

GOOD GOVERNANCE GUIDELINES

for Lebanon's Oil and Gas Sector



Executive Summary

June 2018

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Acknowledgments

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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.

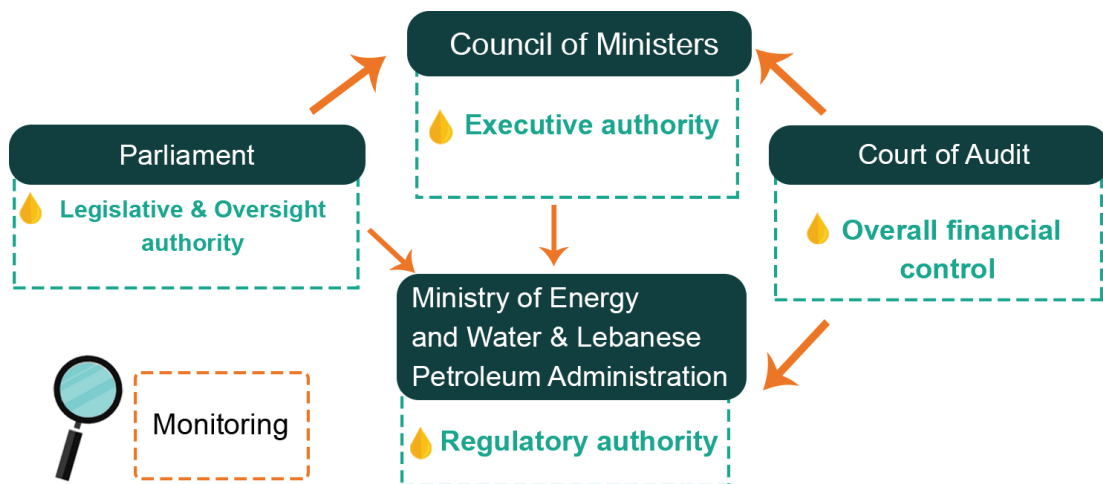
Lebanon has been consistently performing poorly on the World Governance Indicators (WGI) ranking below world average. In the last five years only, it has ranked on or below the 50th percentile on all six indicators.

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 "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

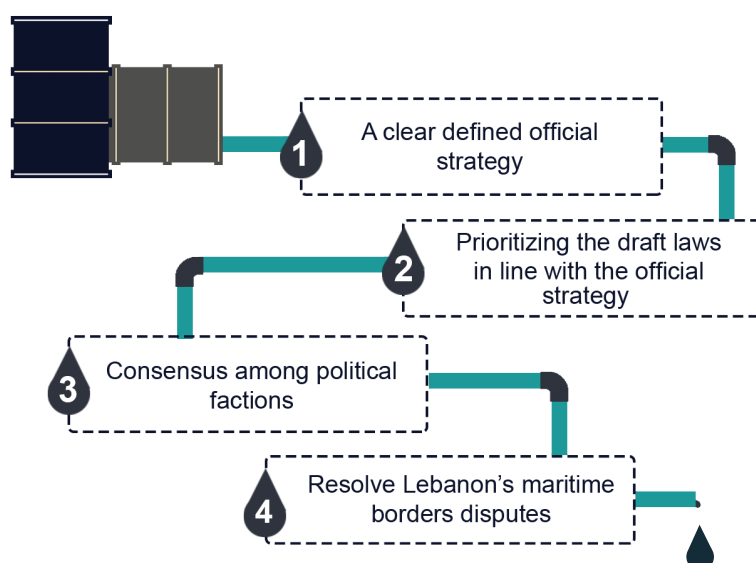
Recommendations:

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.



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.

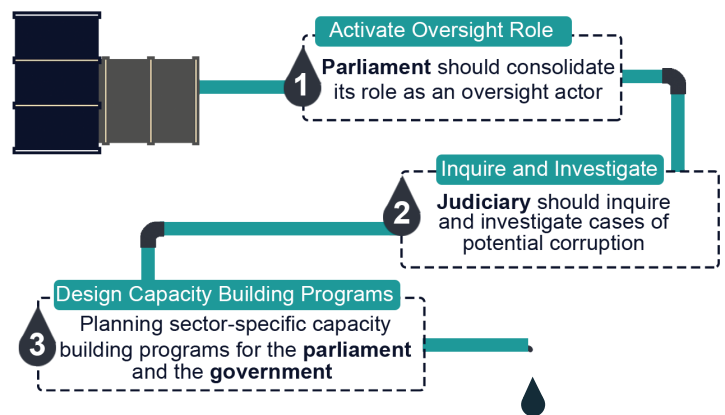
In Lebanon, the sector-specific legal architecture and institutional framework reflect good governance traits. However, within a wider context, these become the victims of rule of law challenges. The First Offshore Licensing Round 3 years delay and the passiveness of the judiciary about allegations of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

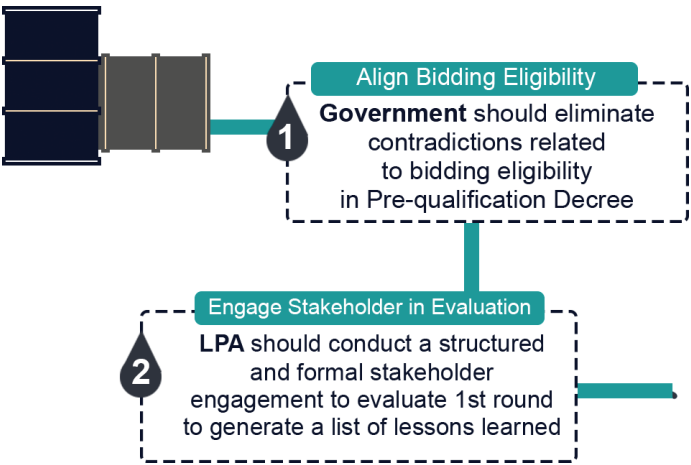
The most dubious element of the pre-qualification decree is article 3.3 that allows for at least one company within a group to prove that it is able to meet the eligibility criteria set forth by the decree. This provision contradicts article 7.4 of the same decree that prevents qualification of any application 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".

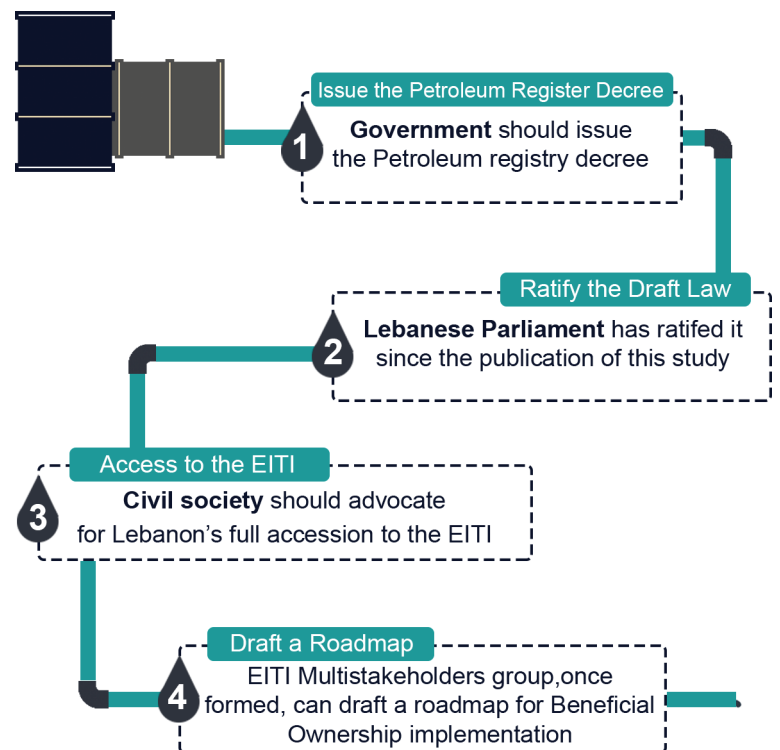
Lebanon's intention to join EITI is an opportunity to put into practice a roadmap for the realization of beneficial ownership.

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.

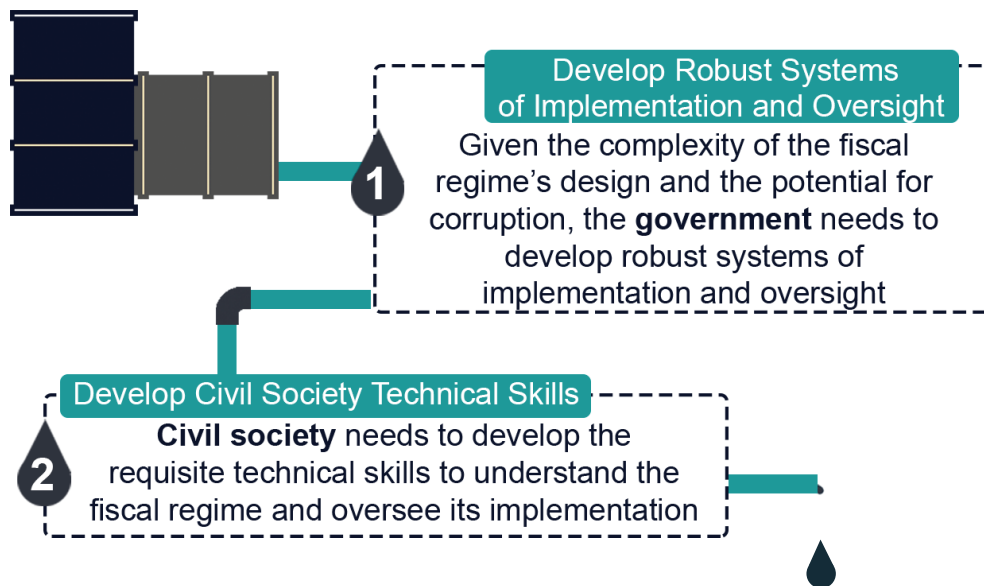
With a combination of fiscal tools, one refers to, not one fiscal regime, but a fiscal arrangement composed of a wide array of fiscal instruments, similarly to many countries worldwide.

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.

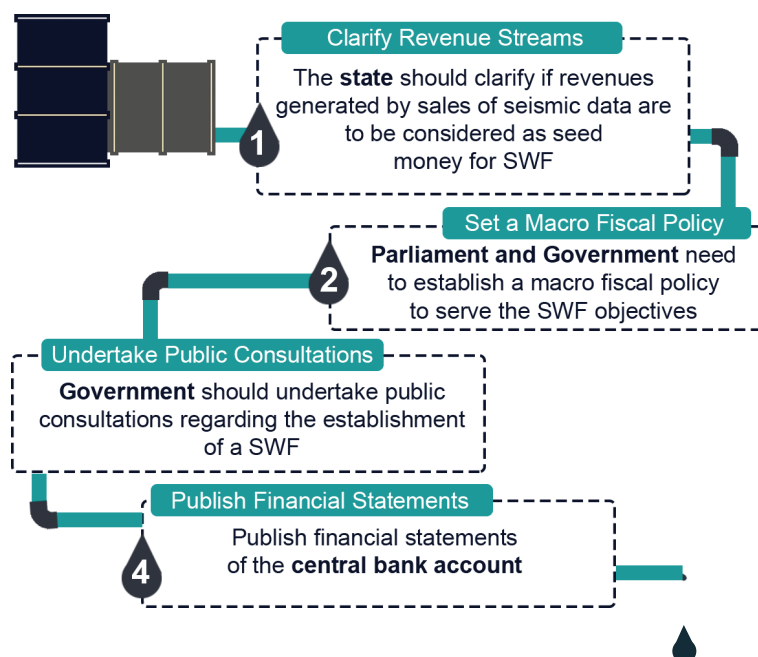
Recommendations:

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.



Forward thinking

- Potential additional revenues generation for the state



Premature Effert

- Commercial discoveries have not been made as of yet
- Lack of rationale for the establishment of NoC

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.

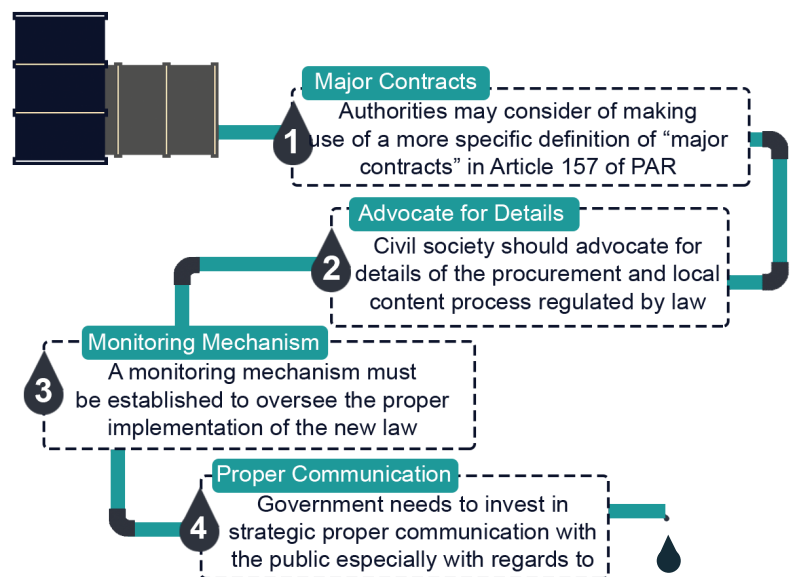
As per the EPA, companies are supposed to assign a budget to train public sector personnel of at minimum \$300,000 per year with a 5% increase mandates each year until the beginning of production phase.

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.



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.

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.



Lebanese Oil & Gas Initiative
المبادرة اللبنانية للنفط والغاز



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