, mitigate transparency concerns, and help investors feel that they are being treated fairly.



The Legal Framework in Lebanon

“Lebanon has established a legal framework and governance structure for its nascent petroleum sector that incorporates necessary elements of international best practices.”(International Law and Policy Institute (ILPI, 2013.)

If we are to assess Lebanon’s legal framework, we need to examine the legal instruments at hand and establish how they serve the governance of the sector. The Lebanese constitution briefly mentions natural resources in article 89 that reads:

The Constitution of the Republic of Lebanon stipulates that no contract or concession for the exploitation of the natural resources of the country may be granted except by virtue of a law and for a limited period (Lebanese Petroleum Administration, 2017.)

As a result, the Offshore Petroleum Resources Law (OPRL,) issued on August 24th, 2010, preserves the Lebanese state’s ownership of these resources and its right to participate in the exploitation of its resources. This law lays the foundations for the governance of the sector and applies to oil and gas activities within territorial waters and waters of the Exclusive Economic Zone (EEZ).

Furthermore, the Petroleum Activities Regulations-PAR, present the application decree of OPRL and embed the implementation rules of the main provisions for petroleum activities mentioned in OPRL. The PAR is governed by Decree No. 10289 (30-04-2013)and includes 27 Application Decrees providing legal, technical, commercial provisions that regulate petroleum activities in Lebanon.

In addition to the PAR, the following decrees were issued (Lebanese Oil and Gas Initiative -LOGI, 2017):

- Pre-Qualification Package of 2013, including the Pre-Qualification Decree Number 9882/2013 dated February 16th (“Pre-qualification Decree”) and Pre-Qualification Package of 2017 (decision number 1/m of the minister energy and water of January 26th, 2017 regarding the launch of a prequalification process.)
- Decree number 43 dated January 19th, 2017, encompassing the Model Exploration and Production Agreement (the “Model EPA,”),with the Tender Protocol (the “Tender Protocol”) as Annex 1;
- Decree number 42 dated January, 19th 2017 on the delineation of blocks;
- The Decree no. 1177/2017 dated August 3, 2017, amended the Decree no. 10289/2013 dated April 30, 2013 (Petroleum Activities Regulations).



Moreover, the law for tax provisions related to oil and gas activities in accordance with Law 132 is another legislative tool voted by parliament on September 19th, 2017, that elaborates on the different taxes applicable on oil and gas activities, including the income tax, and the custom duties applicable on all machinery imported for that matter.

The Exploration and Production Agreement (EPA) issued by Decree n. 93/2017 is a model contract that regulates the legal and contractual relationship between the state and the right holder. It stipulates the contractual elements of exploration and production activities and specifies the rights and obligations respective to the government and the awarded company.

As the name indicates, this model contract, serves as a template or a guiding document for the bidding. In most of the cases, “model contracts” are not ends in themselves, but serve as starting point in negotiations with companies.

Benefits of a Model Contract.

- 1. Assists the government in getting a better deal by adopting international standards and helping avoid long negotiations**
- 2. Promotes uniformity providing conditions for fair competition by putting all the competing companies on the same starting line**
- 3. Improves investors' perception of government making the sector more attractive**
- 4. Facilitates monitoring and oversight,**
- 5. Reduces opportunities of corruption.**

Box 3.1 Benefits of a Model Contract.



Figure 3.2 Importance of Model Contracts- Lebanese Legal Architecture

By looking at Lebanon’s legal architecture showcased in figure 3.3., we can observe that there are details to be elaborated as we move up the legal hierarchy from the constitution to the contract, leaving much for the decrees, regulations, and contract to resolve. Here is where the EPA comes in handy as it provides a context for efficient, fair, and transparent awarding procedures.

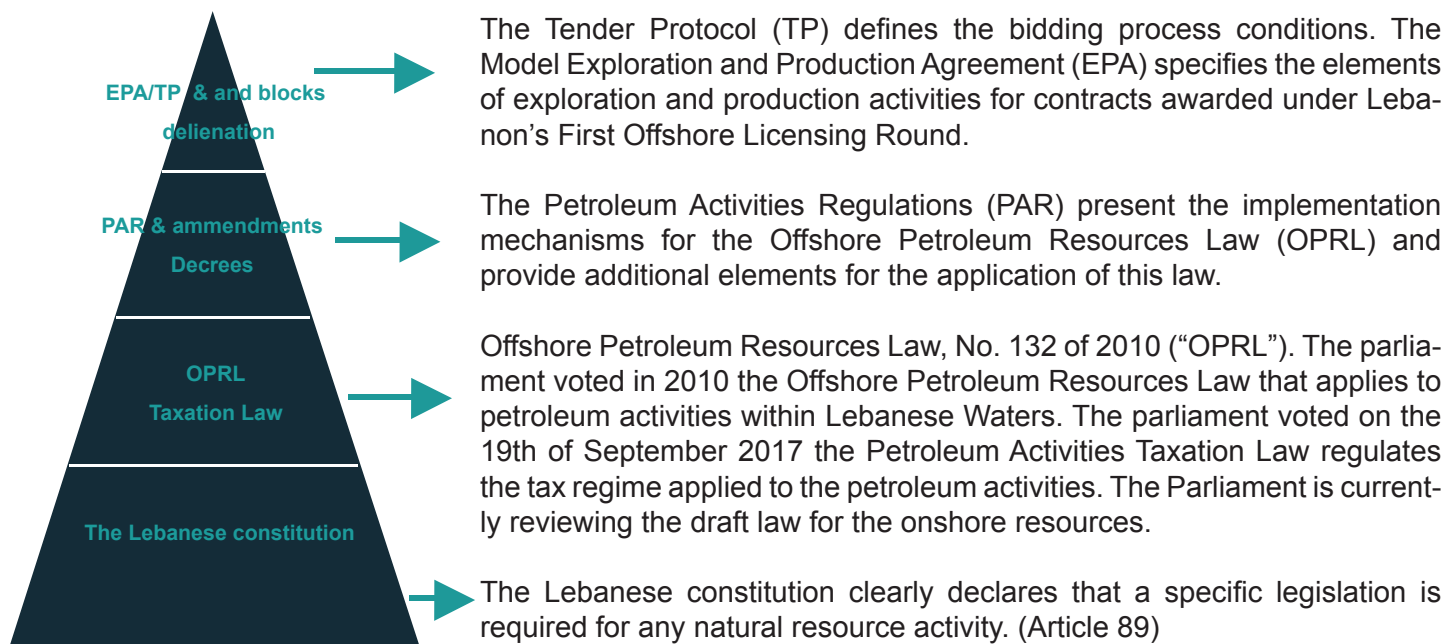


Figure 3.3 Legal Hierarchy in Lebanon

The Institutional Framework in Lebanon

The Natural Resource Charter (NRC) is a set of principles outlining how best to take advantage of opportunities for development created by natural resource exploration. Precept 1 of the NRC establishes that it is critical to determine clearly the institutional framework governing the behavior of actors involved in resource management and clarify their roles and responsibilities to ensure strong and efficient resource governance.

The institutional decision-making of Lebanon’s resource sector is built around three governmental entities:

- The Council of Ministers (CoM)
- The Ministry of Energy and Waters (MoEW)
- The Lebanese Petroleum Administration (LPA) whose board is composed of 6 heads of departments and a president (a yearly rotational function amongst its members)(International Law and Policy Institute (ILPI), 2013)

Petroleum Administration, PA Organization Chart

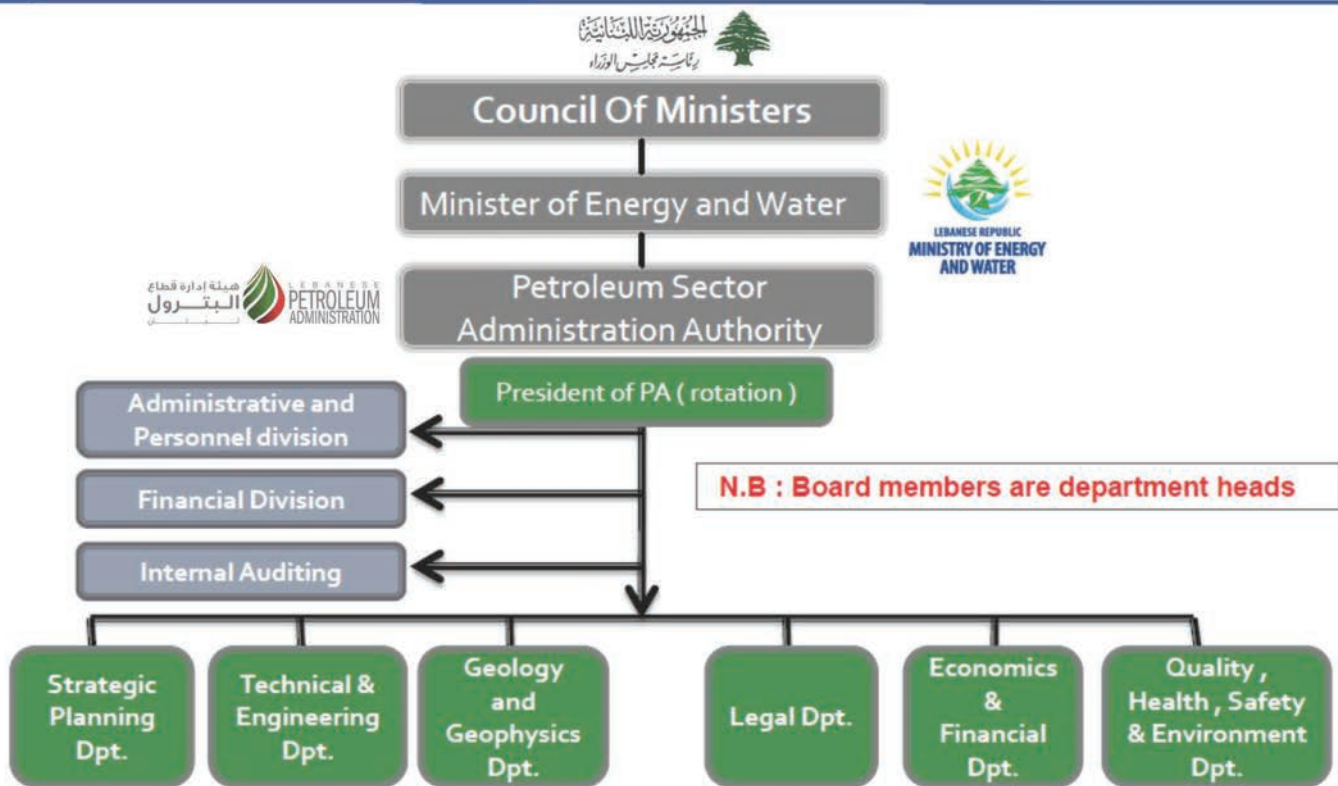


Figure 3.4 Lebanese Institutional framework

CoM sets the general policy of the sector and is responsible for its overall management. The CoM’s core mandate revolves around several prerogatives that are described in detail in the OPRL. The CoM issues and implements regulatory decrees for the sector (PAR,) approves the exploration and production agreements, and sets prequalification conditions for bidding and licensing after conferring with the MoEW. The CoM authorizes the MoEW to sign exploration and production agreement with the winning consortium, and approves the production and development plan. The CoM appoints the board of the LPA and defines its internal regulations.

The MoEW is responsible for implementing the national oil and gas policy, as well as monitoring and supervising the respective sectoral activities. The MoEW exercises tutelage over the LPA and undertakes the necessary preparations for the announcement of a licensing round. The MoEW submits to the CoM the results of the bidding round and a recommendation for signature from the EPA. The MoEW approves the exploration plan to be submitted by the winning consortium.

The LPA is a body required by the OPRL to play an advisory and regulatory role in the oil and gas sector. The LPA falls under the tutelage of the MoEW and enjoys relative administrative autonomy under the law. In that context, the MoEW relies on the LPA’s mandate to regulate the oil and gas sector in Lebanon.

The LPA plays an important role in the awarding of exploration rights from prequalification to the signature of contracts, as it prepares prequalification criteria, prepares bidding and licensing rounds, evaluates the contesting consortia, and submits an evaluation report to the MoEW.

More specifically, the LPA is charged with:

1. Conducting studies to promote Lebanon's oil and gas potential
2. Reporting to the Minister about the assessment of qualifications and capabilities of applicants and applications for oil and gas exploration rights
3. Drafting invitations for bids, conditions for applications, model exploration and production agreements, and licenses and agreements in accordance with this law
4. Assisting the Minister in negotiating exploration and production agreements and reporting on results of negotiations to the Minister to enable the CoM to make final decisions
5. Managing, monitoring, and supervising hydrocarbon activities and the proper implementation of licenses and agreements and, in this regard, submitting quarterly reports to the Minister for approval
6. Evaluating plans for the development, transportation, and cessation of hydrocarbon activities and decommissioning of facilities
7. Management of oil and gas activities data
8. Keeping and managing the petroleum register (once its respective decree is issued).

The Lebanese parliament is the legislative authority for oil and gas.

On August 24th, 2010, the parliament laid the foundations for the development of the sector by voting for the Offshore Petroleum Resources Law (OPRL.)

Although the OPRL does not constitute parliamentary oversight of the council of ministers and the minister's activities, according to its bylaws, the parliament oversees the council of ministers through questions, interrogations, vote of confidence, and parliamentary enquiries.

Moreover, as per article twenty-five of the law for the tax provisions related to petroleum activities voted by parliament on September 19th, 2017: "The Ministry of Energy and Water shall prepare every four months a report on the progress of petroleum activities and submit it to the Parliament." (LPA, 2017)



This reporting is thought to help parliament in contributing to informed and targeted oversight.

In practice, executive governance functions are divided between the Council of Ministers, the Ministry of Energy and Water, and the Lebanese Petroleum Administration. Accordingly, the separation and balance of powers is as follows:

Institutions	Roles & Institutions
Com	Executive authority
Parliament	Legislative and Oversight authority
MoEW+LPA	Regulatory Authority
Court of audit	Overall financial control

It is nonetheless important to note that the above-described institutional framework of the sector is a piece of a broader governance puzzle that necessitates collaborative interaction among several bodies and entities, notably ministries. Revenue management, environmental protection, and trade agreements, for example, are tasks that render this collaboration necessary making it subject, as a result, to standards of good governance as well.

Moreover, NGOs play an important role in terms of monitoring and oversight of good governance of the oil and gas sector. While Lebanon enjoys an enabling environment for NGOs activities and interventions, asymmetry of knowledge and capacity remains a considerable challenge to overcome for CSOs operating in the field (Coalition, 2018). In fact, due to the specificity of the sector know-how and the early stage of its development, CSOs find themselves in a situation of amplified need for capacity.

The LPA has adopted a policy of openness in communicating information with NGOs (Coalition, 2018). However, more efforts need to be put, in order to create a more structured and formal channel for consultation (Coalition, 2018.) In other terms, to ensure that NGOs participate in the decision-making process, and not to be solely contented with receiving information, but rather to have a margin of influencing the course of the sector.



CSOs are responsible of overseeing the oil and gas sector, holding politicians accountable in case they fail to abide by best practices while managing the sector, and ensuring that transparency measures are implemented where applicable. Additionally, CSOs play a major role in advocating for the sector to move forward and in shaping policy making during consultative processes. CSOs are also responsible to disseminate information related to the petroleum sector in order to educate the general public and engage in public discussions and debates, while managing expectations.(Lebanese Petroleum Administration, 2018)

Box 3.2 Role of CSOs

Is Lebanon's Institutional and Legal Framework Consistent with Good Governance Practices?

The Resource Governance Index(RGI), a measurement tool that ranks oil producing countries in order of their quality of governance, interprets good governance as “having good rules, strong oversight to enforce the rules, and the competence and willingness to follow them(Natural Resource Governance Institute, 2017).”

In Lebanon, the sector-specific legal architecture and institutional framework mirror good governance characteristics, as it establishes to a large extent the behavior of actors involved in resource management and clarify their roles and responsibilities to ensure strong and efficient resource governance. However, within a wider context, the latter become susceptible to existing rule of law challenges in the country's governance.

Initially, the development of Lebanon's extractive sector experienced some setbacks. The launch of an offshore bidding round was delayed for 3 years due to political paralysis: the first prequalification round was conducted in 2013, but the bidding did not occur until 2017. The CoM at the time was not issuing decrees related to blocks delineation and tender protocol/EPA. In addition, when rumors of corruption and bribing of Lebanese officials were made in connection with the Italian oil company ENI, the judiciary did not investigate these.

Furthermore, the parliament's modus operandi for law-making and legislation has been inconsistent. In December 2017, three draft laws focused on the creation of a SWF, anNOC and a "petroleum assets directorate at the Ministry of Finance" were presented to the parliament(Salman T. F., 2018.) The draft laws took an unorthodox fast track review process through their transfer to the parliamentarian joint committees for study.Through an unorthodox fast track processing³. This was in stark contrast to the progress made on the draft law for "Strengthening Transparency in the Oil and Gas Sector" which was submitted for review in March 2015 but never reached the general assembly for vote. The Onshore Petroleum Resources Law is facing the same fate.

These discrepancies reflect, if anything, a lack of consensus on the natural resource sector development strategy among different political factions constituting Lebanon's particular brand of power-sharing democracy.

Another challenge hampering the work of the structure described earlier, is the "asymmetry of capacity" among the different actors involved in oil and gas governance. Given that developing this nascent sector requires highly-specialized competences, a multitude of programs have sought to develop the LPA and the parliament's capacities to govern the sector. But the same cannot be said about the CoM which is expected to make pivotal decisions and to formulate and monitor the sector's policy.

3. The joint committees are composed of six parliamentary sub-committees, and such an approach is usually used to reduce the reviewing and discussion timeframe of the draft laws, before transfer for vote by the parliament.



Legal and Institutional Framework

Current Situation in Lebanon:

The legal framework for natural resource governance is comprised of a set of instruments that include the constitution, legislation, regulations, and contracts.

The Lebanese parliament and the COM have established the legal foundations for the oil and gas sector.

Institutional decision-making for Lebanon's resource governance is built mainly around three governmental entities: the COM (Policy Making/Executive Authority), the Ministry of Energy and Waters-MoEW (Regulatory Authority), and the Lebanese Petroleum Administration-LPA (Regulatory Authority/Consultative). The Lebanese parliament also plays legislative and oversight roles.

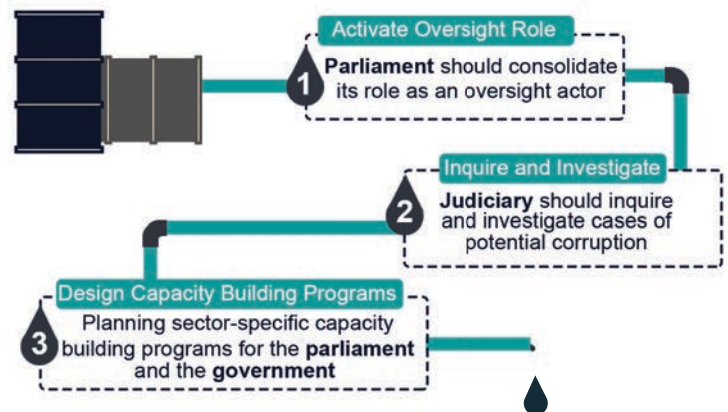
In Lebanon, the sector-specific legal architecture and institutional framework reflect good governance traits. However, within a wider context, these become the victims of rule of law challenges. The First Offshore Licensing Round 3 years delay and the passiveness of the judiciary about allegations of corruption are examples of this vulnerability.

Recommendations:

The parliament should consolidate its role as an oversight actor as per the mandate conferred to it by its bylaws.

The judiciary should inquire and investigate cases of potential corruption.

With the election of a new parliament, and the upcoming formation of a new government, sector-specific capacity building programs for the parliament and the government ought to be undertaken.





Chapter 5

On Allocation of Exploration and Production Rights



Chapter 5

On Allocation of Exploration and Production Rights

Countries that lack local capacities have commonly undertaken extractive activities on their own and tended to rely on private Oil & Gas companies. However, inviting a foreign company and granting it rights over the country's resources can yield undesired outcomes. Whilst the elaboration of an appropriate allocation mechanism is crucial, it is also dependent on the process chosen by the government to award rights. Luckily, for Lebanon, there are many lessons to be learned from other countries' experiences.

The following looks at how petroleum rights are allocated and monitored in light of international best practices in that regard.



The Institutional Framework in Lebanon

There are two main approaches for the allocation of hydrocarbon rights for exploration and production: direct negotiations or competitive bidding.

Direct negotiations refer to exclusive negotiations between the government and extractive companies. Direct negotiations are also referred to as non-competed contracts which allow for boundless discretion of the process and content of negotiations. (Myanmar, Afghanistan)..

Competitive bidding is a selection process based on pre-defined criteria, often with little room for negotiations on selected terms.

While direct negotiations are often associated with opacity and less than optimal "good governance" outcomes (although transparency measures can be adopted), international best practices tend to favor competitive bidding as a process that incorporates principles of fair competition, transparency, openness, value maximization, and equal treatment of investors.

The success or failure of the bidding, however, hinges upon its design, the legal and institutional framework in which it is set, and the government's pledge to transparency and effective oversight.



Direct negotiations can be a useful tool in a scenario where the government is powerful enough and experienced enough to leverage negotiations with private companies. However, in places where the sector is still at infancy, competitive bidding is advised.

Conditions for successful open bidding:

- Conditions and prequalification results (if applied) should be made public.
- Rejected companies should be notified in writing of why their application was not admitted.
- Rejected companies should be given the right of complaint.
- All details on rules and criteria of the award should be made publicly available.
- Pre-qualified companies should compete on pre-determined criteria with very restrained space for negotiations and discretion.
- Results of the bidding process should be made public.
- Governments should ensure that there is minimal need to negotiating terms after the bidding.
- The entire process should be subject to external oversight and monitoring hence the importance of the open access to information.

Box 4.1 Conditions for Successful Open Bidding

Lebanon's First Offshore Licensing Round (May 2013 – October 2017)

Rules and procedures for awarding petroleum rights in the Lebanese waters are expressed in the OPRL, assisted by a sequence of ministerial decrees and decisions that detail the process further.

- ◆ Chapter four of the Offshore Petroleum resources law-OPRL,
- ◆ Articles 23-27 of the Petroleum Activities Regulations Decree, No. 10289 of 2013-PAR,
- ◆ Pre-Qualification Package of 2013 including the Pre-Qualification Decree Number 9882/2013 dated February 16th and Pre-Qualification Package of 2017 (decision number 1/m of the Minister of Energy and Water of January 26th, 2017 regarding the launch of a prequalification process for the first licensing round).
- ◆ Decree number 42 dated January 19th, 2017, on Blocks Delineation.
- ◆ Decree number 43 dated January 19th, 2017, on the Model Exploration and Production Agreement (the Model EPA) , with the Tender Protocol (the Tender Protocol) as Annex 1.

Box 4.2 Legal Instruments Stimulating Lebanon's First Offshore Licensing Round

In practice, the Lebanese state adopted a three stages process for its first offshore licensing round:



Figure 4.1 - Lebanon's First Offshore Licensing Round: a three-stage process.

Prequalification Rounds:

The prequalification rounds are mandatory according to Law 132/2010 and regulated by the PAR and Pre-Qualification Decree Number 9882/2013. At this stage, the government evaluates whether the applicants are capable or “qualified” to operate within the industry and meet the country’s general policy objective for the sector. Companies can be qualified as operators or non-operators and are assessed on the basis of four components: legal, financial, technical, and quality of health, safety, and environment, as illustrated in table 4.1.

	Non-operator	Operator
Legal	Joint stock company conducting hydrocarbon Activities	Joint stock company conducting hydrocarbon activities
Financial	Total assets of USD 500 million	Total assets of USD 10 billion
Technical	Having an established hydrocarbon production	Operatorship of at least one hydrocarbon development in water depths in excess of 500m.
QHSE	QHSE policy statement(s) Established and implemented QHSEMS	QHSE policy statement(s) Established and implemented QHSEMS

Table 4.1 Pre-qualification requirements for both operators and non-operators.

Operators are mainly in charge of managing the day-to-day field operations on behalf of other companies in the consortium. This includes the design and execution of the exploration program, good design, drilling, completion, production, engineering, infrastructure and facilities construction and maintenance, services and logistics, and representing the consortium.

Non-operators, on the other hand, are responsible for co-financing the project, participating in commercial and marketing activities, providing technical input, and ensuring the regulatory function.



During the first prequalification round held in 2013 pursuant to the prequalification decree (Decree No 9882/2013), 46 out of 52 companies were qualified, among which 12 qualified as operators, based on a scorecard reflecting the criteria mentioned above (Lebanese Petroleum Administration, 2018). The results were published during a press conference held by the Minister of Energy and Waters and can be found on LPA website (Lebanese Petroleum Administration, 2018).

During the second prequalification round of 2017, five new companies joined the list of non-operators and one company was upgraded to the statute of operator. Results were also announced and published officially. As a final outcome, both qualification-rounds led to the qualification of 13 operators and 38 non-operators.

In its report on “Transparency and Accountability in Lebanon’s Petroleum Legislation,” LOGI considered the pre-qualification decree to be in large parts in line with good international practices, but recommended that some amendments be made to the decree.

The most striking element needing a review is article 3.3 of the pre-qualification decree that allows for at least one company within a group to prove that it is able to meet the eligibility criteria set forth by the Decree. This provision contradicts article 7.4 of the same Decree that prevents qualification of any application that doesn’t meet the eligibility criteria.

However, this loophole was partially remedied by item 12 of the Tender Protocol that binds pre-qualified companies to form a joint-stock company in order to submit an application in the petroleum licensing round.

Bidding Round

On the January 26th, 2017, the MoEW announced the launching of a bidding round on 5 selected blocks (1, 4, 8,9, and 10). This announcement followed the issuance by the CoM of two decrees related to delineating Lebanon offshore into 10 blocks, and the Tender Protocol and the EPA pertaining to the bidding round, respectively Decrees No. 42/2017 and Decree No. 43/2017.



The Tender Protocol determines the bidding process for the licensing round, the timetables, the conditions for participation, instructions for applications, and the criteria for evaluation, and contains in Annex 1 the EPA – Model Contract.

Prequalified companies interested in the bid needed to regroup in a consortium composed of at least three prequalified companies, one of which prequalified as an operator, and submit a technical and commercial proposal.

The technical proposal was required to include the approach and timing of proposed exploration work, a preliminary assessment per block, and proposed activities per exploration period including number and depth of exploration wells to be drilled (at least one exploration well per exploration period).

The commercial proposal had to include cost recovery ceiling (the percentage of cost to be recovered by the company on yearly basis needing to be below 65%,) the profit petroleum sharing (state share) based on the gradual accumulation of non-taxable income and cost (R factor), with a minimum 30% share to the state⁴.

As a result, one consortium composed of France's Total SA (as operator), Italy's ENI International BV, and Russia's JSC Novatek submitted 2 bids for blocks 4 and 9.

Awarding Rights

LPA evaluates the different bids submitted by each applicant (consortium). The grading system overall weight split adopted for this tender gives 30% for the technical proposal (the general approach and concept of the exploration program, the proposed Minimum Work Commitment) and 70% for the commercial proposal (cost petroleum recovery ceiling and profit petroleum sharing). The company that obtains the highest score will be considered as the provisional winner.

4. For a more detailed analysis, please refer to Fiscal Regime chapter.



The LPA then ranks the consortia by order of their scores from highest to lowest, and presents the findings to the minister for consultation, who can then proceed if necessary to negotiate with the bidding companies only the technical offer. The minister submits then a report to the CoM. Article 12 of the OPRL stipulates the process of awarding petroleum rights as follows:

“The Council of Ministers may, on the basis of a proposal by the Minister based upon the opinion of the Petroleum Administration, award an exclusive Petroleum Right to carry out Petroleum Activities in accordance with an Exploration and Production Agreement pursuant to this law.” (Lebanese Petroleum Administration, 2017)

In practice, since there was one single source offer for each of the blocks, the CoM decided on December 14th, 2017, to award exclusive petroleum licenses for exploration and production, to the only bidder based on the recommendation of the Minister through a report he had submitted to the CoM (this report included as well the results of the technical negotiations).

In fact, the LPA conducted a benchmarking exercise by comparing the average government take of different possible scenarios (oil prices, quantities, etc.) to international and regional examples, similar in context, as there was only a single offer per block, and the task of ranking scores was not applicable.

Because article 9.8 of the Tender Protocol (Council of Ministers, 2017) does not strictly require that LPA to abstain from recommending the award of exploration and production rights when fewer than two applications are submitted per block, the process occurred through benchmarking rather than ranking scores.

Thus, although it appeared as if Lebanon enjoyed the benefits of a competitive bidding process for rights allocation, the reality was otherwise. The LPA attributed the lack of offers to the decline in international oil prices, pushing down with it exploration budgets of the IOCs (Nasr, 2018).

Alarmingly, this decline coincided with a 3-years political deadlock that neutralized progress in the sector as Lebanon was not able to capture the benefits of an increase in oil prices and had to settle for a single source offer per block three years later. This is reflective of an underlying structural deficiency in the overall existing system of governance that has failed to immunize the sector against the spillover of highly anticipated political hindrances.



Article 9.8 of the Tender Protocol: The Lebanese Petroleum Administration may recommend selecting no Application for a Block...., in particular in the event where fewer than two (2) Applications are submitted for a given Block. (Council of Ministers, 2017)

Box 4.3 Article 9.8 of the Tender Protocol

On Allocation of Exploration and Production Rights

Current Situation in Lebanon:

International best practices favor competitive bidding, which reflects principles of fair competition, transparency, openness, value maximization and equal treatment of investors.

The Lebanese state adopted a competitive bidding process in prequalification, bidding evaluation and awarding.

The allocation of rights process was stipulated by the Offshore Petroleum Resources Law, assisted by a sequence of ministerial decrees, including Petroleum Activities Regulations, Tender Protocol, and Exploration and Production Agreement.

In practice, there was one single source offer for blocks 4 and 9 that were benchmarked to similar scenario. On December 14, 2017, the CoM approved the awards of two petroleum licenses for exploration and production in blocks 4 and 9 for the consortium made up of Total S.A, Eni International BV and JSC Novatek.

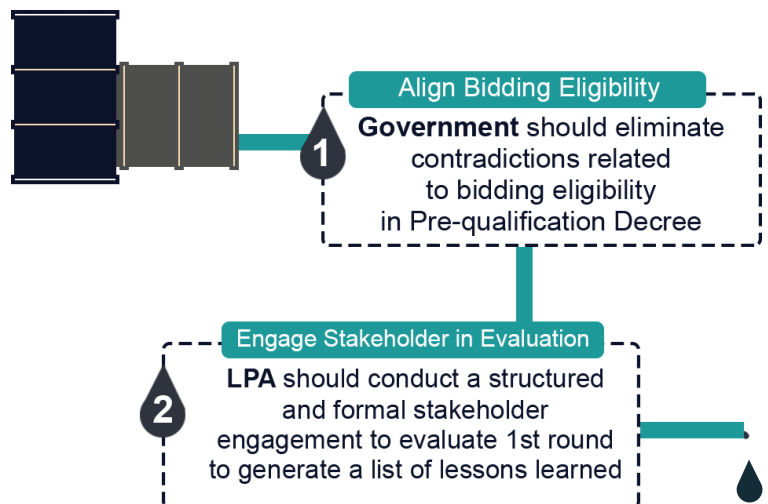
The most dubious element of the pre-qualification decree is article 3.3 that allows for at least one company within a group to prove that it is able to meet the eligibility criteria set forth by the decree. This provision contradicts article 7.4 of the same decree that prevents qualification of any application that doesn't meet the eligibility criteria.

Recommendations:

The Lebanese government needs to evaluate, through a consultative process, the process through which rights are allocated to ensure that Lebanon reaps the benefits of competitive bidding.

The government needs to re-evaluate the pre-qualification decree and assess the relevance and implications of article 3.3.

Before launching the second licensing round, the LPA should conduct a structured and formal stakeholder engagement to evaluate feedback from the first round.





Chapter 6

Beneficial Ownership



Chapter 6

Beneficial Ownership

Disclosing beneficial ownership can help to mitigate revenue losses linked to corruption, revenue leakages, and fiscal evasion. It can also help reduce the effects of the resource curse that manifests itself as weak governance and weak economic performance.

In Lebanon, fiscal evasion is estimated at between \$1.1 and \$1.7 billion annually (Chbeir, 2017.) Since Lebanon's overall taxation monitoring and collection system suffers from implementation challenges, a number of policy measures can be adopted by decision makers to mitigate the revenue losses from beneficial ownership. These can lead to more adequate legal instruments and enforcement mechanisms for taxation collection, also avoiding potential collusion between Politically Exposed Persons (PEPs) and companies involved in different streams of the hydrocarbon sector in Lebanon. This section will examine the concept of beneficial ownership, and the prospects of a disclosure policy and practice that can help mitigate the risks arising from opacity in this regard.



What is Beneficial Ownership?

Beneficial owners are all persons and legal entities that control or share in the profits of a company (Natural Resource Governance Institute, 2015). Beneficial ownership is often masked by complex company structures purposefully designed for that end. Resource-rich countries have struggled with companies avoiding--and even evading--their tax dues and getting away with exploitive practices. Much of this is linked to companies having corrupt relationships with government officials that are shielded by the secret ownership structures of companies.

Knowing the real owners of extractive companies—and hence the capacity of the entities and their owners-- enables government to make more informed decisions, especially in granting licenses. It also enables holding them accountable for the conduct of company activities. This applies also to subcontractors providing goods and services to IOCs. Figure 5.1 below illustrates a beneficial ownership situation in a corporate structure (LexisNexis, 2017).



WHERE BENEFICIAL OWNERS FIT IN A CORPORATE OWNERSHIP STRUCTURE

Below is an example showing how beneficial owners might exist in a corporate structure.

In reality, such structures are often multilayered and very complex, involving many private companies:

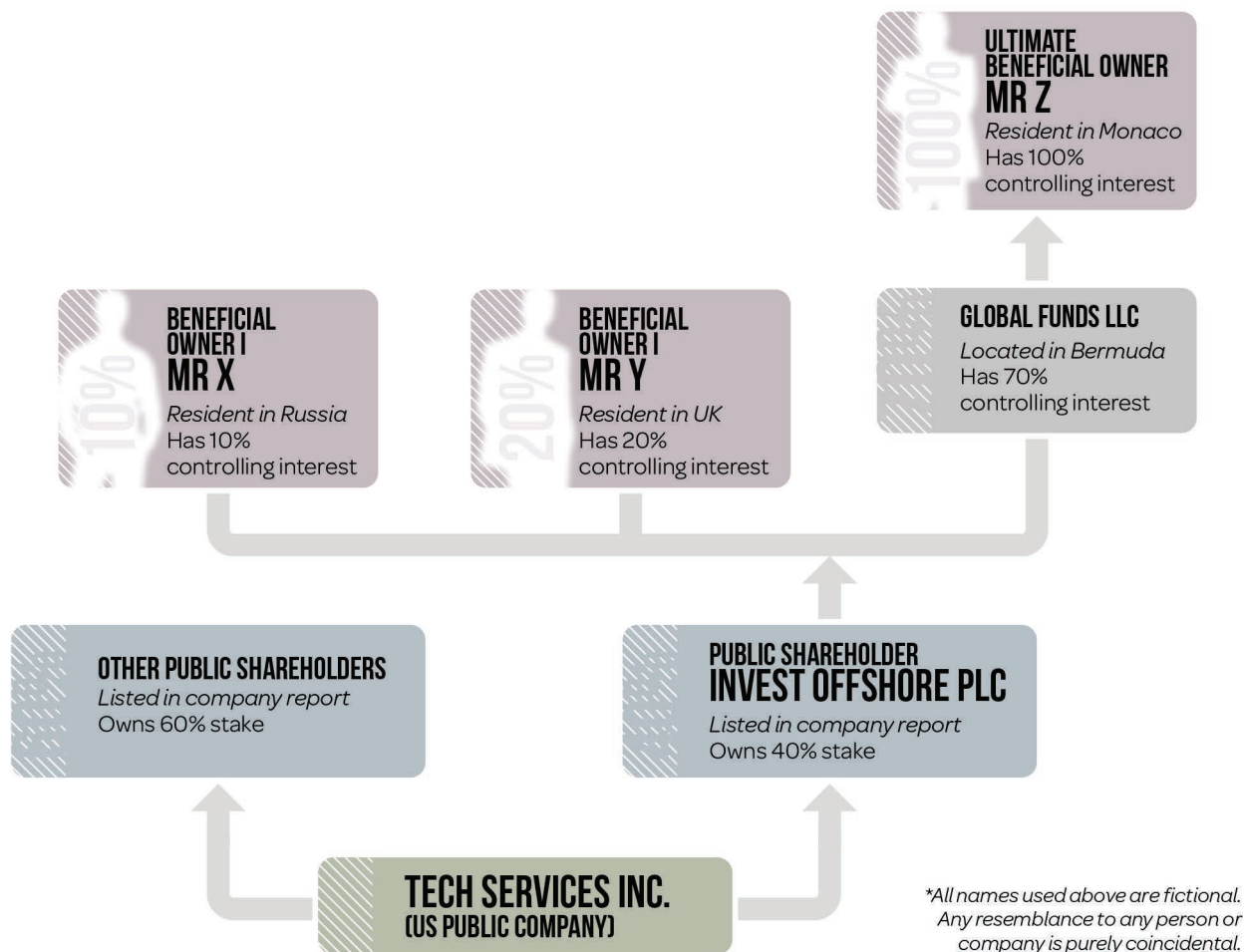


Figure 5.1 Example of Hidden Beneficial Ownership -LexisNexis

The most popular manifestations of opaque corporate ownership structures are:

Tax avoidance and evasion. Some extractives companies seek tax avoidance in the dominions where they produce, buy, or sell material.

Discretion on ownership structures becomes particularly problematic when “Politically Exposed Persons” (PEPs) hold hidden stakes in a company. A PEP is generally defined as “an individual who is or has been entrusted with a prominent public function. (Sayne, Westenberg, & Shafaie, 2015)” This duality of influence and interests can easily result in corruption and the exploitation of public authority to advance personal interests.

Table 5.1 below that reveals how beneficial ownership is concealed in the extractive sector.

Means to hide interests	Description
Substituting natural persons	One or more people stand in as shareholders for the beneficial owner. These can include family members, fronts, or aliases.
Inserting opaque entities into the ownership structure	Politicians and other politically influential individuals can hide behind corporate shareholders, such as community development corporations and trusts, with unclear beneficiaries. Such vehicles can funnel money and control into more influential private hands.
Holding assets and sending payments offshore	Setting up legal entities in offshore locations can provide other options for moving money to hidden persons and masking lines of benefit and control. Authorities in many banking secrecy and tax haven jurisdictions do not disclose company shareholders, much less beneficial ownership, making it even more difficult for investigators to pinpoint true owners, and for the governments of producing countries to fully assess and collect taxes.
Suspect commercial relationships	Extractive companies can pay their hidden beneficial owners using suspect commercial transactions, such as service contracts that are paid regardless of performance. While such transactions may sometimes more closely resemble simple bribes, they could be proof of hidden beneficial ownership if the recipient also controls the paying company's operations such that he or she can direct the company to make payments.

Table 5.1 OGP Openness in Natural Resources Working Group | Issue Brief | February 2016

It is important to recognize that beneficial ownership can arise long before reaching the stage of production and revenue collection, and thus identifying beneficial owners at the early stages of the sector's development is of ultimate importance.

 **Whose Company is this?**

The task of identifying the beneficial owners of companies is not a simple exercise. Although the EITI seems very clear on the definition, the task of unearthing who “ultimately controls” a company is a complex undertaking. Furthermore, it is not obvious if persons can have control over a company, but not be considered as beneficial owners.

All of these ambiguities validate governments attempts to formulate their own definitions and normalize them according to existing legal frameworks. Good definitions need to be expansive enough to target all loopholes and contained enough not to lead to administrative limitations on both the government and the company. That said, successful definitions of beneficial ownership should as a minimum cover the following:



Ultimate owners or the notion that “ownership” should transcend simple direct legal claims on equity in the company and be able to trace long chains of ownership.

Economic benefit: There are cases where the possession of equity is not a necessary condition for receiving significant economic benefit from the company. Beneficiaries can hide behind indirect relationships or other lines of influence and thus definitions should be coined in a way to take this into account.

Control: There are instances where individuals can have significant influence on the control without necessarily owning any equity.

Beneficial Ownership Disclosure: A Policy to Foster Trust in Governance

It would appear that nearly all undesired repercussions of opaque ownership structures can be boiled down to information asymmetries.

This implies that disclosing the company’s beneficial owners can be a straightforward way of deterring these practices and reducing the risk of contracting a company whose ownership structure makes it prone to them.

Beneficial ownership disclosure is becoming more and more important for extractive countries seeking to improve the governance of the sector. However, whilst the rationale for it is obvious and uncomplicated, the same cannot be said about the application of it.

Given the flexibility of definitions and the multiplicity of evasion methods, setting up a comprehensive legal background for disclosure becomes ever more challenging. This is perhaps why very few countries are so far capable of publicly disclosing ultimate beneficial ownership information for companies.

Furthermore, these challenges persist all along the value chain of the sector, whether upstream, in the extraction and production of oil, or downstream in marketing and selling. Moreover, companies that benefit from puzzling ownership structures are incentivized to always look for “new places to hide,” making them very difficult to unearth.



In a scenario where disclosure is enacted by law and where companies and governments commit to it, publishing beneficial ownership information would prove to be valuable on different levels as well:

- ◆ Multiple oversight actors, whether internal government agencies or external actors in civil society, would improve their performance by relying on this information. This would inherently increase accountability and foster trust in the governance of the sector.
- ◆ Investors in the industry and banks that would rely on the information to better assess the risk associated with their business endeavors.
- ◆ Having a public registry of beneficial ownership would fill knowledge gaps for relevant government agencies, particularly law enforcement personnel, and limit abuses that rely on anonymous covers.

Governments are responsible for designing effective disclosure programs that account for potential loopholes but allow an ease of administration. Beneficial ownership, studies have shown, can help curb corruption and tax evasion, despite the administrative burden involved up front (EITI- Extractive Industry Transparency Initiative, 2015).

In 2016, led by Coordinating Ministry of Economics, Indonesia EITI produced a roadmap to beneficial ownership and hosted international conference on Beneficial Ownership Transparency in Jakarta in 2017. These initiatives have contributed to the adoption of, in early March 2018, a Presidential Regulation on the Implementation of the Know Your Beneficial Owner Principle for the Prevention and Eradication of Criminal Acts of Money Laundering and Terrorism Financing. This regulation sets out the rule that requires Indonesian corporations to state and disclose their beneficial owner(s) to the relevant authority and to update this disclosure at least once every year. Today, more than 50 EITI countries have published their plans for increasing transparency in beneficial ownership by 2020. This includes building the required institutional and legal frameworks, putting in place reporting processes and creating registers to host beneficial ownership data.

The Extract: Beneficial Ownership and Networks of Incorporation, Extractives Hub, April 25th, 2018 <https://extractiveshub.org/servefile/getFile/id/6772>

Box 5.1 New Regulation on Mandatory Disclosure of Beneficial Owners in Indonesia.

Beneficial Ownership in the Oil and Gas Sector in Lebanon

Annex 1 of the Pre-Qualification Application Form pertaining to the Prequalification Decree (Lebanon Petroleum Administration, 2013), requires any company wishing to submit an application to the LPA for assessment of its eligibility to participate in the bidding round to declare the identity of any shareholder who holds above 20% of the total company's shares. In addition, if the submitting company is not the "ultimate parent," it must provide an "organization chart showing chain of ownership."

It is the only legal provision in Lebanon that tackles a partial aspect of beneficial ownership in the petroleum sector at this stage. However, a draft decree on the petroleum register, that is under preparation, will tackle the beneficial ownership, in addition to the draft law on "Strengthening Transparency in the Oil and Gas Sector." On the top of that, with Lebanon's declared intention to join the EITI (EITI,2017), an opportunity emerges to put into practice early on a roadmap for the realization of beneficial ownership best practices in resource wealth management.



Beneficial Ownership

Current Situation in Lebanon:

Annex 1 of the Pre-Qualification Application Form pertaining to the Prequalification Decree requires any company wishing to submit an application to the LPA for assessment of its eligibility to participate in the bidding round to declare the identity of any shareholder who holds above 20% of the total company's shares. It is the only legal provision that tackles a partial aspect of beneficial ownership at this stage.

A petroleum register draft decree tackling beneficial ownership is underway and will supposedly complement the draft law on "Strengthening Transparency in the Oil and Gas Sector".

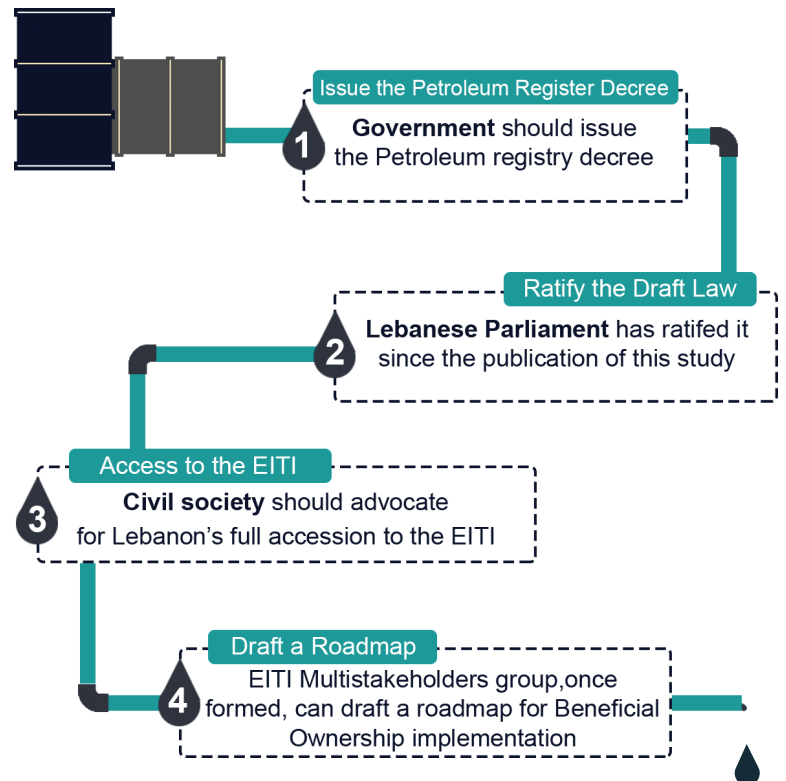
Lebanon's intention to join EITI is an opportunity to put into practice a roadmap for the realization of beneficial ownership.

Recommendations:

The Lebanese government should issue the Petroleum register decree as soon as possible.

The EITI's MSG, once established, should consider drafting a roadmap for the enforcement of beneficial ownership.

The Lebanese parliament should ratify the "Strengthening Transparency in the Oil and Gas Sector" draft law, which will contribute to increasing the transparency of the sector.





Chapter 7

Fiscal Regimes



Chapter 7

Fiscal Regimes

Financial revenues are the most substantial benefits a country receives from the exploitation of its natural resources, making “getting a good deal” – one that is equitable and durable – all the more important. Knowing what a good deal is and designing a fiscal regime is one of the most arduous sector governance tasks. However, like in any business venture, there are costs to be incurred, risks to be borne, and profits to be distributed among stakeholders.

In the case of nascent petroleum sectors, in particular, governments have to interface with private companies to develop their natural resource potentials. With the uncertainties around the profitability of resources available and the high market volatility, as well as the level of technical know-how required, the task of “sharing the pie” becomes more daunting. How are costs and revenues shared among states and companies? What can be said about Lebanon’s fiscal regime?



What is a Fiscal Regime?

A fiscal regime determines how oil and gas revenues are shared between the state and the extractive companies on the basis of a set of fiscal instruments or tools that figure in the contract for exploration and production as agreed by both parties.

The main objective of the fiscal regime is to “define the features of the oil and gas sector and set the main framework for profit sharing of the hydrocarbon wealth between the government and the investors, whose interests diverge more often than they converge”(Nakhle, Lebanon Petroleum Fiscal Regime: Guiding Principles, 2014).

There are numerous factors to take into consideration when establishing the sector’s fiscal regime, all of which should be assessed in the larger context of the state’s interests and the company’s needs. Indeed, the fiscal regime should be designed in a way that allows the state to capture the maximum revenue possible while simultaneously attract investment.



Two essential players in the hydrocarbons industry are governments and investors. Given their mandates and agendas, these often have diverging if not rival interests. While companies strive to secure predictable and profitable ventures in the sector, governments seek to maximize their take from resource revenue. This underlines the importance of a solid fiscal regime capable of striking a balance between maximizing the government's shares of revenues, while simultaneously fostering sustainable investment in exploration and production for the investor.

As touched upon previously, the state allocates hydrocarbons rights by signing contracts that determine all aspects of the relationship between state and extractive company. The fiscal regime determines the character of this relationship as it lays the foundations for making the development of the sector, a beneficial endeavor for both parties. In the context of political, geological, and commercial uncertainties realities, contracts are prominent when it comes to splitting cost and profit and balancing risk and reward.

Concessionary and Contractual Regimes

As shown in the figure below, there are two types of agreements under a contractual fiscal regime each stipulating a distinct allocation of costs and returns.

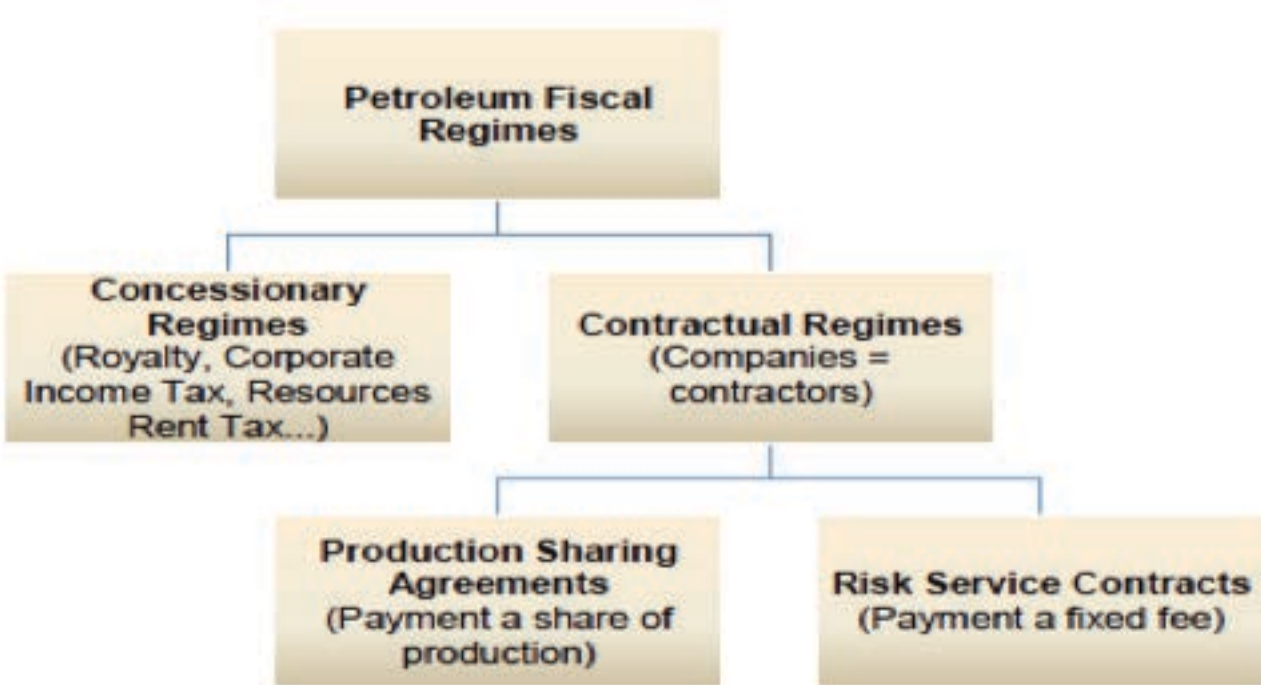


Figure 6.1 Types of Fiscal Regimes



Each of these regimes depicts a certain fiscal relationship between the state and the investor:

Within the framework of **concessionary regimes**, the company owns the resources in the ground, whether offshore or onshore. The government licenses a company to explore and develop resources in a given geographic area. The company bears all the costs of exploration, development, and production, and holds the rights to the resources. The government typically receives a royalty and other fees, bonuses and taxes on the basis of the contract when petroleum is sold. Australia, Canada, Norway, and the UK all operate concessionary regimes.

With **contractual regimes**, the state owns the resources and contracts the company to develop the sector. The company recovers costs and shares the profit gradually with the government according to an agreed revenue sharing formula. Such a format is called a Production Sharing Contract (PSC). This type of contract has become popular worldwide and has been used in Angola, Azerbaijan, Iraq, and Nigeria in particular.

In the case of **technical service agreements**, the contractor receives a fee for extracting the resource. The government retains control of the resources and the company provides technical services in the form of exploration work, construction, and management of the development process. Remuneration is not based on production, but on activities, such as man-hours rendered by the contractor.

That said, it has become increasingly difficult to determine in a clear-cut manner a country's specific fiscal regime. Today, states increasingly rely on hybrid fiscal arrangements that borrow features from the various models explained above, mainly a mixture between concession and production sharing agreement in a way that better suits their local context and the strategy they set for the sector as a whole. The revenue sharing schema becomes mainly composed of royalty, taxes, and a share of the production.



Royalty for Concession or Contracts?

In concessionary regimes, a royalty theoretically serves as compensation for the transfer of ownership of the oil produced. In practice, however, royalty is perceived as a way for the state to secure an early and relatively predictable flow of revenues. Consequently, many PSCs around the world have a sturdy royalty component, even though governments still hold full production ownership rights (Nakhle, Lebanon Petroleum Fiscal Regime: Guiding Principles, 2014)

Box 6.1 Royalty for Concession or Contracts

Fiscal Regime in the Lebanese Petroleum Sector

The question that immediately comes to mind when talking about Lebanon's oil and gas sector is "how much money Lebanon will make?" Understanding the fiscal regime that governs this sector provides answers to the questions of who pays what and to whom.

The legal framework in Lebanon reveals helps us understand certain features of the fiscal regime adopted in the sector.

As stipulated by the OPRL, the state retains ownership of the resources (OPRL Article 4, Article 6). The extractive company undertakes petroleum activities at its own risk and expense (OPRL Article 43.5). Once production begins, the state receives a "royalty" from the total amount produced (OPRL Article 42). The state receives a share of the company's profit (after production costs are deduced) (OPRL Article 44). The company is also subject to taxes including a corporate income tax, and the state retains the right to participate in commercial activities (OPRL Article 45).

To sum up, the Lebanese fiscal regime includes: a royalty, cost recovery, production sharing between the government and the company extracting the resource, income tax on the company's share. Although the OPRL stipulates a production sharing fiscal regime, the above describes elements of both production sharing (cost oil, profit oil) and concession (royalty and income tax).

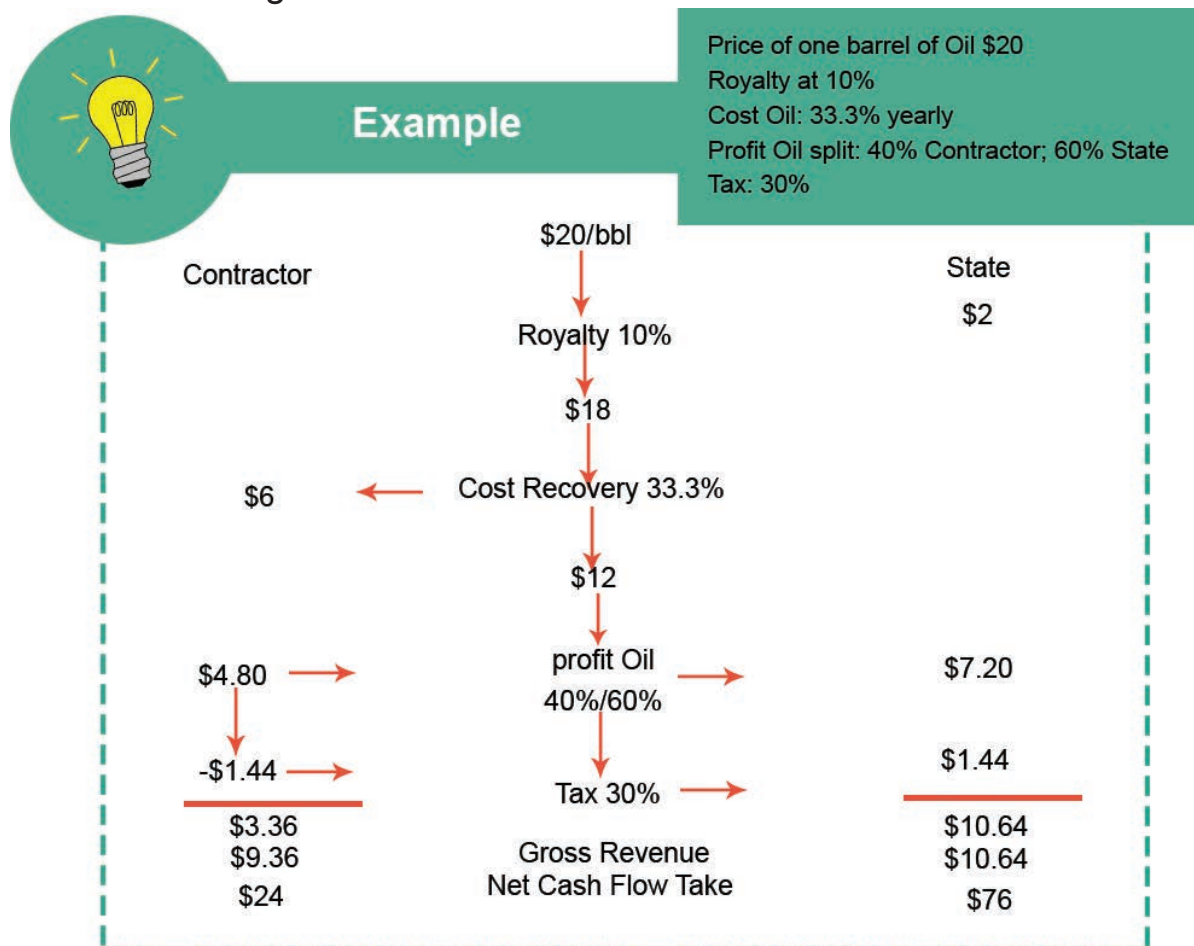
The table below explains these fiscal tools in more detail:

Royalties	These represent a payment made to the state from the gross value of production before accounting for production costs. Royalties are a fiscal tool that ensures the government a revenue stream from the beginning of production. Royalties are related more to production rather than profit. This means that the government gets its share of the oil, regardless of the profitability of the project, which makes the company more susceptible to the risk of price volatility.
Corporate income taxes	Taxes are measured as a percentage of the net profits of a project after costs are deducted. Here, governments take on certain risks, as the size of their shares depends on the size of the profit.
Production sharing	The production of oil and gas is shared between the private investor and the state according to a certain formula. This arrangement allows for the company to recover costs first (with a certain yearly ceiling,) and then the remaining profit oil (with a certain yearly minimum) is shared with the state, usually according to a sliding scale.
State equity participation	A state may purchase or negotiate shares in an extractive project. Such participation may entail may increase the state's share of risks and costs as well.

Table 6.1 Fiscal Tools, Lebanon's Petroleum Sector

N.B: OPRL preserves state participation, however, for the First Offshore Licensing Round, the Lebanese Government took the decision of not to participate.

Below is an illustrative simple example outlining the fiscal regime in Lebanon based on the following characteristics:



Box 6.2 Application on the Lebanese Fiscal Regime for the Petroleum Sector

Consider that the market price for a barrel of oil is at \$20, out of which the state receives \$2 as a 10 % royalty. From the remaining \$18, \$6 are deducted for cost recovery (33.3%) leaving a \$12 profit to be shared by the state and the company, according to a 60%/40% split. This means that the state receives a total of \$9.20: \$7.20 as profit and \$2 as royalty. The company receives \$6 for cost recovery and \$4.80 as profit. The company pays \$1.44 as 30% tax to the state. This leaves the state with a total share of \$10.64 and the company with a total of \$9.36 from the initial \$20.

With a combination of fiscal tools, it becomes difficult to talk about one fiscal regime but rather a fiscal arrangement composed of a wide array of fiscal instruments. This is reflective of the international trend in fiscal engineering, especially in the extractives sector, with fiscal systems becoming more and more hybrid.

In the end, these classifications, although very important to the “who gets what” issue, should not divert attention from the overall question of how they are implemented when it comes to “splitting the pie.” This is why, when comparing fiscal regimes, it is important to look at the overall government versus company take as opposed to comparing each instrument on its own.

The fiscal regime in the Lebanese petroleum sector can thus be represented as follows (Lebanese Petroleum Administration, 2017.)

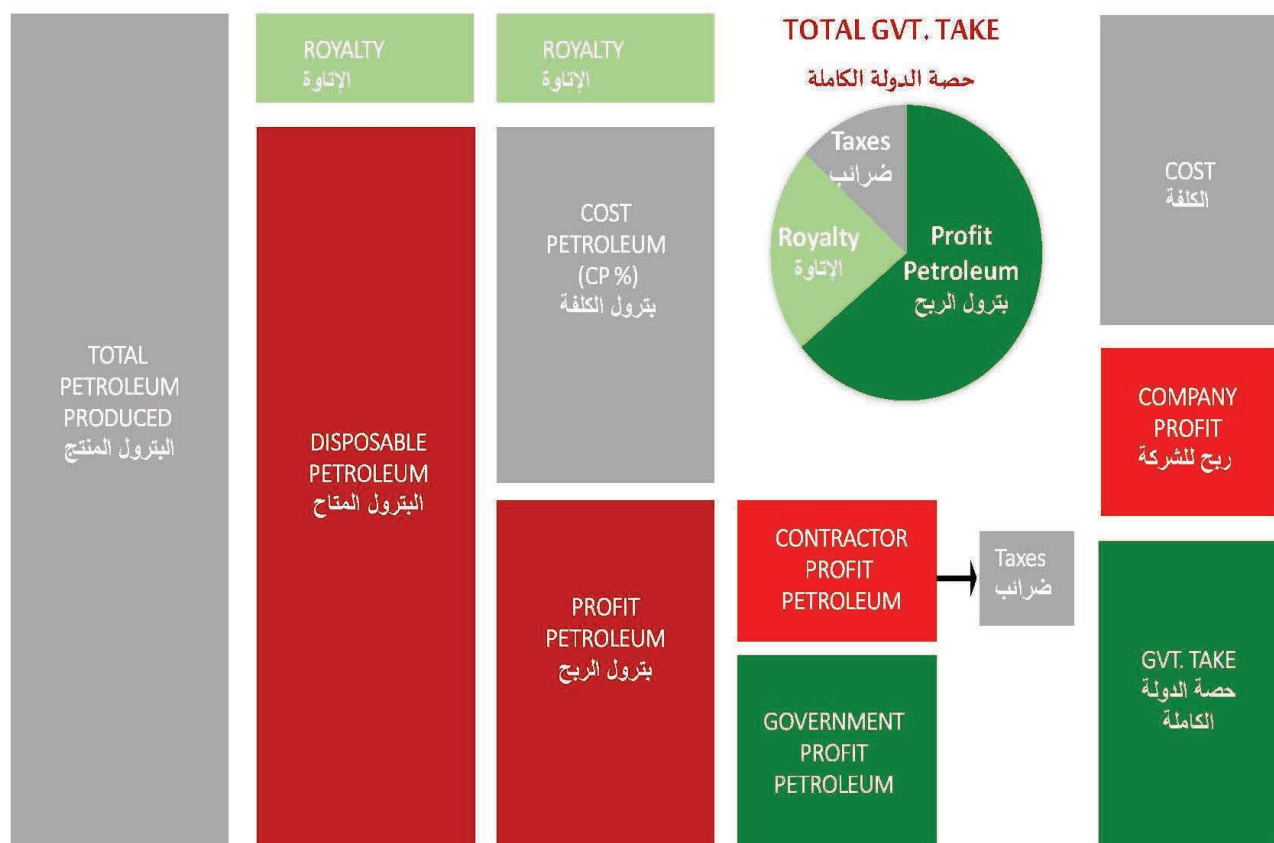


Figure 6.2 Lebanese Fiscal Regime Explained - LPA

The proper utilization of these tools requires careful auditing and controls and well- pronounced regulations. With the risks and uncertainties associated with the sector, and the fiscal regime’s role in allaying these concerns for both the investors and the state, transparency becomes the best insurance policy for both parties.

Fiscal Regime Tools in Lebanon

According to the Production and Exploration agreement recently signed with the winning consortium and published by the MoEW, the government’s take is calculated as follows:

Royalty: the state receives royalty on oil, and royalty and on gas. Natural gas royalty is calculated based on fixed a rate of 4 percent. Meaning that the state receives 4 percent of the gas produced. Crude oil royalty, on the other hand, depends on the number of produced barrels per day. It is calculated based on a sliding scale, or in more simpler term, a rate that varies as the production increases. The sliding scale is explained in table 6.2 below:

Royalty Rate for Crude Oil

Production Rate (number produced of barrels per day)	Royalty Rate
0 to 15,000	5%
15,001 to 25,000	6%
25,001 to 50,000	7%
50,001 to 75,000	8%
75,001 to 100,000	10%
Above 100,000	12%

Table 6.2 Royalty Rate for Crude Oil

N.B: as stipulated by the OPRL, the state has the right to collect its entitlements to royalty either in cash or in kind proportionally as extracted in the form of liquid petroleum and gaseous petroleum.



Cost recovery:

After deducting royalties, the company covers a part of its cost using what cost recovery or the limit in percentage of gross production (minus royalty) each quarter. As per the EPA the cost petroleum ceiling shall not exceed the limit of 65% of disposable petroleum and it is a biddable parameter. In this step, the company profits and recovers a part of its investment.

The contract between the consortium of Total, Eni, and Novatek signed in January 2018 specifies the cost ceiling to be lesser than 60% in block 4 and lesser than 65% in block 9 (Lebanese Petroleum Administration, 2017).

Production sharing:

Profit oil is what remains after deducting government royalty and recovering some of the company's cost. Profit-oil is shared between the government and the company through the production sharing nature of the exploration and production agreement. The EPA, ensures a minimum of 30% for the state's share and assesses the company's share by subtracting the government's take from the profit since it is not a pre-determined rate (100%- State Share). In Lebanon, as per the EPA, the state's share ranges between 30% and 55% in block 4 and 30% to 40% in block 9. This variation is based on a calculation method in function of the "R-factor."

The R-factor can be simplified in the formula below:

$$\text{R-factor} = \frac{\text{Cumulative net revenues}}{\text{Exploration and development}}$$

This means that when:

R>1 => revenues exceed expenses,

R<1 => revenues are less than expenses.

R-Factor	State Share	Right Holder Share
Less than or equal to 1	30%	70%
Greater than 1 and less than 2.5	30%+ 16.67(R-1)	100% - State Portion
Greater than or equal to 2.5	55%	45%

Table 6.3 Production sharing between state and right holder according to R-Factor

Income tax:

As per the law for tax provisions related to petroleum activities signed in September 2017, right holders and operators are subject to a tax rate of 20% of the taxable result. The government's take from tax is therefore equal to 20 % of the company's share of profit oil, after royalty cost, and government's profit oil are deducted.

💧 A Balance Between Different Types of Fiscal Tools

As shown in figure IV, the Consortium is the main bearer of costs as it is bound by a production sharing agreement to undertake hydrocarbon activities at its own expense. The figure above represents this. We can see that although the state does not receive significant revenues before production starts (which might take around 8-10 years), it does not undergo an expense. And if there is a commercial discovery, the state will not be responsible for recovering the exploration cost for the consortium.

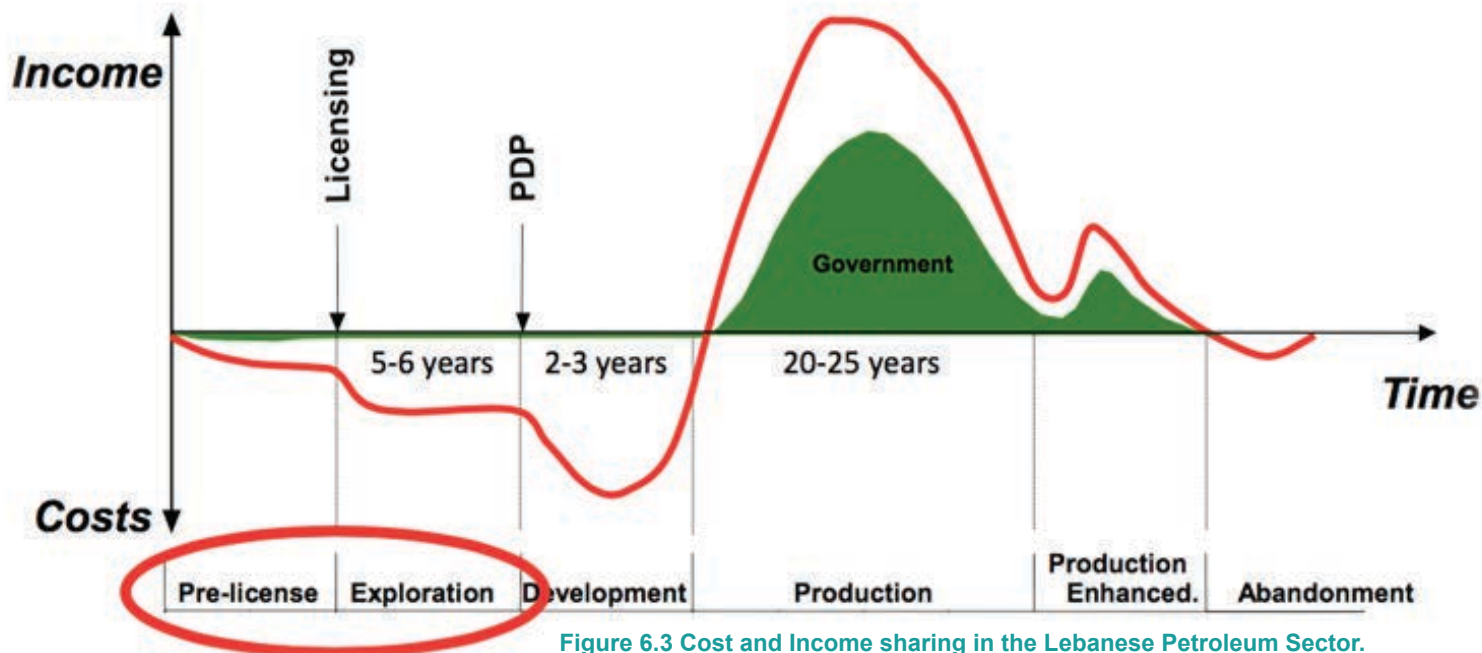


Figure 6.3 Cost and Income sharing in the Lebanese Petroleum Sector.

In practice, the fiscal tools are affected differently by the variation in market profitability of the sector. In other words, the market value of the resources extracted depends on many uncontrollable and unpredictable factors such as price volatility, political security, market demand on extracted resources, among others. With some of these tools assessed on the basis of market value and others size of production, there is a great deal of variation in their impact on the size of the shares.

Three categories of tools have been evaluated on the basis of their impact on government's shares given variations in profitability (Natural Resource Governance Institute, 2015):

- 💧 Neutral fiscal tools that yield the same revenue for the state regardless of whether profitability increases or decreases.
- 💧 Progressive fiscal tools that allow the government's share to increase when the profitability increases (and vice versa).
- 💧 Regressive fiscal tools that provide the government with a smaller share as profitability increases.

Depending on the desired outcome and the local context in the country, these tools can be very beneficial. For instance, neutral and regressive tools assure steady streams of revenue for the state, which facilitate auditing and economic planning especially in light of the exhaustibility of resources. However, because they are less sensitive to cost increases, they can be discouraging for investors. Progressive fiscal tools, on the other hand, are perceived favorably by the companies as they provide financial protection in periods of low profitability. It is important to highlight that progressive tools are very beneficial for the government as well, as they allow it to capture greater revenue when profitability increases. However, the enforcement of these tools is often more challenging as it is associated with careful auditing of costs and an accurate calculation of prospects.

Based on the explanations provided so far, it would appear that this fiscal regime relies on a diverse set of tools each responding to changes in market profitability (Natural Resource Governance Institute, 2015). The table below shows how these tools impact government's share in light of these changes:

Royalty	Regressive
Corporate Income Tax	Neutral – Progressive
Production Sharing (R-factor)	Progressive

Table 6.4 Impact of different fiscal tools on government's share in light of changes in market profitability.

A good fiscal regime is one that allows the state to minimize its share of risks and costs and maximize its share of revenue, while simultaneously appearing attractive for extractive companies, and adjusting for changes in the market. It would appear that the fiscal regime in Lebanon was designed in a way to meet these criteria. However, whilst the government's take seems promising, one should keep in mind that these revenue prospects depend on a number of factors including the likelihood of striking a commercial discovery and the real size of commercial reserves. Furthermore, the complexity of the fiscal regime's design requires robust systems of implementation and oversight.



Fiscal Regime

Current Situation in Lebanon:

Lebanon’s fiscal regime includes royalties, cost recovery, and production sharing between government and extractive company, plus income tax on the company’s share.

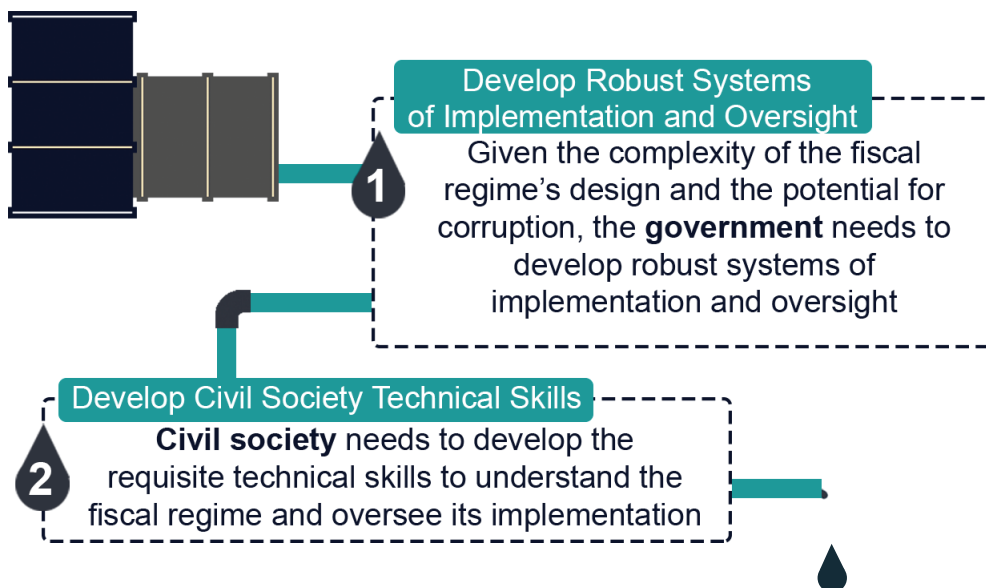
With a combination of fiscal tools, one refers to, not one fiscal regime, but a fiscal arrangement composed of a wide array of fiscal instruments, similarly to many countries worldwide.

The fiscal regime in Lebanon was designed to allow the state to minimize its share of risks and costs and maximize its share of revenues, while simultaneously appearing attractive for extractive companies, and adjusting for changes in the market.

Recommendations:

Given the complexity of the fiscal regime’s design and the potential for leakages, the Lebanese government needs to develop robust systems of implementation and oversight.

Civil society needs to develop the requisite technical skills to understand the fiscal regime and oversee its implementation.





Chapter 8

Natural Resource Funds



Chapter 8

Natural Resource Funds

With large amounts of resources at their disposal, sovereign wealth funds have captured the imagination of investment professionals and the public's imagination. Natural resource funds held approximately 4 trillion of assets in July 2014, (Natural Resource Governance Institute, 2018) and more often than not, natural resource funds have been used as slush funds enabling patronage and corruption

The Kuwait Investment Authority (KIA) was the first SWF established in 1953. Abu Dhabi followed with the Abu Dhabi Investment Authority (ADIA) in 1976, Singapore, with Government of Singapore Investment Corporation (GIC) in 1981, and Norway, with the Government Pension Fund of Norway, also known as the "Oil Fund" in 1990. Over the last few decades the size and number of SWFs have increased dramatically. ADIA, for example, manages \$828 billion in assets, making it one of the richest in the world (CNBC, 2017).

Article 3 of the Lebanese Offshore Petroleum Resource Law explicitly stipulates the establishment of a sovereign wealth leaving the "statute regulating the Fund, the rules for its specific management the principles of investment and use of proceeds to be regulated by a specific law."

Today, a proposed draft of the Lebanese SWF Bill has been submitted to the Lebanese parliament for review. What are good governance practices Lebanon should consider when evaluating this draft law?



What Are Natural Resource Funds?

As of 2017, there were approximately 60 sovereign wealth funds around the world. These funds, commonly established from balance of payment surpluses, are generally perceived as a revenue management tool aimed at containing resource revenue volatility (Bauer & Toledano, 2014). This globally popular investment mechanism has grown largely in number and size, and increasingly imposes itself as a powerful player in the international financial arena. Norway sits on the largest sovereign wealth fund in the world, recently exceeding the one \$1trillion threshold, with investments in over 9000 companies including Apple and Microsoft according to the Sovereign Wealth Fund Institute.



Simply put, this strategy can be understood as governments “putting money into a different account,” rather than putting it straight into the budget. This account has separate institutional arrangement and is not included in the annual budget law. This is mainly why SWFs can also be referred to “extra budgetary funds.” These funds can have different sources of revenue. Those that are particularly financed by revenue generated from natural resources are referred to as Natural Resource Funds or NRFs.

Ideally, NRFs would provide “safe storage” for money generated from the sector and foster the adequate usage of it later on.

NRFs are composed of:

1. The fund’s objective
2. The fiscal rules
3. The investment rules
4. The institutional structure

Establishing an effective NRF depends on the integration of good governance standards in design and implementation. This calls upon another dimension of institutional enablement. Even the best of rules may not ensure governmental compliance in their application if not sustained by a process that generates a broad political consensus and aligns all stakeholders into a common scheme for revenue management.

The objective of an NRF refers to its modus operandi. Objectives can encompass:

Stabilization: Governments attempt to stabilize their budgets by receiving deposits when oil prices are high, and supporting the budget when prices are low. Funds in that line of objectives resemble air conditioners in their utility. When temperature is high, you can simply turn it on to adjust the ambiance in the room. Similarly, governments use NRFs to regulate the “ambiance” in the market, depending on how prices fluctuate. This explains why resource-rich states in the U.S. like Wyoming depict positive growth even when oil prices are relatively low.

Saving: This is mainly as a preventative measure to help accommodate governments when resources are depleted and resource revenues are no longer available. This makes the development of the sector a beneficial project for the economy even beyond the life of the sector. There are also cases where the economy is not yet ready to absorb the spending of these revenues. Governments choose to “freeze” these revenues until the timing is economically right for spending. Timor-Leste, for instance saves revenues in the fund as it does not possess the economic and managerial capacities to sustain big expenditures.



Mitigating Dutch disease: By saving a portion of resource revenues in foreign assets, governments aim to moderate inflation and local currency devaluation, that are often due to the abrupt boom in the natural resource sector. Countries such as Norway and Saudi Arabia have managed to control their local currency exchange rates and contain inflation by relying on funds that store assets in foreign currency.

Reserving for public investment: This approach is a way to guarantee financing for development projects that governments have been having a hard time financing. Examples of such practice include Ghana's legal insistence that oil revenues must be spent on "development-related expenditures." This allows for more transparency on the management of revenues as funds allow for expenditure to occur on specified projects.

Ring fencing: This involves protecting the revenues against corruption or mismanagement by imposing strong measures of transparency and public scrutiny. It is only possible when funds are governed by strict measures of disclosures and monitored by strong institutions. Without these conditions funds, can easily go in the opposite direction as they give public officials an easy way to escape governmental oversight and foster personal interests.

Assuring political leverage and autonomy: Governments gain autonomy and political leverage locally and internationally, by not having to rely on private banks and international financial institutions during times of economic distress. The fund thus acts as a self-lending mechanism that the government puts in place for its rainy days to come. In Northwest Canada, the recently established Heritage Fund is thought to give the territorial government more political autonomy from the Canadian Federal government.

In general, governments are strongly urged to crystalize the SWF's objective to ensure that the fiscal and investment rules are tailored appropriately. Chile, Ghana, Kazakhstan, Russia, and Trinidad and Tobago are examples of countries in which funds have explicit and clearly stated objectives. However, strong objective statements are not enough for funds to achieve their objectives. The Canadian province of Alberta's Heritage Savings Trust Fund for instance, was not able to save for a 25-year period, in spite of its clear objective statement to do so. Some governments like that of Azerbaijan, and Russia, simply resist even the most basic rules, leaving the funds at risk of not fulfilling the objectives they were designed for.



Fiscal Rules

Fiscal rules command the yearly movement of money in and out of the fund. In other words, they specify how much a government deposits into and withdraws from the fund each year. These rules should be designed in a way that enables the overall fund objective and not the opposite. Deposit rules, for instance, should accommodate the revenue streams (bonuses, royalties, and profit oil), and withdrawal rules should specify the conditions for withdrawals to be made.

Fiscal rules contribute greatly to the success of NRFs in meeting their policy objectives. These rules ensure a long-term strategy for achieving these objectives as they bind successive governments to one vision of public finances. This means that, even when new officials come to power, NRFs would remain under one financial management. Fiscal rules, and exceptions to these should be embedded in the legal framework governing the sector to ensure enforcement. When such clarity is lacking, serious risks arise. That is because when rules fail to clearly state what is allowed and what is not, they become subject to manipulative interpretation and discretionary behavior that stimulates lavish spending and mismanagement. The lack of withdrawal rules⁵ in Azerbaijan are a clear example of that. Again, the lack of a deposit rule of Alberta Heritage Savings Trust Fund (Canada) undermined the fund's ability to save for 25 years.

While the experience of other countries such as Chile, Ghana, and Trinidad can be very beneficial when determining the fund's fiscal regime, it is important to keep in mind that this is not a "one size fits all" scenario. Local context should be the main arbitrator in determining the fiscal design. Guided by the fund's policy objective and supported by broad and sustainable political consensus, fiscal rules should be well reflective of the country's socio-economic setting as well. In Timor-Leste for instance, spending has exceeded fiscal limits nearly every year since 2010, and this can be attributed to an overly restraining rule for a country.

5. Rules that determine and limit the amounts to be withdrawn from the fund.



Investment Rules:

These rules dictate how, where, and when SWFs deposits should be invested. As it is the case with any investment, these decisions mirror a balance between risk and reward that should be established on the basis of the fund's objective and not at its expense. Investment rules have to be in line with fiscal rules as well.

For example, money in a stabilization fund is held in a way that allows for short term liquidity, which may be needed to fill budget gaps in the short term.

If a government chooses to establish a fund for stabilization purposes, it would need to withdraw money to fill budget gaps when resource prices are low. With the fluctuation of prices being very unpredictable, fiscal rules need to allow for frequent withdrawal of money, and investment rule have to ensure that the money is easily accessible when such withdrawal needs to happen.

Public disclosure of fund-owned assets (e.g., real estate, stocks, bonds, etc) is very important as it limits high-risk investments and impedes obscure endeavors (the Alaska Permanent Fund [USA] is an example along these lines). When investment rules are not tailored in a way to avoid high-risk, funds are prone to undergo severe losses. The KIA for instance, suffered from a \$5 billion loss inflicted by poor investments choices mainly attributes to a weak system of oversight and a loose set of investment rules.

The Structure of the NRF:

This aspect determines who are the actors responsible for decision-making about the fund.

These responsibilities can be aligned along three main levels:

- ◆ Ultimate authority sits at the top of the decision-making pyramid, approves deposits and withdrawals, appoints a fund manager, and regulates its decisions.
- ◆ Fund manager sets investment guidelines and deposits and withdraws money from the fund.
- ◆ Operational manager is responsible for daily operations, advises on investment guidelines, chooses and supervises external managers, and reports on fund activities.



It is imperative that the fund's structure is designed to take into account comprehensiveness but also clarity of roles. Ambiguity on roles and responsibilities raises serious management challenges and renders the fund susceptible to corruption and nepotism. The fund's structural architecture should pay particular attention to strong mechanisms for oversight and accountability and ensure transparency and disclosure. This is all-the-more crucial for ensuring that the fund's functioning responds to its structural design.

Norway and Texas (USA) are examples of NRFs that are constructed on the basis of solid internal controls, ensured by regular and publicly available internal audits, ethical guidelines for employees, effective mechanisms of monitoring and accountability.

Countries vary greatly in how they have designed these different components. However, no matter how cleverly designed, for SWFs to be effective, they should be based on good governance standards.

NRFs Good Governance Elements

It is not always the case that NRFs fulfill their purpose of protecting oil revenues. There are many world examples of SWFs that were self-defeating and ended-up accentuating the challenges inflicted by the sector, rather than alleviating them. This is essentially why, there is an important need for good governance considerations. Transparency is of particular importance for good fund governance as it stimulates compliance with fiscal and investment rules by aligning public expectations with the fund's objectives.

Opacity on the other hand, is detrimental to fund as much as it is to the sector in general, as it fertilizes the seeds of corruption and patronage. There are funds in places like Botswana, Equatorial Guinea, Iran, Kuwait, Mexico, Russia and Qatar that remain relatively opaque despite their governments attempts towards better performance in that regard. That is because pledging transparency is not enough to become "transparent". Strong mechanisms for checks and balances should be instilled to make sure that public acts mirror public pledges.

Due to lack of strong measures of transparency and oversight, the Libyan Investment Authority for instance lost around \$1.2 billion in the aftermath of the 2008 financial crisis. On the other hand, Alberta (Canada), Ghana and North Dakota (USA) are examples of countries where transparency and accountability are strongly enforced and contribute greatly in the Fund's successful management of resource revenue.



Key Elements of NRFs Good Governance Practices

1- A clear policy objective

2- Appropriate fiscal rules with adequate clear investment constraints and the estimations on which these rules were based

3- An effective institutional structure

4- Strong independent oversight bodies

5- High degrees of transparency on: When or how often reports are published, who is responsible for publishing fund reports, the size of the funds, deposit and withdrawal amounts, Returns on investments, detailed asset allocations

Box 7.1 Key Elements of NRFs Good Governance Practices

NRFs Good Governance in Practice

The Resource Governance Index (RGI) evaluated 33 sovereign wealth funds (SWFs) that collectively manage at least USD 3.3 trillion dollars in assets. The index shows that Colombia operates the top performing fund. Funds operated by countries like Ghana and Timor-Leste also make it to the top 6 best governed funds list of that index (Natural Resource Governance Institute, 2017). Surprisingly the index depicts that the sovereign wealth funds of Chile, Colombia and Ghana perform better than those of Canada and Norway. Metrics in the index classify 11 funds as failing including the United Arab Emirates' Abu Dhabi Investment Authority, the second-largest fund assessed in the index. These funds have simultaneously suffered the most from excessive risk-taking, high management fees and politically motivated investments. Furthermore, the opacity prevailing around other funds such as those in Algeria, Angola, Chad, Equatorial Guinea, Gabon, acts as a barrier to information rendering it impossible to know how much may be lost to mismanagement—or who benefits from these funds' investments.

Lebanon's Sovereign Wealth Fund

In November 2017, MPs Yassine Jaber and Anouar El Khalil submitted a draft law to the parliament for the establishment of a SWF in Lebanon (Lebanese Oil and Gas Initiative-LOGI, 2018). Similarly, to the process pertaining to the creation of a NOC, the draft law took a fast route legislative track, which led to reactions among civil society actors about the rashness of the process, and the absence of public consultation related to a subject that concerns every citizen, such as, how are revenues generated by the hydrocarbon sector going to be spent.

LOGI has drafted a brief analysis about the provisions of the Law (Lebanese Oil and Gas Initiative, 2018), pinpointing several loopholes in that regard, mainly about the good governance measures embedded in the draft law. Below are the main points highlighted by the analysis:

1. The fund objective: The proposed draft law suggests the establishment both a savings account and a development account. The latter is designed to reduce the public debt level, and eventually contribute to financing part of the public expenditures.
2. The fiscal regime: The fund receives deposits under the Saving account through the revenues generated by royalties and production sharing. Withdrawal for a specific purpose from the Saving account needs parliamentary approval, and budget deficit compensation from the Development account depends on the Treasury's ability to sustain debt from "non-petroleum revenue". The Development account receives deposit from the Petroleum Activities Taxes, and revenues in this account may be used to sustain public debt denominated in foreign currency, in order to alleviate pressure on the national budget, without insinuating to any debt ceiling policy.
3. The investment rules: The draft law prevents the fund from investing in financial derivatives, except in certain circumstances, but that is the extent of its control on asset allocation. The proposed law is evidently lacking in this area, especially when it comes to specifying the types of investments allowed (or types of asset purchases, e.g., real estate; below investment-grade shares). Alarming, the law is completely silent on details regarding limits on management fees, as well as selection and monitoring of external managers, and appears to be very loose on standards for conflict of interest and penalties for misconduct.
4. The fund structure: The bill lays down a very basic engineering of the fund's institutional structure that should be developed with more refined detail on roles and responsibilities, as well as on the oversight apparatus.



Also, the draft law does not clearly spell out several controls, especially with regards to external auditing, and transparency obligations.

With the inexistence of a clear fiscal governmental policy aiming at managing and reducing the high public debt level, and the less likely probability to start generating revenues from the sector in the near future (not before 8 to 10 years) what becomes more needed than an all-encompassing revisiting of the bill, is mainly and primarily, caution and prudence in the government's approach to SWFs. Parliament seems to be unconventionally ahead of schedule and the legal endeavor seems to be all in all premature.

Clearly, it is highly challenging to elaborate a document that would explain the rationale of the draft law, since many of the economic justifications depend on the long term economic policy of the government, and those are still inexistent, and would need consensus in order to be sustainable. On the top of that, it is still extremely difficult to predict the amount of the potential revenues that could come out from the sector, making the task of defining suitable objectives for the fund risky and inefficient.

Similarly, to the NOC, the fast track process the draft law review took raises concerns especially that the subject matter needs substantial analysis and information related to the economic vision and strategy of the Lebanese state, that is still lacking.

Without delving again into the importance of stakeholders' engagement, public consultation, similar to Ghana for instance, represent an opportunity to seize, especially with the ample of existing time before the need for a SWF.

Creating an SWF should be a well-thought-out, gradually maturing process that manages expectations, and allows for mitigation of sector revenue volatility. In a Q&A conducted by the executive on SWFs, Vidar Ovesen, a Norwegian consultant on petroleum revenue management, on the basics of timing, design, and fund management warned:

Starting the planning for an SWF too early has, in some cases, raised unrealistic and overly optimistic expectations, which have resulted in increased public spending, rent-seeking, and loss of attention to other economic sectors that might be even more important for the country's long-term economic development (Arbid, 2018).



In addition, because the very nature of the oil and gas industry, there will be a certain time lag before state revenues flow. Currently, the Lebanese government has only two sources of revenue from the sector: (1) the application fees paid by companies to participate in the first offshore licensing round; and (2) the sales of seismic data to interested companies (Lebanese Oil and Gas Initiative, 2017).

Participants in a workshop organized by LOGI around its report on “Transparency and Accountability in Lebanon’s Petroleum Legislation” clarified that these revenues are deposited in a Central Bank account under the authority of Minister of Energy and Water, and the Director of Tripoli and Zahrani Facilities (Lebanese Oil and Gas Initiative, 2017).

These revenues have attracted a lot of questions especially about the amount collected so far, and whether it is to be considered as seed money arising from oil and gas activities and consequently, whether it will be reallocated to the sovereign wealth fund as stipulated by Article 3.2 of the OPRL or whether it will be subject to use by the state and, in such a case, on what basis.

“I don’t think these are questions you should ask [].. Am I allowed to ask you how much money you have in your bank account?” this is how former Minister of Energy and Water Arthur Nazarian answered the Executive Magazine in a 2015 interview on the subject matter. (Nash, 2015) Despite the government’s declared desire to uphold transparent practices in the management of the sector, there is yet to be an official and explicit answer that directly alleviates these legitimate concerns.

Although Minister Nazarian does not consider this information to be public (Nash, 2015) it is precisely in the interest of transparency that these revenues - should not escape the eye of the monitor. To that end, financial statements pertaining to streams from application fees, and sales of seismic data should be published on annual basis. The fundamental question at stake therefore is the following:

How does the Lebanese State classify these revenue streams? Are those considered as generated from oil and activities? Should those constitute seed funds for a SWF?



Natural Resource Funds

Current Situation in Lebanon:

Good governance of NRFs requires a clear policy objective, appropriate fiscal rules, adequate clear investment constraints, an effective institutional structure; strong independent oversight bodies; and high degrees of transparency.

Currently, the Lebanese government has two sources of revenue from the sector: (1) the application fees paid by companies to participate in the first offshore licensing round; and (2) the sales of seismic data to interested companies. Those revenues are deposited in a Central Bank account under the authority of Minister of Energy and Water, and the Director of Tripoli and Zahrani Facilities.

In November 2017, MPs Yassine Jaber and Anouar El Khalil submitted a draft law to the parliament for the establishment of a Sovereign Wealth Fund in Lebanon (LSWF). The draft law took a fast route legislative track after the creation of a joint parliamentary committee to discuss and review the law.

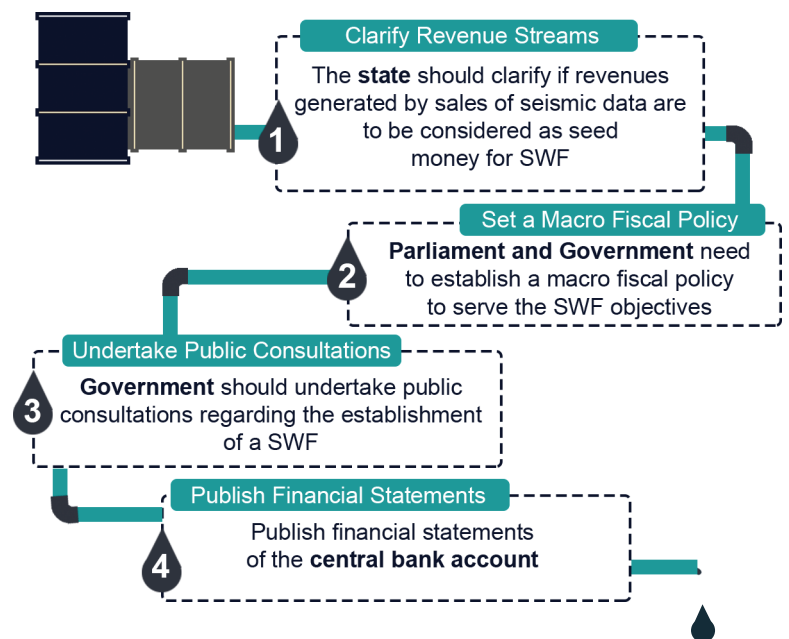
Recommendations:

The government needs to elaborate a macro fiscal strategy and a national development plan to serve as the basis for SWF objectives in the draft law.

The government should seek to undertake public consultations and stakeholder engagement for the establishment of a SWF, and should carefully account for loopholes that may instigate a “Presource Curse” scenario.

The Lebanese state should classify the revenue streams already generated from application fees and seismic data sales and clarify if those revenues should be considered as a seed money for the SWF.

Financial statements pertaining to those revenue streams should be published on annual basis.





Chapter 9

National Oil Companies



Chapter 9

National Oil Companies

A national oil company (NOC) is an oil and gas company fully or majoritarily owned by a national government. While companies like British Petroleum (BP), Total, and Shell are referred to as international oil companies (IOCs) and primarily owned by private entities, state-owned enterprises, such as Sonangoil, Petrovietnam, GNPC (Ghana National Petroleum Corporation), and Saudi Aramco, are entrusted with 90% of the world's oil reserves.

The rationale behind establishing NOCs is linked to the desire to improve the state's governance of the sector and its ability to exercise oversight over other private companies involved in the sector, in addition to increasing the state's share of earnings. Strong NOCs can be the conduit of technological and operational expertise into the country whilst protecting their nation's wealth. NOCs with an extensive reach include Malaysia's Petronas for example, is active throughout Africa and Asia and has a global footprint that equals any large IOC. PetroChina and Sinopec are also very influential around the world (Natural Resource Governance Institute, 2015).

Establishing NOCs seems prevalent when the extractives sector is still at infancy and with local competences and experiences often inexistent. Governments, in this moment, tend to rely on international expertise, but then establish NOCs in order to retain ownership of the resources, create an additional source of resource revenue for the state, and particularly, working towards autonomy in management rather than dependence on international oil companies.

NOCs today represent world's largest energy producers: combined oil and gas production figures in 2014 show that 15 of the world's 20 biggest energy producing companies are state owned (Carpenter, 2015). With a significant number of oil-producing countries seeking to nationalize their production activities, new discoveries, such as in São Tomé e Príncipe and Sierra Leone, continue to raise the question of whether to nationalize.

In November 2017, MPs Michel Moussa and Ali Osseiran submitted a draft law for the establishment of a Lebanese NOC. This draft law made the NOC a topic important enough to address in this report, although some would argue it is premature to consider an NOC in Lebanon's context. But what are NOCs? What are the different functions they assume in the sector? What can be learned from existing NOC models? What can be said about the draft NOC law?



Roles of National Oil Companies

With the NOC model significantly present across oil producing countries, NOCs today have a wide spectrum of functions and roles (Natural Resource Governance Institute, 2015).

A. NOCs can play a commercial role and participate in the sector as business players and take on revenue generating activities. However, whilst certain NOCs under take a narrow scope of commercial activities, others act like a traditional extraction company and directly enroll in exploration and production activities. Saudi Aramco (Saudi Arabia), Petrobras (Brazil), and Statoil (Norway), are examples of what we call “operating” NOCs, which enter in complex exploration and production endeavors and can even run projects overseas. These NOCs resemble IOCs in size and function. There are also cases of NOCs embarking on different forms of joint ventures depending on how roles and risks are allocated.

In one example, Saudi Arabia’s Aramco has exclusivity over operating activities in most fields in the country and does not typically partake in joint ventures. Ghana’s GNPC on the contrary, relies primarily on a minority membership in joint ventures with private companies. Other NOCs, such as Cosmo Oil Co (Japanese), SK Energy (South Korean), and CPC corporation (Taiwan), can be tempted to take on downstream investments as well. Wherein, upstream investment looks at activities of transforming subsoil resources into crude oil (with, as examples, the TIMOR GAP of Timor-Leste and Tanzania Petroleum Development Corporation), downstream petroleum investments are ones that address the passage from crude oil to end products available for final consumption. This is considered a huge endeavor as it requires a very diversified set of skills that surpass the scope of the petroleum sector (transportation, marketing, etc.) However, there are examples of NOCs who have succeeded in the downstream direction. Uruguay’s ANCAP, for example, has a leading national status in the marketing of products. ANCAP exemplifies upstream and downstream flexibility. In the ambition to diversify in a more upward outlook, the company founded, in 2014, a center for training exploration and production activities.

B. NOCs can play a regulating role in the oil and gas sector when in charge of managing the development of the sector by, for instance promoting efficient exploration and production, through licensing and awarding rights, overseeing compliance with legal framework governing the sector, and envisaging the general policy of the sector. NAMCOR of Namibia, as an example, contributes greatly to the regulatory governance of the sector as it advises the ministry and is in charge of data management on behalf of the government.



NOCs can have a quasi-fiscal role that would typically be carried out by ministries in charge of managing government expenditures, such as the Ministry of Finance. NOCs, in this case, directly channel resource revenues towards development projects (such as building infrastructure, servicing debt etc.) without having to transfer the money to the treasury. This was the case in Venezuela in 2012 when spending on social programs reportedly exceeded that on oil projects by almost \$1.5 billion.

Fuel subsidies are also considered a main quasi-fiscal expense for NOCs. Subsidies are financial support given on a certain local commodity in the attempt to make it more affordable to the public. Accordingly, NOCs would then have to allocate a portion of oil revenue to help “make the oil cheaper”. Consumers thus purchase oil at a price that is below the original price, and the NOC then pays the difference from resource revenues.

In some countries, NOCs are not restricted to a unidirectional, singular mandate. In addition to movement along the supply chain from bottom to top, they can combine commercial and non-commercial roles. GNPC is one company that well illustrates well this functional *mélange* in its financial and operational flexibility.

There are various examples as to how countries have coped with their ambitions to diversify the roles of their NOCs. While Norway spreads four functions across separate government agencies--Statoil for commercial activities, Storting for policymaking, the Norwegian Petroleum Directorate for monitoring and evaluation, and Ministry of Finance and line ministries for economic development--, Sonangol in Angola conducts all of these activities within one agency. Liberia also established a new entity recently for purposes of handling licenses and regulation to improve the sector.

This can be too thin of a spread if not undertaken with the adequate timeframe and if not managed properly. Despite contributing to increasing state earnings and building sector related capacities, such expansion is not always desirable from a good governance perspective.



Benefits of Establishing a National Oil Company

Promoters of government presence in the extractives sector see NOCs as an opportunity to strengthen local capacities in the commercial management of the sector. Over time, this can encourage the development of the industry and, indirectly, other oil-dependent industries as well. Countries, accordingly would become less and less dependent on their foreign partners. This would have positive spillover on the political realm as well. A capable and successful NOC is a statement of sovereignty and an emphasis of resource ownership. For that end, NOCs often depict a stronger commitment to training to compete with international oil companies. With local capacities reaching an international level, NOCs can start expanding their activities beyond the country's borders generate thus more revenue to the state. Furthermore, by undertaking exploration and production activities, NOCs diversify the state's source of revenue from the sector, away from sole reliance royalty and tax.

NOCs can also improve government's oversight of the industry. By becoming more familiar with the sector and looking more closely at what is happening in the field, governments can scrutinize foreign partners more effectively and ensure that the national interest is put forward every step of the way.

Challenges of Establishing a NOC

The repercussions of improper management of state owned extractives companies can be slower development of the sector, amplification of the task of monitoring and accountability, and increased corruption. In many countries where the institutional framework is weak, NOCs have been exploited by public officials to foster their own personal interests especially where NOCs play regulatory and quasi-fiscal functions.

Since states tend to have strong control on investment and operational decisions of NOCs, the incentives and objectives driving these companies can differ greatly from those of IOCs in the private sector. While such companies are, both motivated and disciplined, by maximizing profit to shareholder, the incentives of those acting as the "State" might not be as smoothly aligned, as the profit of one state-actor does not necessarily mean the "profit" of the other. The NOC innately bears, in its structural nature, the political contestation that tend to pull in different directions, and ones that are not necessarily "profit generating."

In terms of productivity, and when compared with IOCs, NOCs with 300,000 employees are associated with 2.2 times lower revenue per employee than IOCs of the same size (Victor, On Measuring the Performance of National Oil Companies (NOCs), 2007). Table 1 provides clear evidence of efficiency gap showing that the average employee in an IOC generated around 53% more revenue for the year 2004.

Average revenue per employee for the year 2004	
NOCs	\$962,000
IOCs	\$1.8 million

Table 8.1 Average revenue per employee for the year 2004

Oftentimes, NOCs find themselves at the center of some of the biggest corruption cases in the industry—examples are Brazil’s money laundering scandal involving Petrobras, or the shocking mining deals in the Democratic Republic of Congo (Gillies, Heller, and Kauffman, 2018). By examining the opacity within which these companies operate, their immunity against oversight and monitoring forces, and their susceptibility to political manipulation it is no surprise that NOCs have a bad reputation. Yet, there are NOCs that have succeeded in contributing to “good” natural resource management, such as Colombia’s Eco petrol and Norway’s Statoil...

The case of Brazil’s Petrobras illustrates perfectly the difficulty of plotting a simple road map for NOC success. Its corruption scandal came as a big surprise since it was for years, praised for its corporate governance systems and attracted massive foreign investment. On the other hand, the success stories become less attractive when compared side-by-side with the heavy cost of establishing unaccountable NOCs. The 2017 Resource Governance Index assessed the performance of 74 state-owned enterprises across 10 governance and transparency practices. The results are showcased in figure I and reveal that only 9 SOEs receiving a “good” score, many influential SOEs failing (Natural Resource Governance Institute, 2017).



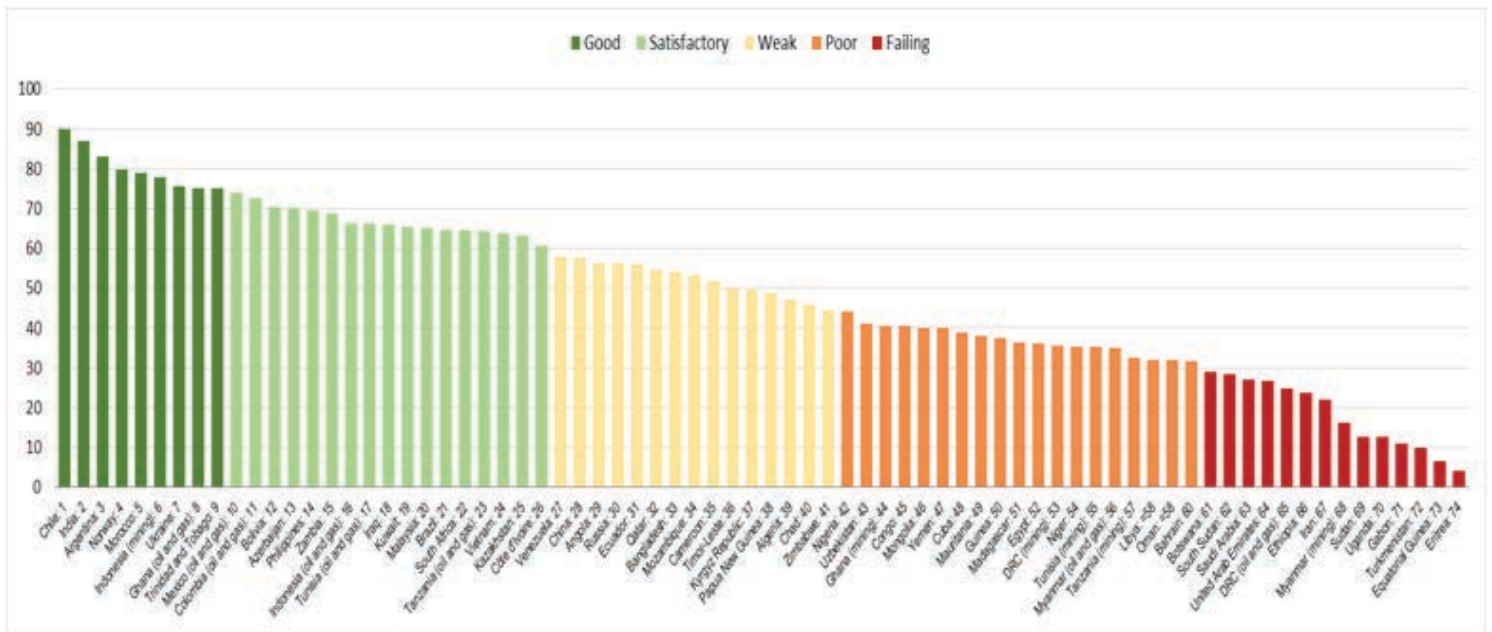


Figure 8.1 Resource Governance Index 2017

NOC talks in Lebanon

On November 2017, MPs Michel Moussa and Ali Osseiran submitted a draft law for the establishment of a Lebanese NOC. This motion generated reactions and disagreement on parliament’s prerogative, as well as the relevance of the timing. Amidst rival political rhetoric, the OPRL is very clear on the establishment of an NOC:

“When necessary and after promising commercial opportunities have been verified, the Council of Ministers may establish a national oil company on the basis of a proposal by the Minister based upon the opinion of the Petroleum Administration” (Article 6)

Talal F. Salman, UNDP project director for fiscal reform in Lebanon stated that “this law does not establish the NOC, but rather organizes its corporate governance, defines the participation methodology of the government, and starts consolidating government oil and gas assets under one legal entity”. Salman explains that “the law clearly states that the NOC will be established in accordance with the 2010 Offshore Petroleum Resources Law (OPRL) (Salman, 2018).



Proponents of the draft law argue that an NOC will generate revenues for the state's participation in the sector. Given Lebanon's local capacity in terms of know-how, securing the state involvement in the implementation of Exploration and Production activities, increasing state earnings, and undermining external leverage would have a positive effect.

Those who lie on the opposite end of the spectrum, argue that by effect of article 6 of the OPRL, any discussion around the establishment of an NOC is considered premature as long as commercial discoveries have not been made. They question the process through which it draft was reviewed.

The NOC draft law was unexpectedly fast-tracked after the creation of a joint parliamentary committee to discuss and review the law. With the absence of a published, background paper providing a rationale for the draft law, it becomes increasingly difficult to assess the efficiency of such a move. Wherein the assessment of the law should be guided by well-grounded and substantial information, argumentation, and analysis that is currently not publicly available, the parliament ought to reconsider the review process of the law in a way that leaves enough space for thorough discussion, and better integration in the overall petroleum sector strategic orientation (that has yet to be drafted). Furthermore, just as it should be the case on any strategic decision for the sector, the principle of stakeholders' engagement lends itself as a tool in the hands of the state, contributing to the creation of an environment of trust and transparency.





Chapter 10
Local Content



Chapter 10

Local Content

Extractive activities have the potential to create benefits to other sectors in the economy if the goods, services, and labor locally available are compatible with the needs of that sector in progress. Consequently, the entire economy would have found itself a “new customer” which could yield additional value to the country as a whole.

This value can be manifested in a number of ways including hiring local labor, training and capacity-building, and procuring locally that all leverage the activities of the oil and gas sector to create domestic economic opportunities. This value to the local or national economy from an extractive project is what is referred to as local content.

How is local content safeguarded in a country? What are the challenges that arise in this regard? What has Lebanon done to preserve and maximize its local content?



What is Local Content?

Many resource-rich countries make efforts to capture the benefits of extractives projects beyond the revenues generated from the activity itself. This is referred to as local content. Emerging producers especially see this as an opportunity to improve their economies as a secondary objective of resource development. The United Kingdom, Norway, Trinidad, and Brazil are countries that have successfully designed local content policies which have maximized the positive exploitation of their resources.

However, countries vary on the policies they adopt to encourage local content. A number of methods can be used to involve local labor, products, and businesses in extraction-related activities, including:



- **Quotas** or percentages of hires, contracts, or equity ownership that the international companies are required to award to locals.
- **Training program requirements** to build the skills of the domestic workforce.
- **Public education initiatives** taken by the state to develop local expertise in the sector through training programs or scholarships.
- **Incentives for small business development**, such as better access to credit.
- **Processing and production of derivative products** such as refining crude oil for example, however this can be very expensive and complicated.

In general, local content requirements are either enforced on a project by project basis or through signed contracts with the companies. One example is Timor-Leste's production sharing contract that draws attention to the suppliers based in country; others are specific legislation, such as the Nigerian Oil and Gas Content Development Act of 2010 or the Indonesian Bill on Mineral and Coal Mining on 2008, that contain local content provisions.

Challenges of Local Content

Local content policies differ on the degree of flexibility they leave for companies to deviate from local content requirements when necessary standards are not locally available. While this margin of freedom is necessary to ensure that the implementation of Local Content does not occur at the expense of the quality of the work, it makes the task of monitoring the company's compliance with these requirements quite challenging. This is mainly because, despite their appeal, local content policies are often difficult to design and administer.

This difficulty is attributed to the nature of the sector that is very capital-intensive and requires highly specialized technical skills. This means that the jobs that necessitate employees are few relative to the those that use machinery. Even in areas where labor is needed, it is not always the case that the local labor is competent to fill the positions. An example of that is the British multinational oil company that was recruiting welders for the establishment of the offshore gas platform in Tanzania. Although the country did have experienced welders, only few were recruited as the rest required highly advanced training to meet the job requirements.

In addition, non-technical services also necessitate capacities that may not be locally available. Food production, for instance, can be subject to sector-specific quality and quantity criteria. Although local food suppliers might try to accommodate these criteria, it can be more cost effective for the company to purchase food from outside the country.

Poor access to information can cause negative local labor allocation consequences. A mismatch between how the host nation perceives the capacity of its sector and how the company perceives it can translate into shortage or excess of local capacities to participate in extractives-related projects.

With limited knowledge of the real size of a company's demand together with uncertainties about the sector's prospects and the variability of this demand along the different stages of development, suppliers and training institutions often fail to capture these opportunities. Similarly, there is lack of reliable information on local suppliers and individuals that would prompt the extractive company to outsource instead of "buying local".

Furthermore, some local content policies tend to focus more on immediate benefits and fail to take the long run into account, leaving the economy more oil and gas-dependent than before.

This tends to happen in cases where an economic vision for the country and a guiding policy for the oil and gas sector are absent. Weaker oversight and monitoring as a result leads to serious governance concerns. That happens especially when benefits are captured by local elites that prioritize the pursuit of their personal economic interests over competitive solutions for the economy as a whole. In such a case, corruption takes hold.

All of the above raise questions on the overall sustainability of implementing a local content policy, especially when this involves restructuring the economy to accommodate a sector that is tentative and volatile.



Local Content in Lebanon

The OPRL and the PAR contain both provisions that safeguard local content interests by giving preferential treatment standards on quality, price, and performance. The EPA also sets an 80% quota for Lebanese employees as right holders. In April 2014, during an oil and gas conference at the Beirut-based École Supérieure des Affaires, Peter Gougeon, Director of the ESCP's Business School in London, noted during his presentation that the 80% target could prove difficult to achieve in the early phases of exploration and development given the lack of a specialized labor force in Lebanon.

The legislation thus allows flexibility in considering this quota to be a long-term objective that will be reached gradually as local capacities increase in specialization to meet sector requirements. The winning consortium is expected to devise a detailed recruitment and training program in the six months after the EPA's approval. An updated program for recruitment and training will have to be submitted to the LPA by December 31st of each year. If the consortium is unable to meet the 80 percent threshold, they will be required to submit a written explanation detailing the reasons and requesting an exemption. In addition, the companies are expected to assign a budget of \$300,000 to train public sector personnel working on the oil and gas sector, with a 5 percent increase each year, until the beginning of the production phase, at which point the amount will increase further. These costs are recoverable costs for the companies.

The procurement of goods and services will occur through public tenders through which a reasonable number of suppliers with adequate capacities will be first invited to a prequalification round and, later, to a bidding round for those who qualify.

Bids will be evaluated based on quality, price, delivery and guarantees offered, and contracts will be awarded on that basis. Contracts with substantial value are referred to as major contracts, contracts "that materially or substantially affects the design or functionality of facilities, the concept or timeline of development, production or resource management and depletion policies." Consequently, the implementation or abstention from implementation of these contracts may significantly affect the development of the sector.

Here again, it is important to pay particular attention to Beneficial Ownership of the companies participating in the sector within its different streams (view ch. 6 on beneficial ownership) to maximize efficiency and benefits for the economy.



Box 9.1 elaborates in detail how is local content mentioned in the legal framework of the sector.

Article 67: Local content (Offshore Petroleum Resources Law)

- *A Right holder as well as its subcontractors shall give priority to Lebanese persons in the award of contracts for construction of a Facility and the supply of material, goods and services related to Petroleum Activities when terms and conditions offered by Lebanese suppliers are equal to their competitors*
- *A Right holder as well as its subcontractors shall employ qualified personnel of Lebanese nationality whenever available. Right Holder shall also organize and fund the training of Lebanese personnel associated with Petroleum Activities.*

Art. 20 Recruitment and training (Exploration and Production Agreement):

- *As of the beginning of the Exploration Phase, not less than eighty per cent (80%) of the aggregate number of employees of the Right Holders (including the Operator) shall be Lebanese nationals.*

The EPA also includes a clause in that binds the operator to select Lebanese entities for procurement of products, even if the local prices exceed the international prices by a 5 percent margin for goods or 10 percent margin for services. However, all Lebanese goods and services should have the same standards as foreign and international products.

Box 9.1 Article 67 OPRL

In its report on “Transparency and Accountability in Lebanon’s petroleum legislation” (Lebanese Oil and Gas Initiative -LOGI, 2017), LOGI suggests that the definition of major contracts remains vague, and therefore, *Lebanese authorities “may wish to consider to make use of a more specific definition of “major contracts” in Article 157 of PAR, e.g. by use of threshold values.”* (Lebanese Oil and Gas Initiative, 2017).

LOGI recommends as well “*to regulate and flesh out the details of the procurement and local content process by law and establish a monitoring mechanism to oversee the proper implementation of that new law*” (Lebanese Oil and Gas Initiative, 2017).

The challenge of effectively implementing local content policy in Lebanon is linked, more broadly, to expectations management. It is not yet clear how much labor supply will be needed, mainly given uncertainties about development of the sector. These are fueled by mismanagement of the expectations of local labor, especially with several universities and vocational schools developing, since 2013, different majors that would equip students to work in the sector (Arbid, Educating the Oil and Gas Generation, 2013). Therefore, more efforts need to be invested in proper communication with the public and in managing people’s expectations about the sector especially with regards to job opportunities therein.

Local Content

Current Situation in Lebanon:

The Lebanese Offshore Petroleum Resource Law and the Petroleum Activities Regulations contain provisions that safeguard local content interests by giving preferential treatment standards regarding quality, price and performance.

The Exploration and Production Agreement (EPA) sets an 80% quota of Lebanese employees on the right holders.

The EPA includes a clause that binds the operator to select Lebanese entities for procurement of products, even if the local prices exceed the international prices by a 5 percent margin for goods or 10 percent margin for services.

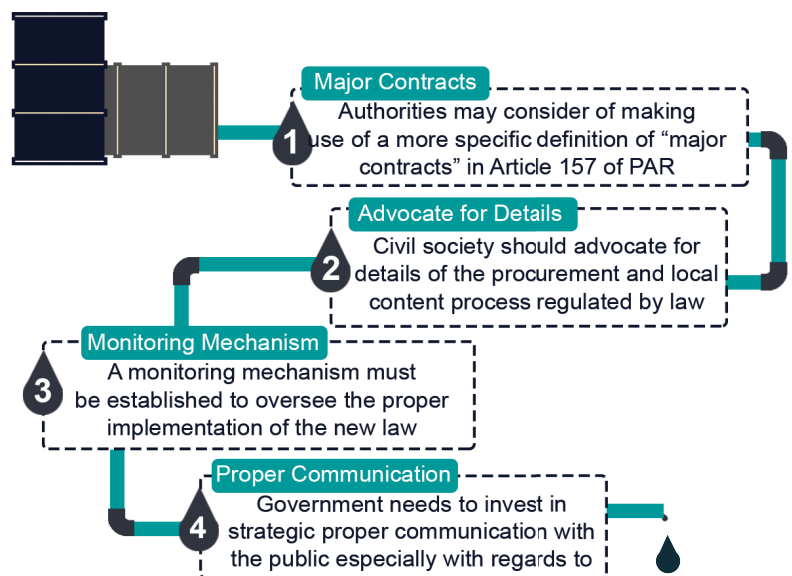
As per the EPA, companies are supposed to assign a budget to train public sector personnel of at minimum \$300,000 per year with a 5% increase mandates each year until the beginning of production phase.

Recommendations:

Lebanese authorities should mitigate vagueness around “major contracts” by making use of a more specific definition of “major contracts” in Article 157 of PAR, such as by using threshold values, which specify a value above which contracts should be subject to public tender.

Civil society should advocate for details of the procurement and local content process regulated by law, and that a monitoring mechanism be established to oversee the proper implementation of the new law.

The Lebanese government needs to invest efforts in strategic communication with the public and in managing people’s expectations especially about job opportunities.





Chapter 11

Petroleum Sector and the Environment



Chapter 11

Petroleum Sector and the Environment

Oil and Gas development activities have high environmental risks and concerns, that elicit particular attention from governments in order to best assess and mitigate these impacts.

Failing to do so can have massive financial costs for governments for petroleum companies, and tragic consequences for ecosystems. The Deepwater Horizon spill in the Gulf of Mexico in 2010 provided a good example of this highly undesirable scenario; the responsible company has incurred a cost of \$67 billion for the spill. It is estimated that the disaster caused the death of 11 workers and the waste of 134 million barrels of oil into the Gulf over nearly three months, catastrophically harming the marine ecosystem therein. (Arbid, 2018)

It is essential for the government to be fully aware of the potential impacts of resource projects, so that it can appropriately mitigate the potential environmental, social and health costs either by direct intervention or indirectly by influencing involved companies. Mitigation measures should primarily focus on prevention when possible, in addition to minimization, and rely on compensation for the costs incurred as a last resort. (Natural Resource Governance Institute, 2017)

For that end, international best practices in the industry, recommend developing a “Strategic Environmental Assessment (SEA)” in relation to petroleum activities.

A SEA provides the government with a methodical process for evaluating the overall benefits and costs of petroleum exploration and production activities. The SEA considers whether such an endeavor converges with government objectives, examines the government’s institutional readiness to manage resource extraction, and studies the government’s need of revenue accordingly. The SEA process also allows governments to recognize environmental restraints, potential effects, cultivate adequate solutions, and enables accurate communication of information to stakeholders (Lebanese Oil and Gas Initiative, 2017).



Article 7.2 of the OPRL explicitly recognizes the importance of carrying a SEA and requires it before opening areas for petroleum activities and awarding licenses:

The State shall conduct a strategic environmental assessment study prior to any Petroleum Rights being awarded or Petroleum Activities initiated. The scope for this study shall be stipulated by a Council of Ministers Decree made on the basis of a proposal by the Minister based upon the opinion of the Petroleum Administration (Lebanese Petroleum Administration, 2017).

In 2014, the Lebanese Government published the SEA report that was originally commissioned in 2011 and finalized in 2012 (Lebanese Oil and Gas Initiative, 2017). In May 2017, an analysis of the SEA published by LOGI-Lebanese Oil and Gas Initiative found that it falls short from being an effective tool for risk mitigation, mainly due to lack of information. Its author, environmental consultant Klemen Strmšnik, explained to Executive Magazine that: “The SEA was not fully implemented and was based on a lack of data. Stakeholder involvement was limited, and the SEA report was not presented to the public through public consultations. Additionally, national legislation on SEAs was substantially changed, and the current SEA report simply does not satisfy the standards set by new environmental legislation. Therefore, it does not provide all needed answers and cannot represent a sound decision-making tool.” (Arbid, 2018). Furthermore, Lebanon’s ability to enforce environmental measures on large oil and gas companies was put in question, especially in light of the country’s offsetting performance on other national environmental problems. (Arbid, 2018)

Currently, and within the process of updating the SEA, as stipulated by Legislation on Environmental Protection (Ministry of Environment, 2017), a first consultation workshop is being organized by the LPA as a key milestone in the preparation of the SEA Study Update for the oil and gas sector in offshore Lebanon. This forum brings together representatives from Governmental and Non-Governmental entities, international organizations, and the private sector to discuss and potentially improve many aspects of Lebanon’s SEA for its developing petroleum sector. (Nasr, 2018). This update is thought to assist the MoEW, the LPA and relevant authorities, in managing the Exploration and Production activities in offshore Lebanon in a sustainable manner. Consequently, the responsible entities would be able to completely incorporate major environmental and social apprehensions at the earliest possible stages of decision making.



For Lebanon to extract its natural resources without irreversibly damaging its ecosystem, there are many issues that the government and the LPA need to tackle—indeed, they need to address the lack of health and safety legislation in the oil and gas sector, challenges in implementing a national contingency plan that extends beyond the case of natural and foreign invasion, to include the case of large scale oil spills for among others, the issue of data deficit, and the need for an effective infrastructure for waste management infrastructure (Lebanese Center for Policy Studies, 2015).

Oil & Gas Sector and the Environment

Current Situation in Lebanon:

International best practices in the industry, recommend developing a “Strategic Environmental Assessment (SEA)” in relation to oil and gas activities.

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Article 7.2 of the OPRL explicitly recognizes the importance of carrying a SEA.

In 2014 the Lebanese government published the 2012 SEA version report that fell short from being an effective tool for risk mitigation, mainly due to lack of information.

Within the process of updating the SEA, as stipulated by Legislation on Environmental Protection, a series of consultation workshops are being organized by the Lebanese Petroleum Administration for the SEA Study Update for the oil and gas sector in offshore Lebanon.

Recommendations:

The government and the LPA need to be more proactive in trying to account for environmental risk mitigation, especially given the lack of health and safety legislation in the oil and gas sector, the need for a more comprehensive national contingency plan, the issue of data deficit, and the need for an effective infrastructure for waste management infrastructure.



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 **About the Author:**

Julien Courson is the Director of Lebanese Kubernao Center, a not-for-profit civil company working on promoting good governance and personal leadership. With more than 12 years of experience working as a professional consultant & trainer, Julien lead the strategic development of several local and regional capacity development programs. He has consulted, throughout his career with numerous international organizations in areas ranging from human rights and economic justice to conflict-resolution/negotiation, advocacy and lobbying, good governance and leadership. Julien's work experience has spanned Lebanon, Tunisia, Libya, Egypt, Syria, Iraq, Jordan and Morocco.

He has been, from 2004 till 2015, a lecturer at the Faculty of Economics of the Saint-Joseph University, and selected by the European Union Delegation in 2010 to participate to the European Union Visiting Program in 2010 in Bruxelles. Julien holds a Masters in Economic Policy from Saint Joseph University, and a professional certificate in Mediation from USJ & Université Catholique de Paris.





Lebanese Oil & Gas Initiative
المبادرة اللبنانية للنفط والغاز



Norsk Folkehjelp

in Partnership With: Norwegian People's Aid