

**Should the Norwegian Model of Direct State
Participation in Petroleum Activities be used in
Resource Rich Developing Countries as part of the
Solution to the 'Resource Curse'?**



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Chapter 1 Introduction

The discovery of petroleum resources represents a valuable opportunity to improve a country's development. Sales of oil and gas can generate huge revenues and have the potential to raise living standards and improve economic growth. However, many countries fail to use the wealth that these resources represent. Living standards remain low and the nation is still poor in spite of their resource endowment. This is known as the 'resource curse'. Research has repeatedly shown that resource wealth does not tend to create wealthy nations. On the contrary, there is often a decline in development¹. This curse represents a missed opportunity to improve the country's economic situation and social well-being.

The resource curse is not inevitable though. Norway used the discovery of petroleum to improve economic development and benefit the country as a whole. It was one of the poorest countries in Europe at the beginning of the 20th Century, but it is now one of the richest². It is ranked as the world's seventh largest oil exporter and the second largest gas exporter³. The petroleum sector represents a 26% share of state revenues and 21% of Norway's total value creation⁴. Norway is often cited as one of the best examples of how natural resources can be managed for the benefit of the population⁵. It has succeeded in defying the resource curse.

This thesis will identify whether there are lessons that can be learnt from resource management in Norway and applied to help prevent the resource curse in developing countries. The core strategy in Norway was to channel the oil profits into an oil fund, but other methods were also important. The legal organisation of petroleum activities on the Norwegian continental shelf (NCS) played a fundamental role. Indeed, the extent to which *any* country succeeds in using its natural resources to improve development will depend on the application of an appropriate legal framework for exploiting them. It is the starting

¹ Auty (1993) p1

² Duruigbo (2005) p9

³ Hansen and Rasen (2012)

⁴ Norvik et al (2010) Figure 1.2, p14

⁵ Ryggvik (2010) p5

point of good resource management. The *broad* focus of this thesis is, therefore, to examine how petroleum law can be used to help prevent the resource curse.

The *particular* focus is Norway's petroleum law in relation to direct state participation (DSP) in petroleum activities. This is the direct financial investment of the state in a national oil company to perform petroleum activities on the government's behalf. Norway's legislative framework for DSP played a key role in enabling the country to overcome the resource curse. The government used DSP to benefit the population in a number of ways. As an example, it facilitated the integration of the petroleum sector into the wider economy, significantly improving the growth of related Norwegian industries. Ultimately it is these economic benefits that will have a longer life than the petroleum industry itself. Moreover, the experience of directly participating in petroleum operations improved the government's ability to manage the wider petroleum industry in a manner that furthered the national interest. The main objective of this thesis is to identify whether other countries can learn lessons from how DSP was structured in Norwegian petroleum law in order to realise the potential benefits natural resources represent.

1.1 The structure of the text

The structure of this thesis is designed to provide an understanding of the Norwegian system of DSP and whether it could be applied to address the resource curse elsewhere. Thus, in Chapter Two the issues facing resource rich developing countries will be outlined. This provides the background for analysis as it is the problem that DSP needs to address. The legal principle of Permanent Sovereignty over Natural Resources will then be explained to show why it is that natural resources should be managed in a way that benefits the population. Following this is an outline of the solution proposed by the Natural Resource Charter. Chapter Three describes the system of DSP and its role within the Norwegian petroleum sector. The benefits it gave Norway and how the government structured the system to achieve these benefits will be explained in detail. Chapter Four identifies the features that enabled DSP to function effectively in Norway. This gives an indication as to whether the system has the potential to be applied in other countries. Chapter Five provides an analysis of the lessons that can be learnt by developing countries from the Norwegian legislative structure of DSP. The overall objective is to assess whether

this system could be applied to address the resource curse outside of the Norwegian context.

1.2 Legal sources

The starting point of this thesis is Norwegian petroleum law, which sets out the legislative framework for its petroleum sector. International law will also be used to underpin my analysis. This includes the principle of Permanent Sovereignty over Natural Resources, which formally places the benefit of natural resources in the hands of citizens. It also includes a 'Natural Resource Charter'. This is a document compiled by world experts in politics and economics who have created an ideal legal framework for resource management. These are my primary sources.

In order to evaluate the Norwegian legal framework, I will use evidence from economic and political scientists as my secondary resources. This research provides evidence of the impact of the law and thus provides the critical perspective on Norwegian DSP. These researchers will be used to identify the advantages and disadvantages of using the Norwegian legal structure of DSP. Since laws governing resource management aim to address economic and political issues, indications of its success or otherwise must come from economic and political sources. These sources demonstrate the implications and actual outcomes of the law and are therefore the focus of my research.

Thus the particular methodology used is a literature review. I will use a combination of online resources, journals, books and statistical research. Evidence will be taken from scholars discussing a range of countries and legislative regimes. They include economists and political scientists such as Al Kasim, Nelsen and Noreng that provide an analysis of the Norwegian petroleum industry, and experts in other models of resource management, such as Victor, Hults and Thurber. Other research focuses on analysing the different methods of resource management, as opposed to specific country analysis. This includes an extensive research project into NOCs by The World Bank and a study on the effects of privatisation by Wolff and Pollitt. The literature will show the potential economic and political implications of transferring the Norwegian legal system of DSP beyond the Norwegian context.

Chapter 2 Background

2.1 The problem of ‘the resource curse’

The resource curse is a frequently occurring and contradictory economic situation where resource rich countries perform worse than less well-endowed countries. In order to understand whether DSP has the potential to overcome this issue, we must first understand the problem in greater detail.

The resource curse is essentially a failure to use natural resources in a manner that benefits the population. In some countries though, the detrimental effects go well beyond a lack of economic growth. The discovery of natural resources has been blamed for causing corruption, autocracy, high levels of inequality and even civil war⁶. This is most clearly visible in certain African countries: oil resources have contributed to civil strife in The Congo, The Sudan and Angola and endemic corruption and extreme poverty in Nigeria⁷. These countries provide a stark illustration of the daunting problem that mismanagement of natural resources represents.

The causes of the resource curse are numerous and include economic, political and social problems⁸. The primary cause is that petroleum resources represent a huge source of income. This creates an incentive for those in power to engage in ‘rent-seeking’, corrupt, behaviour. This weakens democracy because rulers are not reliant on taxation for revenue and thus do not need the vote of their citizens to stay in power⁹. Rulers are also able to use petroleum revenue to keep themselves in power and repress their opponents. Put simply, high economic rent increases the probability of poor wealth management and oppressive

⁶ Humphreys (2005), X. Sala-i-Martin and A Subramanian (2003), Tsui [2005]

⁷ Nigeria is amongst the fifteen poorest nations in the world and the poverty rate between 1970 and 2000, the share of the population subsisting on less than one dollar a day, increased from close to 30% to just under 70% Sala-i-Martin and A Subramanian (2003) pp 4 and 35 (Figure 1A)

⁸ Duruigbo (2005) pp13-21

⁹ Humphreys et al (2007) p4

behaviour, which can undermine, rather than enhance, a country's economic and political situation.

There is though great variation in the way countries have responded to the discovery of natural resources. A comparison between Nigeria and Indonesia illustrates this. Approximately thirty years ago Indonesia and Nigeria had similar per capita incomes and both depended heavily on oil sales. Indonesia's per capita income is now four times that of Nigeria¹⁰. The 2011 UN Human Development Index highlights more broadly how some oil and gas producing countries have performed much better than others. Norway is at the top of the Index and The Netherlands is third, while other petroleum producers such as The Democratic Republic of the Congo, Chad, Equatorial Guinea, The Sudan, Nigeria and Angola all rank at or close to the bottom of well-being statistics¹¹. This indicates that developing countries in particular struggle to use natural resources in a manner that benefits, rather than harms, the population. However, it also shows that the resource curse is not inevitable since not all petroleum-producing countries suffer from it.

The focus of this thesis is addressing causes of the resource curse in the upstream sector; capturing the value of the resource, as opposed to the downstream sector; how that value is used by government. Corruption, weak state institutions and information asymmetries between government and multinational oil companies have all been blamed for a failure of the state to capture the true value of sub-sea petroleum resources¹². Any legal framework that could address the problems upstream has the potential to be part of the solution to the resource curse.

2.2 Permanent Sovereignty over Natural Resources

The principle of Permanent Sovereignty over Natural Resources explains *why* it is that government must seek to use natural resources for the good of its citizens and gives this argument legal grounding. Put simply, it means that natural resources belong to the people of the territory in which the resources are found. A logical consequence is that a government, acting on behalf of its people, has a duty to use those resources in a manner

¹⁰ Humphreys et al (2007)p2, and Ross (2003) pp13-15

¹¹United Nations Development Programme (2011) pp 127-130

¹² Humphreys et al (2007) pp xi and 4, Duruigbo (2005) pp18-21

that benefits the owners of that resource. Any solution to the resource curse must enable the state to uphold this principle.

Norway used DSP in a manner that benefited its population and thereby complied with the Principle of Permanent Sovereignty. Indeed, the state's founding aim for the petroleum industry was to improve the development of Norwegian society. This is clear from Norway's Petroleum Act 1996 s1-2, which states '*Resource management of petroleum resources shall be carried out in a long-term perspective for the benefit of the Norwegian society as a whole*'¹³. It was the opinion of the Norwegian government that its petroleum legislation should be designed with this principle at its core.

Permanent Sovereignty over Natural Resources is a key principle of international law, which applies to other countries in the same way as it does to Norway. The General Assembly gave recognition to the principle in Resolution 1803 (XVII) in 1962. The Resolution provides that states shall strictly and conscientiously respect that '*the right of peoples and nations to permanent sovereignty over their natural wealth and resources must be exercised in the interests of their national development and the well-being of the people of the state concerned*'¹⁴. Further to this, violation of this right was declared to be in breach of the principles of the United Nations Charter. The principle developed out of the colonial period and the political claim of newly independent states to take control over their natural resources. Its reason for being was to improve the economic development of these countries and is a basic constituent of the right to self-determination¹⁵. Resolution 1803 reflects the sovereign right of a state to control the exploitation of resources on their territory, but additionally imposes an obligation on states to exercise this right in the best interests of its citizens¹⁶.

The principle of Permanent Sovereignty was later consolidated in international law. Further General Assembly Resolutions strengthened its standing and Common Article 1 of the International Covenant on Civil and Political Rights and the International Covenant on Cultural, Economic and Social Rights made it a binding part of international human rights

¹³ The Petroleum Act, Act 29 November 1996 No. 72, s1-2

¹⁴ UNGA Res. 1803 (XVII) para 1

¹⁵ Kilangi (2008)

¹⁶ Elian (1979) p98

law. The right is also enshrined under Article 21 of the African Charter on Human and People's Rights, proclaiming that '*All peoples shall freely dispose of their wealth and natural resources. This right shall be exercised in the exclusive interest of the people. In no case shall a people be deprived of it*'. In the *East Timor Case* Judges Weeramantry¹⁷ and Skubiszewski¹⁸ referred to the principle as being part of international law with *erga omnes* character. Today it is generally accepted that Permanent Sovereignty over Natural Resources is a prerequisite for economic development and thereby a fundamental principle of international law¹⁹.

Thus it is not simply a moral obligation that a government manage resources to benefit the nation, but a legal duty with a corresponding right that citizens can expect this to be done²⁰. However, while the principle establishes a legal right, it does nothing in and of itself to solve under development. It is a legal prerequisite to economic development, but requires further expansion for its founding purpose to be fully realised. The issue is whether the Norwegian structure of DSP could be part of a legal solution to this economic problem.

2.3 The Natural Resource Charter

The Natural Resource Charter (NRC) proposes a universal solution to the resource curse. It is '*a global initiative designed to help governments and societies effectively harness the opportunities created by natural resources*'²¹. It aims to enable the use of natural resources as a 'pathway out of poverty' for developing countries. The Charter constitutes a set of guiding principles identified by leading economists, lawyers and political scientists and has at its core the principle of Permanent Sovereignty as its legal and philosophical underpinning²². As such, the NRC is the point of reference for this thesis.

¹⁷ *East Timor Case* (1995) Separate Opinion of Judge Weeramantry, pp142, 221

¹⁸ *East Timor Case* (1995) Separate Opinion of Judge Skubiszewski, pp 127

¹⁹ Nincic (1970), Perrez (1996)

²⁰ This duty has been recognised by the African Commission on Human and Peoples' Rights in *African Commission on Human Rights in Social and Economic Rights Action Center (SERAC) v. Nigeria* (2001)

²¹ Collier et al (2010), p20

²² See, for example, Collier et al (2010) p1: 'governments of resource-rich countries, ... have both the sovereign right and the moral responsibility to harness natural wealth for the benefit of their peoples'

The NRC consists of twelve ‘precepts’ to inform decision-making from the point of discovering natural resources. Each precept provides guidance on a stage in the decision-making process, from extraction to the use of the revenue generated. The authors see the resource curse as a consequence of misguided and short-sighted choices made by those in power. The Charter recognises that resource management is a complex process, but if each ‘link’ in the decision-making chain is complied with, it can generate economic growth and improve the welfare of the population. The NRC does not dictate a detailed legal structure. It recognises that this depends on the objectives and needs of the particular country in question. Instead it is a framework with which particular decisions should comply to maximise the opportunities provided by resource wealth. These precepts apply to all extractive industries and are presented as being universally applicable.

The preamble to the Charter takes an expansive view of the potential benefits, stating that *‘Exploitation of natural resources should be pursued in order to help a country meet its broader social and economic goals’*²³. It is a development opportunity that can be used to improve the country as a whole, in the long term, and in a comprehensive manner. A successful petroleum sector needs to fit into a country’s economic future. This means that government, as the key decision-makers in this process, must recognise their responsibility to manage resources for the benefit of their people. The overall aim of the solution proposed by the Charter is to enable governments to realise this objective. This is also the objective of this thesis.

2.4 The Natural Resource Charter and direct state participation

Precept 6 relates to direct state participation of a nationally owned resource company in developing a resource base. In the oil and gas sector, this is a national oil company (NOC) participating in upstream petroleum activities. Precept 6 outlines how a NOC should be organised. The consensus is that it can be beneficial, but only if managed correctly, since many NOCs have performed poorly²⁴. The NRC guidance can be categorised into the internal and external legal organisation of the NOC:

²³ Collier et al (2010) p1

²⁴ Collier et al (2010) p10

- Internal organisation: nationally owned resource companies should:

Have the ultimate objective of becoming commercially viable;

Have a limited functional scope;

Avoid engaging in governmental activities, such as social functions and distributing subsidised output;

Avoid engaging in regulatory functions to avoid conflicts of interest between public and commercial goals

Be professionally managed;

Be transparent;

Operate as efficient revenue generating operations

Be able to adapt to changes in the economic environment

- External organisation: the government should ensure that:

The NOC operates in an open and genuinely competitive environment with other companies

The NOC is organised as a separate legal entity with clearly established authorities and objectives and by having governing and management boards separate from the government.

Independent government entities conduct the licensing, technical and regulatory supervision of the resource sector

The Charter recognises that a well-managed NOC can assist economic development and have other social and political benefits. It *could* be a part of the solution to the resource curse, but only by complying with the principles under Precept 6.

Chapter 3: The Norwegian petroleum sector: direct state participation in context

Precept 6 of the NRC indicates that Norway's use of DSP has the *potential* to help governments use petroleum resources to benefit the population. However, it also suggests that this depends on the specific organisation of DSP in Norwegian petroleum law. This will be addressed in Chapters Three, Four and Five. Chapter Four addresses *how* DSP worked in Norway and Chapter Five explains *why* it worked in Norway. First though, Chapter Three puts DSP in the context of the Norwegian petroleum sector as a whole. The legal arrangement of Norwegian DSP within this context and the benefits it achieved for Norway will be presented. The description shows that Norway's legal organisation of DSP helped to prevent the resource curse. This indicates that it does indeed have the *potential* to address the resource curse beyond the Norwegian context.

3.1 Direct state participation in context: the Norwegian state's objectives for the petroleum sector

The government's main concern for the future of its petroleum industry was that it would benefit all of Norwegian society. The means to achieve this was good resource management. The '10 Oil Commandments' reflect this overarching objective²⁵. This is a White Paper from the Parliamentary Committee on Industry and was unanimously adopted by the Norwegian Parliament in June 1972. In particular, Commandments 1, 4, 7 and 8 reflect the desire for a comprehensive and controlled approach to oil policy:

1. National supervision and control must be ensured for all operations on the NCS.

4. The development of an oil industry must take necessary account of existing industrial activities and the protection of nature and the environment.

7. The state must become involved at all appropriate levels and contribute to a coordination of Norwegian interests in Norway's petroleum industry as well as the

creation of an integrated oil community, which sets its sights both nationally and internationally.

8. A state oil company will be established which can look after the government's commercial interests and pursue appropriate collaboration with domestic and foreign oil interests²⁶

These founding principles remain relevant today and are reflected in the Petroleum Act 1996 s1-2 ²⁷

3.2 Norwegian oil policy

In order to realise these objectives, the Norwegian state considered it of paramount importance to maintain national control over its petroleum sector. The ability to exercise this control derives from the Law of the Sea Convention, Articles 77(1) and 77(2) (UNCLOS). This international convention grants the state ownership of its sub-sea resources located on its continental shelf and the exclusive right to exploit these resources. The system that developed in Norway must be seen in connection with this basic state ownership²⁸. The 'exclusive right' means the state must grant express permission to any outside entity wishing to exploit its sub-sea resources and can impose any conditions it sees fit on the grant of this right. This is the legal underpinning of Norwegian oil policy. The characteristic features of Norwegian oil policy include the licence system, state organised licence groups and state participation within these groups²⁹.

3.2.1 Norwegian petroleum legislation

The main source of current Norwegian petroleum legislation must be outlined at the outset.

²⁵ Innst. S. no. 294 (1970-71)

²⁶ Innst. S no. 294 (1970-71)

²⁷ The Petroleum Act, Act 29 November 1996 No. 72

S 1-2 Resource management of petroleum resources shall be carried out in a long-term perspective for the benefit of the Norwegian society as a whole. In this regard the resource management shall provide revenues to the country and shall contribute to ensuring welfare, employment and an improved environment, as well as to the strengthening of Norwegian trade and industry and industrial development, and at the same time take due regard to regional and local policy considerations and other activities.

²⁸ Hammar et al (2011) p28

²⁹ Hammar et al (2011) p28

The Petroleum Act 1996³⁰ regulates the significant stages of petroleum activities and establishes a framework for state management of petroleum resources. S1-1 reflects Art 77(1) UNCLOS. It vests the property rights to sub-sea resources located on the NCS in the Norwegian state. S1-2 first paragraph reflects Art 77(2) UNCLOS. It states that resource management is exercised by The King and decisions of The Norwegian Parliament. The King in this context means The Cabinet. Pursuant to these powers, the state established its legal framework to exploit petroleum resources and regulate the companies conducting petroleum activities on the NCS. The Ministry of Petroleum and Energy (MPE), referred to as ‘The Ministry’ under the Petroleum Act, has been delegated overall responsibility for resource management in the petroleum sector. It is the MPE that administers the licence system.

3.3 The licence system

The Norwegian state implemented a concessionary system whereby foreign oil companies must apply for a licence to exploit petroleum on the NCS. The companies own the petroleum they produce, but the state controls how this is done.

This licence system ensured that the government maintained oversight and control at each important stage of petroleum activities. This was emphasised in Parliamentary Report No. 25 by the Ministry of Industry, stating that the organisation of petroleum activities must ‘*provide Norwegian authorities with full control of all stages in the operation: exploration, production, processing, export and marketing*’³¹. No major petroleum activities could be conducted without prior government approval. This is explicit under the Petroleum Act s1-3 ‘*None other than the State may conduct petroleum activities without the licences, approvals and consents required*’. A separate licence is required for exploration activities, production activities and to install and operate facilities for transportation and utilisation of produced petroleum³². The MPE stipulates the terms of each licence and additional approvals may be required for other significant activities.

³⁰ The Petroleum Act, Act 29 November 1996 No. 72

³¹ Parliamentary Report No. 25 (1973-1974) Petroleum Industry in Norwegian Society

³² The Petroleum Act, Act 29 November 1996 No. 72, Chapter 2, Chapter 3 and section 4-3 PA

3.4 State organised licence groups

The MPE selects a group of suitable companies to create a licence group for each licence it grants. This is another feature of Norwegian oil policy: the state considered it better resource management to have several oil companies conducting oil activities rather than one company acting alone. The MPE invites oil companies to apply for a licence to explore or produce petroleum in a defined licence area. On the basis of these individual applications, the MPE organises the licence group. The licensees are chosen on the basis of financial strength and experience in petroleum operations. In the early years the Ministry would also consider whether the applicant would be contributing to the Norwegian economy³³. The licensees are obliged to enter a Joint Venture Agreement with one another and conduct petroleum operations in partnership. Petroleum is produced jointly, but each licensee owns its proportionate share of produced petroleum. This process ensured government discretion over who and how activities were conducted. The NOC would participate in co-operation with foreign oil companies, but did not need to apply for a licence itself.

3.5 State participation within the licence groups

The eighth 'Oil Commandment' shows that the state aimed to create a NOC to look after its commercial interests within the licence groups. In 1972 a 100% state-owned company, Statoil, was established by decision of the Norwegian Parliament. This entity directly participated as a fully operational oil company in every licence group from the third licensing round in 1974.

According to Noreng there were three main objectives for DSP:

1. Revenue: securing the highest possible share of the earnings from oil, excluding tax and royalties
2. Government control: ensuring more direct control of operations than is possible through the licence system alone

³³ This could be through marketing in Norway, constructing refineries, using Norwegian ships etc. In addition, a condition for granting the licences was that the applicant would utilise onshore bases in Norway and use Norwegian labour, Al Kasim (2006) pp19-20.

3. Know how: to learn as much as possible about the oil industry through active cooperation with private companies³⁴

These aims are clear from the government papers debating the establishment of Statoil, stating that DSP would *‘besides the opportunity for greater economic revenues, secure direct state influence in the activities, at the same time as being able to develop more comprehensive Norwegian know-how’*³⁵.

The legal structure of Norwegian DSP will first be outlined to show *how* the Norwegian government set about achieving these aims. The actual contribution of DSP to these stated aims will then be discussed.

3.6 The organisation of direct state participation in Norwegian petroleum law

The ‘Norwegian model’ of DSP included a 100% state-owned NOC and two independent legal entities to regulate this company: The MPE and the Norwegian Petroleum Directorate (NPD).

3.6.1 Statoil: the national oil company

Statoil is Norway’s NOC. When created in 1972, it was as an ordinary joint stock company under Norwegian company law³⁶, but with all the shares held by the Norwegian state³⁷. Thus Statoil’s legal status was somewhat unclear at this stage, being a business enterprise, but with complete state ownership, which implied a national purpose.

This national purpose was to uphold the government’s commercial interests in licence groups and to serve as a vehicle for technology transfer and economic development³⁸. Statoil was thus an instrument of the Norwegian state, but unlike most state-run entities, it was structured as a relatively autonomous company. The directors held the main responsibility for fulfilling Statoil’s commercial mandate. They were given a large degree

³⁴ Noreng (1980) p121

³⁵ St.prp.nr.113 1971-1972:8

³⁶ Limited Liability Companies Act (1957)

³⁷ Mestad (1985) pp 65-66

of freedom from the government in making these commercial decisions³⁹. Furthermore, Statoil's own fortune was formally separated from the state treasury because it was governed by Norwegian company law. Thus it did not need the state's permission to use its own money⁴⁰. It paid taxes, as other oil companies did, and the state earned money through dividends as company shareholder. Thus Statoil was essentially a commercial enterprise, but acted primarily in the state's interest, rather than its own private interests.

Statoil's legal status has been reformed considerably since its creation. These reforms were designed to reflect the state's changing objectives for its NOC and to ensure the company continued to function in an efficient manner. This legal reform is a key part of the Norwegian Model for DSP and will be discussed as such in Chapter Four.

3.6.2 The responsible authorities

The legal organisation and mandate of the authorities responsible for the petroleum sector were designed to maximise state control and to promote good resource management. The system is structured in a hierarchical manner. The Norwegian Parliament (The Storting) makes the main decisions and sets the key principles. The government has the overall responsibility to see to it that these principles are followed. The MPE is the delegated government department with specific responsibility to regulate activities on the NCS. The NPD is subordinate to the MPE and responsible for regulating the day-to-day activities on the NCS, while Statoil, like the other oil companies, is subject to the decisions of both the NPD and the MPE⁴¹.

The overarching function of Statoil, the NPD and the MPE is to ensure good resource management of petroleum activities. Their relationship to one another was structured in law to enhance this purpose. The key roles were clearly separated between these three, independent, legal entities in what is known as a tripartite system. The MPE has the main policy making function, the NPD is responsible for regulating the oil companies and Statoil

³⁸ Stenvoll (2007) p23

³⁹ Mestad (1985) p67

⁴⁰ Mestad (1985) p72

⁴¹ Mestad (1985) p47

was made responsible for the state's commercial interests. This prevented overlap of responsibilities and conflicts of interest between these key functions.

3.6.3 The Ministry of Petroleum and Energy and the Norwegian Petroleum Directorate

The MPE is central to the legal and administrative system for resource management on the NCS. It took over responsibility for the sector from the Ministry of Industry in 1978. This ensured that the necessary considerations in petroleum activities were safeguarded by a separate sector ministry dedicated to these activities⁴². The MPE was made specifically responsible for the formulation of oil policy and the licensing system. It works with the political leadership to plan the development of the sector and does the preparatory work prior to the Cabinet granting production licences. All other major licences and approvals are issued directly by the MPE pursuant to the Petroleum Act 1996⁴³. Thus, while the ultimate legislative and executive power rests with the state, the central governing functions rest with the MPE.

The NPD was established simultaneously with Statoil in 1972 as a separate government entity. It was made responsible for technical and regulatory supervision and guidance in the petroleum sector. It compiles data, collects fees, sets regulations within its areas of responsibility, and advises the Ministry on technical matters⁴⁴. It is subordinate to the MPE and, while the MPE has overall responsibility for resource management, the NPD has more day-to-day, technical and regulatory control. It also handles the more detailed approvals and consents⁴⁵.

This division of commercial, regulatory and policy functions into three independent legal entities enables the state to have greater control over petroleum activities. This tripartite system is an essential part of the legal framework for Norwegian DSP.

⁴² The Norwegian Petroleum Directorate (2003)

⁴³ The Petroleum Act, Act 29 November 1996 No. 72, see I particular Chapters 2, 3 and S 4-3

⁴⁴ Thurber et al (2011) p5367

⁴⁵ Hammar et al (2011) p11

3.7 The contribution of direct state participation to Norwegian oil policy

The state's objectives for DSP were to increase revenue, know how and control. In the following sections, the contribution that Statoil made to these goals will be described.

3.7.1 State revenue

DSP significantly contributed to state revenue. Statoil was granted a 50% participatory interest in each licence, giving the state a proportionate share of the value of the resource extracted. This was in addition to the revenue received from royalties and taxation of the oil companies in each joint venture. The state optimised government take by mandating further privileges for Statoil. The 'sliding scale' provision was introduced in the fourth licensing round in 1979. If a field was deemed commercial, Statoil reserved the right to increase its participating interest by up to 85%, depending on the size of the field. In addition, Statoil's exploration costs were 'carried' during the exploration phase, reducing capital investment during this uncertain phase of activities.

The Statfjord Field provides an example of how DSP contributed to state revenue. This field was discovered in a block during the third licence round. This was the first round during which Statoil held a 50% interest. This field would turn out to be one of the biggest reservoirs in the world. By this time the oil price had also risen to four times that of the year prior to the Statfjord find⁴⁶. Had the state not secured Statoil's 50% interest at this early stage, it would have failed to capture significant revenues from this giant field.

3.7.2 Government control

DSP was at the centre of the government's strategy to 'steer' petroleum activities in the national interest. It was the primary tool of direct control over Norwegian resources⁴⁷. The presence of Statoil in each licence group secured government influence at each important phase, during exploration, development and production. The 50% participatory interest gave Statoil a significant degree of influence in each management committee of each joint

⁴⁶ Ryggvik (2010) p31

⁴⁷ Nelsen (1991) p41

venture and a veto-right over decisions. This effectively gave the state a controlling interest in virtually every producing field covered under licences awarded after 1973⁴⁸. This enabled the authorities to maintain close control over the direction, tempo and impact of petroleum activities on the NCS⁴⁹.

The importance of this national influence within licence groups was demonstrated at the initial stages of developing the pipeline network. The pipeline network is used to transport oil and gas from the field to the European and UK markets. Whoever secures control over access to the pipeline network also, in effect, controls access to the market. Monopoly over the market can develop through strategic ownership of a pipeline network. In the Ekofisk field, the American oil company Phillips insisted that as owner of the field it should also own the connecting pipeline. The pipeline from Ekofisk was of particular strategic importance. It had the potential to be a ‘trunk pipeline’, connecting other fields to the market⁵⁰. The Norwegian state challenged Phillips to gain state control over this pipeline. In doing so the 50% share for Statoil was secured, effectively preventing Phillips obtaining a decisive ownership position. This also opened the way for Statoil to take over as operator of the pipeline at a later point⁵¹. The Norwegian state, through DSP, secured this strategic position, ensuring state control over the development of the pipeline transport network.

3.7.3 Know how

DSP gave Norway a ‘window to the oil industry’. Through Statoil, Norway developed hands on technical and managerial experience of oil operations. In doing so, it generated expertise that could be used to strengthen its position against the international oil companies. Norway was able to overcome the information asymmetries between oil companies and government authorities. As a result, the balance of power turned in favour of the Norwegian state. The knock on effect was an ability to negotiate more favourable conditions for the state because it knew the true value of its resource base. It could, for example, demand more stringent and favourable terms and higher tax rates over time, to a large extent as a result of the learning process of a fully operational NOC.

⁴⁸ Nelsen (1991) p59

⁴⁹ Al Kasim (2006) p242

⁵⁰ Ryggvik (2010) p29

⁵¹ Ryggvik (2010) p29

3.7.4 Norwegianisation

In addition to increasing revenue, control and know how, the state oil company was also involved in the ‘Norwegianisation’ process. This policy objective was based on a desire to build up a strong domestic industry with both oil companies and suppliers⁵². It is alluded to under the third Oil Commandment ‘*that new industry is developed on the basis of petroleum*’ and was formally declared in the Royal Decree of 8th December 1972. This objective became another means of using petroleum activities to benefit the Norwegian society as a whole.

According to Corti and Frazer, Norwegianisation consists of three elements:

1. Increased equity shares and operator responsibilities for the three Norwegian oil companies: Statoil, Norsk Hydro and Saga
2. Increased use of Norwegian goods and services in petroleum activities
3. Norwegian industrial development⁵³

This process was primarily implemented through regulations and conditions attached to licences. However, Statoil also played an important role. It was, as a Norwegian company, both a part of the Norwegianisation process itself and helped to further implement the use of local content⁵⁴. Firstly, Statoil and the two other Norwegian oil companies Hydro (51% state-owned) and Saga (private) were singled out for special treatment by the state to encourage the development of a Norwegian petroleum industry. This preference was clear from the privileges granted to Statoil and the appointment of Norwegian oil companies in licence groups and to the position of operator; the most influential position in a joint venture. In the third licence round Norwegian companies were appointed operator in eight of the twelve licences (four to Statoil). This trend continued in the fourth licence round of the ‘Golden Block’⁵⁵. Secondly, designating the role of operator to Statoil increased the use of Norwegian goods and services. Statoil, as operator, had the corresponding

⁵² Rasen (2102) pp13-14

⁵³ Corti and Frazer (1983) p70

⁵⁴ Nelsen (1991) pp70-72

⁵⁵ Nelsen (1991) p71

responsibilities for procurement, enabling the state to direct the use of Norwegian as opposed to foreign industry. This Norwegianisation process was an indirect and broader means of benefiting the Norwegian society through petroleum activities.

These four main outcomes show that DSP furthered the Norwegian state's objectives for its petroleum sector. This in turn indicates that it is desirable to make the system work in other countries rich in natural resources.

Chapter 4 How the Norwegian state achieved the benefits of direct state participation

The following chapter describes how the state used Statoil to achieve the objectives outlined in Chapter Three. This is the ‘story’ of the development of Statoil. Chapter Three described the company’s role and legal status in Norway. This Chapter will show how this changed according to the changing needs of the country. During the early years of the Norwegian petroleum sector, Statoil was legally granted certain privileges to enable it to achieve the government’s objectives at this particular stage. Once it became a powerful company and the state changed its objectives for the petroleum sector, Statoil went through major legal reform. This chapter is designed to illustrate the complexities of controlling a NOC so that it acts in the interests of the state and thus does in fact help prevent the symptoms of the resource curse.

4.1 The early years

4.1.1 Statoil’s legal privileges

Statoil was granted significant privileges during the early years. This enabled the state to build a strong and competent NOC and rapidly achieve its objectives for DSP. These privileges were a 50% participatory interest in each licence group, the ‘carried interest’ provision and the option to increase its participatory interest if a field was deemed commercial. These privileges helped to maximise the government revenue from and control in each licence group.

During the first licensing rounds, prior to the establishment of Statoil, the government agreed to relatively poor conditions for itself, which benefited the foreign oil companies⁵⁶. This included large licensing areas, low royalty levels and tax reductions to encourage the oil companies to invest in the NCS. The results highlight the importance of Statoil’s privileges during the early years. The first concession round was the largest Norway ever

⁵⁶ Ryggvik (2010) p19

offered and Norwegian companies were only given minimal shares in twenty one of the three hundred and forty six blocks allocated. By chance Hydro had a 6.7% interest in the block that was found to contain the Ekofisk field. Had the Norwegian state mandated DSP and an option to increase its share at this stage, the income from the Ekofisk field could have been far greater. The rights of a NOC may need to be less stringent during the initial phase so as not to deter foreign oil companies. However, the experience from the Ekofisk field demonstrates the importance of securing DSP and mandating certain privileges as early in the process as possible.

4.1.2 The role of system operator

A key means of gaining know how and control was to assign the role of operator to Statoil. This is a strategic and influential role sought after by the oil companies. For example, several foreign companies rallied for the position in the giant Statfjord field. Mobil was assigned the role, but on the condition that it train Statoil as operator and hand over the role ten years after the field became commercial. Statoil was assigned the role of operator in several other joint ventures. Operatorship ensured state presence at every important stage, ‘conquering the strategic heights’ of petroleum activities as the most influential position in a joint venture. The position maximised state influence in each licence group and enabled it to gain expertise over and above that of an ordinary licensee.

4.1.3 Control over Statoil

The legal framework governing the relationship between Statoil and the state

How the state controlled Statoil during the early years made an important contribution to the government achieving its objectives for DSP. In the process of creating a NOC, the government emphasised the need to ensure adequate control over its policies and actions⁵⁷. White paper no. 113 to the Storting (1972) stated in this regard *‘the Ministry of Industry will underline that the authorities will at all times have control over the companies activities since the state as a 100% owner will have the full instruction right in accordance with the rules of the law on public share holding companies’*.

⁵⁷ Al kasim (2006) p179

Statoil was controlled by several state entities; the NPD, MPE, the government and parliament. Each entity had a separate function to prevent a conflict of interest arising that could undermine state control over Statoil. The legal framework for political control aimed to ensure that the new state-owned oil company functioned for the benefit of Norwegian society as opposed to its own, private interests⁵⁸. The methods for controlling Statoil consisted of oversight, reporting and accountability requirements.

Reporting regulations ensured Statoil made sound decisions in managing the state's commercial interests. Under Article 10 of Statoil's Articles of Association, the board of directors was legally obliged to '*submit to the General Meeting ...all matters which are presumed to involve significant political questions or questions of principle which might have important affects on the nation and its economy*'. The Minister for Petroleum and Energy was Statoil's General Assembly who called an annual General Meeting and had the discretion to call for extraordinary General Meetings if required⁵⁹. Article 10 also required an annual plan on all aspects of Statoil's future activities to be submitted to the MPE. Statoil's annual plan was commented upon and amended where necessary by the MPE. It was then submitted to parliament for discussion and approval. Biannual reports were also submitted and quarterly meetings held with the relevant authorities. Article 10 was implemented to ensure that no significant decisions were made without prior approval. It also enabled greater state oversight of the company's activities. This was particularly important considering the significance that oil activity was to have on the Norwegian economy⁶⁰.

The integrity of the information submitted by Statoil to the authorities was ensured by legal requirements and institutional checks. Firstly, *all* licensees operating on the NCS were required to submit large amounts of information to the Ministry. Since each company in every licence group had to submit information, this acted as a check on the reporting of other companies within the same licence group. Secondly, the Minister had rights as an observer in the meetings of the management committee of each joint venture. The MPE could also draw on the independent expertise of the NPD. These checks could be used to

⁵⁸ Nelsen (1991) p37

⁵⁹ Al kasim (2006) p179

⁶⁰ Richardson (1981) p39

verify the information supplied by Statoil and were intended to ensure that it would not conduct its own policy or steer the MPE⁶¹.

In addition, in Norway there is a tradition of informal dialogue and co-operation between government and industry. This supplements and enhances the formal procedures. This is a significant aspect of how the Norwegian petroleum industry functions, but will not be expanded upon in this thesis because it is unrelated to law. Nonetheless, it is important to be aware that it has played a significant role. Considering all formal and informal oversight mechanisms the state had at its disposal, the amount of information passing between the Ministry and Statoil was quite considerable⁶².

4.2 Statoil's changing role as an instrument of the state

The legal framework governing Statoil aimed to allow the company to develop into a powerful instrument for the state, while at the same time control it to ensure that it did indeed act in the state's interest. Throughout the seventies there was political consensus on the need to develop a strong, influential and competent oil company through which the state could pursue its national objectives⁶³. The dilemma that emerged was how to reconcile political control with the maximum possible freedom for the state oil company in its commercial operations⁶⁴. By the 1980s it was clear that this balance needed to be re-instated. As the balance of power began to tip in favour of Statoil, important reforms were introduced to adjust both the control of and role of Statoil as a policy instrument.

4.3 The problems emerge

4.3.1 Losing control

As Statoil became an increasingly strong oil company, it began to wield some political power. The rising wealth of Statoil, its privileged position in licence groups, combined with its ever-growing expertise, enabled the company to become too influential. The

⁶¹ Noreng (1980) p147

⁶² Richardson (1981) p39

⁶³ Al Kasim (2006) p87

⁶⁴ Richardson (1981) p37

formal mechanisms of controlling the company began to show signs of strain.

Statoil was in a dominant position in relation to other oil companies and, to some extent, in relation to government authorities. The voting rules and guaranteed 50% interest in each licence group meant that the company held a veto right in decision-making procedures. Alternative views could thus be subdued and Statoil could commit licensees, as well as the authorities, to decisions that were difficult to reverse politically⁶⁵. Furthermore, disparities between the government authorities and Statoil began to emerge. Statoil was able to develop greater expertise, human capital and financial capacity than the NPD⁶⁶. This is significant because the role of the NPD was to regulate Statoil and unequal capacity undermines this element of governmental oversight. There was concern that the NPD was not able to stay ahead of Statoil and control its activities effectively. Moreover, Richardson suggests that the MPE was also not regulating Statoil as it should. Although difficult to substantiate, the suggestion is that Statoil was granted what it requested with few exceptions⁶⁷. Concerns were raised that Statoil could overwhelm the petroleum policy-making structure⁶⁸.

Problems also began to emerge with the formulation of Statoil's reports to the MPE on its business plans. These reports had to be submitted at regular intervals under Article 10 of Statoil's articles of association⁶⁹. They became a point of contention between Statoil and the authorities. The MPE on the one hand wanted more information on future plans, investment and cost predictions⁷⁰. On the other hand, Statoil was concerned that its business dealings with private companies could be undermined by the constant public scrutiny. Thus for Statoil the goal in writing the Article 10 plans was to reveal as little as possible about the company's forward planning⁷¹. This lack of information would undermine the government's ability to approve and evaluate its plans and thus control its future activities before irreversible actions were taken. On the one hand Statoil wanted greater independence, while the state needed to restrain this freedom to remain in control. This issue is also illustrative of the emerging conflict between Statoil as an instrument of

⁶⁵ Al Kasim (2006) p88

⁶⁶ Nelsen (1991) p78

⁶⁷ Richardson (1981) p40

⁶⁸ Nelsen (1991) p78

⁶⁹ See s 4.1.3, para 3

⁷⁰ Nelsen (1991) p78

the state and Statoil as a commercial enterprise.

4.3.2 Policy instrument vs. commercial enterprise

Problems also began to emerge with the commercial efficiency of Statoil's operations. It became increasingly clear that the company needed to be exposed to market forces and that a change in this direction would be in the interests of both Statoil and the state.

4.3.3 The Mongstad scandal

The events of 1979-1985 over the Mongstad refinery would become the biggest industrial scandal in Norwegian history⁷². It gave a stark illustration of the need to expose Statoil to market forces.

The Mongstad project was controversial and met with opposition from the beginning. Statoil wanted to invest downstream and made plans to upgrade and expand the refinery. Norsk Hydro and the conservative party in opposition both argued that such a project would not provide sufficient return on investment⁷³. After intense political lobbying by Statoil, the plans were eventually approved in June 1984 and given a budget of NOK 4.920 Billion⁷⁴. The project overran its budget by 100%. Statoil had been aware of cost overruns, but did not inform the authorities until two years had passed. The company was criticised in a report by the MPE for a serious lack of leadership and proper management. Another report by the Auditor General accused Statoil of covering up the costs and criticised the MPE for not obtaining verifiable information from the company throughout the project⁷⁵. The scandal led to the resignation of a number of Statoil's board and Arve Johnsen, the company's CEO⁷⁶. The events highlighted the benefits that exposure to market forces could bring to the performance of the company.

Events internationally and domestically following the Mongstad scandal would strengthen

⁷¹ Richardson (1981) p42

⁷² Nelsen (1991) p177

⁷³ Gordon and Stenvoll (2007) p28

⁷⁴ Nelsen (1991) pp176-177

⁷⁵ Nelsen (1991) p177

⁷⁶ Nelsen (1991) p177

the call for greater commercial efficiency. Statoil again experienced significant cost overruns, this time at the Åsgard Field and the Snøhvit project. Moreover, the oil price crash in 1998 weakened the overall profitability in the oil industry. The lower profit margins resulting from the increased cost of conducting petroleum operations and the lower price of oil changed the priorities of both Statoil and the state. The government was now mainly concerned with maximising oil revenue. Statoil had served its initial purpose and the government wanted to focus on maximising return on its investment. Statoil wanted greater commercial freedom to expand internationally and less state oversight of its actions⁷⁷. Thus it was now in the interests of both Statoil and the state to re-structure the legal framework governing Statoil's role and powers in a manner that increased its commercial efficiency.

4.4 Reform of Statoil: stage one 1984

With effect from 1st January 1985, Statoil was reorganised in what became known as the '1984 Reform'⁷⁸. The government and parliament reached a solution to help normalise Statoil's position to that of a strictly business company, without excessive decision-making or financial advantages⁷⁹. The essential concern was to make Statoil a more useful servant to society⁸⁰.

Statoil's privileges were largely removed and a distinction was made between the company's licence shares and those of the state. Three main legislative changes were introduced⁸¹:

1. To moderate Statoil's economic growth, a distinction was made between the shares that generated revenue for Statoil and those that generated revenue directly for the state; the state direct financial interest (SDFI). This would re-direct some of Statoil's revenue directly to the state and put more of the oil income under the direct control of the Storting.
2. Statoil's financial advantages were removed, including the carried interest and sliding

⁷⁷ Austvik (2007) p211

⁷⁸ St meld nr 73 (1983-84) and Innst S nr 321 (1983-84)

⁷⁹ Al Kasim (2006) p88

⁸⁰ Nelsen (1991) p169

scale provisions. These privileges were only to be exercised in favour of the state's share. This also helped to dampen Statoil's financial strength and equalise its position in relation to other licensees, although it did retain the right to a 50% interest in all licence groups.

3. Statoil's administrative advantages were removed. It no longer had the right to vote the state's entire share in each licence group and now needed one of the other companies to vote with it to block or pass a measure. The General Assembly, on approval from the Storting, retained the discretion to instruct Statoil to veto a decision in exceptional situations⁸².

These changes aimed to put Statoil on a more level playing field with other companies operating on the NCS and force it to act more like a private enterprise. Statoil's role as a policy instrument continued, but greater emphasis was now placed on Statoil as a commercial enterprise⁸³.

4.5 Reform of Statoil: stage two 2001

The 1984 reform was only the first step in Statoil becoming a more commercially oriented company. In light of the cost overruns at Mongstad and other projects, the declining price of oil and the desires of Statoil itself to expand its operations, a second major reform was implemented in 2001⁸⁴

Firstly, Statoil was partly privatised and introduced on the New York and Oslo stock exchanges in June 2001. Statoil was now organised as an ordinary, limited liability company as opposed to a state-owned company. The state maintained a majority stake in the company at 81.7%⁸⁵ and thereby reserved a degree of influence. Despite this, the main effect of partial privatisation on the state's relationship with its NOC was to put it on an equal footing with other shareholders⁸⁶. The MPE was now prohibited from consulting Statoil on commercial issues. Meetings with the MPE were now the same as meetings with

⁸¹ Al Kasim (2006) p88

⁸² Nelsen (1991) p95

⁸³ Nelsen (1991) pp170-171

⁸⁴ St prp nr 36 (2000 - 2001) Ownership of Statoil and Future Management of the SDFI and Innst S nr 198 (2000-2001)

⁸⁵ In 2012 the state owns a 67% share of Statoil and thus remains its largest shareholder, Statoil (2012)

⁸⁶ Thurber and Istad (2012) p623

other investors. Thus a more business-oriented relationship was created with Statoil and a clearer distinction was thus made between government authorities and the now partly private NOC.

The Norwegian constitution does not allow a partly privatised Statoil to manage the SDFI. Thus, the second part of this reform was to transfer responsibility for managing the SDFI to a new government entity: Petoro⁸⁷. Petoro is formally a licensee and takes part in the decision-making process in joint ventures, but it was not designed to be another oil company. It is structured as a 100% state-owned, non-operating company and does not generate its own income. All of its operating funds come from the state treasury⁸⁸. Its internal relationship to the state is essentially the same as Statoil's was prior to privatisation. However, unlike Statoil, it does not apply for licences, perform any operator responsibilities or sell the state's shares of produced petroleum⁸⁹. Statoil continues to sell the SDFI, but Petoro supervises this. Statoil was now structured as a purely commercial enterprise and Petoro a purely regulatory body.

The 2001 reform meant that Statoil was removed from managing the state's business interests and was no longer a vehicle for the Norwegian state. This is how the structure of state participation on the NCS stands today. It has enabled Statoil to focus on maximising profit and expand its operations internationally. It continues to bring in significant revenues to the state, but is no longer a policy instrument as it was during the early years.

⁸⁷ Petoro is governed by Chapter 11, The Petroleum Act, Act 29 November 1996 No. 72

⁸⁸ Thurber and Istad (2012) p623

⁸⁹ Hamar et al (2011) p24

Chapter 5: Distinctive features of Norwegian direct state participation: the key factors contributing to its success

DSP was part of the reason that Norway avoided the resource curse and managed to use its natural resource endowment to benefit the population⁹⁰. This success can be attributed to certain legal and non-legal factors that were implemented as part of the petroleum sector or existed prior to the discovery of petroleum on the NCS. This chapter identifies these factors and how they contributed to the success of Norwegian DSP. They have been taken from a range of sources and compiled to show the most salient and commonly cited aspects of the Norwegian system that enabled Statoil and the principle of DSP to work effectively for the benefit of the population⁹¹

5.1 Legal factors

Certain aspects of Norway's legislative framework for its petroleum sector made an important contribution to the success of DSP. Norwegian petroleum law laid down the model system of separating functions between government entities, the rules for ensuring transparency and accountability in the petroleum sector and a licence system that created competition between Statoil and foreign oil companies. Each of these legal factors will be discussed in turn.

5.2 The separation of functions model

A key principle of the Norwegian system of governance is to separate functions between government entities. In the Norwegian petroleum sector this has meant separating three state-controlled institutions, each with its own distinct role: the regulatory (NPD), policy-making (MPE) and commercial (Statoil). Each of these bodies is independent and has an arms length relationship with the other entities. This tripartite separation between

⁹⁰ See section 3.7

⁹¹ These factors largely correspond to those identified under Precept 6 NRC, see section 2.4

commercial, policy, and regulatory functions has become known as the “Norwegian Model” of oil sector governance⁹².

This administrative structure has a number of advantages. Firstly, it avoids any conflict of interest arising between the regulatory/policy-making bodies and the commercial entity. Each function entails a different set of interests, which may conflict in certain situations. The regulator must consider the long-term interests of the population as a whole, while the commercial entity focuses on maximising profits⁹³. If the same institution were responsible for both roles, the drive to increase profit could compromise the need to regulate certain actions that generate profit, but harm broader interests. Maximising the revenue of a NOC should not be at the expense of other important interests. In the Norwegian context, the main non-commercial interests are protecting the environment, other industries such as fishing, and the principle of extraction at a moderate tempo. These interests need to be balanced with the profit motive⁹⁴. Thus it is important that the regulator and the policy-makers are formally separated into two entities, distinct from the commercial objectives of the NOC.

Separating responsibilities into three distinct entities also enables each role to be performed more effectively. Firstly, the government and the MPE are able to maintain a much higher degree of control over Statoil. Where a NOC performs both the regulatory and commercial functions it can quickly grow to become a very powerful entity, undermining government influence over its actions. In the Norwegian system, the government always maintained the full right of instruction through the Cabinet, the MPE and the NPD⁹⁵. Secondly, it also improves the commercial role of the NOC. Where the NOC carries out both commercial and regulatory functions, this can lead to business distrust between the international oil companies (IOCs) and the NOC⁹⁶. This can undermine the relationship of the NOC and IOCs and thereby the state’s commercial interests. The NPD emphasises its objectivity in regulating petroleum activities to reassure the IOCs that this is done in a neutral manner. In contrast to Statoil, the NPD is able to perform this task without bias to Norwegian

⁹² Al-Kasim (2006) p242

⁹³ Noreng (1980) p26

⁹⁴ Al-Kasim (2006) pp132-133

⁹⁵ Al-Kasim (2006) p179

⁹⁶ Al-Kasim (2006) p175

commercial interests and acts as a ‘faithful guardian of the public interest’⁹⁷. Thus the separation of functions model also improves the standard to which each function is carried out.

Separating functions also had the advantage of focusing Statoil more clearly on the state’s business interests. This contrasts to other NOCs, which often have pressure to perform non-commercially. Sonangol, the NOC of Angola, runs an airline, bank and telecoms company and NNPC, the NOC of Nigeria, runs social programmes, in addition to its core activities. Statoil’s more specific function helped it to focus on its key purpose and to avoid becoming embroiled in politics. According to Stenvoll, this independence from politics was critical in Statoil’s development as a successful commercial entity and its ability to take on necessary, but risky investments⁹⁸.

5.3 An accountable and transparent petroleum sector

Statoil was governed by legal norms that ensured its decisions were transparent and public sector agencies were accountable for their actions. This prevented corruption and fostered good practice within the petroleum sector. There was a clear set of internal regulations for Statoil and the other entities, such as the reporting requirements discussed above and laws that limited and clarified the powers of each entity⁹⁹. The legal system in Norway was able to enforce transparency and accountability and thereby upheld these principles. This instilled confidence in the sector from IOCs. For example, licensees could appeal decisions of government agencies, reassuring the foreign companies that they would not be unfairly treated, despite the presence of Norwegian commercial interests in joint ventures. In addition to the legal norms, Norway had an existing tradition of transparency, openness and integrity in its civil service¹⁰⁰. As a result of this transparent system, the Norwegian petroleum sector has thus far been free from corruption and the licensees and authorities are able to cooperate effectively.

⁹⁷ Al-Kasim (2006) p180

⁹⁸ Stenvoll et al (2007) p51

⁹⁹ s 4.1.3

¹⁰⁰ Al-Kasim (2006) p241

5.4 Competition between oil companies

A criticism often made of public enterprises is under-performance because of the lack of incentives generated by commercial competition. Due to the joint venture system, Statoil, to a certain extent, conducted its petroleum activities in a competitive environment. This is regarded as having improved Statoil's performance. Participating as a licensee in joint ventures meant that the NOC's performance would be benchmarked against other oil companies¹⁰¹. The presence of more than one *Norwegian* oil company was of particular importance. According to Al Kasim the presence of both Statoil and Norsk Hydro improved efficiency and prevented a monopolistic dominance by one company¹⁰². This indigenous competition for assets between Hydro, Saga and Statoil is a distinguishing factor between Norwegian and other NOCs because it faced more pressure to perform financially¹⁰³. This feature has been termed a 'value adding force' because it is seen as having increased the revenue generated by Statoil¹⁰⁴. The Storting recognised this, stating that, '*active competition between several competent companies helps to ensure the best possible use of resources. In this way we ensure that they sharpen themselves against each other*'¹⁰⁵. Having Statoil operate in a competitive commercial environment thus improved its ability to generate revenue for the government.

5.5 Non-legal factors: Norway's privileged starting point

The following features are independent from law and were already present in Norway prior to discovering petroleum resources. They include a well-functioning civil service, possessing the tools to quickly and competently establish a NOC, and the ability to attract foreign oil companies relatively easily. These factors enhanced the success of DSP and the formal legal framework. They put Norway in a privileged position to achieve success in the petroleum industry, but are often lacking in developing countries. Isolating these factors will indicate whether lessons could be learnt in developing countries or if DSP is too specific to Norway to be workable elsewhere.

¹⁰¹ Thurber et al (2011) p5371

¹⁰² Al-Kasim (2006) p187

¹⁰³ Stenvoll (2007) p22

¹⁰⁴ Stenvoll (2007) p51

¹⁰⁵ St prp nr 36 (2000 - 2001) Ownership of Statoil and Future Management of the SDFI p10

5.5.1 A competent bureaucracy

The administration of DSP depended on a well-functioning bureaucracy. The separation of functions model can only be an effective framework if those who work within it are competent. Petroleum activities are highly expensive, thus swift and accurate management by government agencies is needed¹⁰⁶. Furthermore, the success of DSP also depended on the MPE and the government being able to adapt the system to changing national and international conditions. For Statoil, the ability of the state to reform its structure, legal status and privileges was particularly important as the need for greater commercial efficiency increased. This involved a significant reassessment of the links between Statoil and the state. The legal solution that the Norwegian bureaucracy created has been termed a ‘Norwegian Innovation’¹⁰⁷. Norway was able to create a more profit-oriented company and avoid the poor-performance often associated with NOCs. Thus the Norwegian civil service were important both in effectively carrying out the roles of regulator and policy maker, and in having the necessary knowledge and foresight to change policy and reform institutions when good resource management required it.

5.5.2 Enterprise capacity

Norway was fortunate to have the necessary tools in place to mobilise its own petroleum operations. Al Kasim has termed this ‘enterprise capacity’ and states that *‘the high level of enterprise capacity in Norway before the oil age was one of the most important factors contributing to its success as a petroleum nation’*¹⁰⁸. The building blocks for developing its own oil company were already in place at the time of the first oil discoveries. The main factors relevant to DSP included: technological expertise in related industries, a developed institutional framework, available infrastructure, a high level of education and relevant skills, a stable economy, experience in state participation in other industries, traditions of transparency and competence in the civil service¹⁰⁹. For example, Norwegian universities were able to quickly develop the relevant research institutions and educate new personnel with specific knowledge of petroleum activities. Norway’s stable economy and efficient administration ensured that the necessary expertise and technology could be adapted to

¹⁰⁶ Al Kasim (2006) p177

¹⁰⁷ Clauss (2002) p8

¹⁰⁸ Al Kasim (2006) p128

¹⁰⁹ Al Kasim (2006) p127-128

petroleum activities in an efficient and reliable manner. This enabled the state to successfully implement DSP and for Statoil to become a competent oil company in a relatively short space of time.

5.5.3 The Norwegian Continental Shelf: an attractive and stable investment

Statoil's success was dependent on foreign oil companies; they were its source of know how and revenue. Thus the success of the Norwegian state's own investment was reliant upon attracting competent and financial strong IOCs to enter into joint ventures with Statoil. These companies provided the experience necessary for Statoil itself to become a competent oil company. They also 'carried' Statoil's exploration costs and made the resource discoveries, which enabled Statoil to produce and generate revenue for the state. Thus Norway had to ensure it remained an attractive investment prospect.

A stable political and legal system

Norway's political system meant the country was more able to attract foreign investment. Norwegian oil was located in a politically stable democracy, which re-assured IOCs that their investments would be secure¹¹⁰. All binding agreements, such as licences, fiscal and royalty terms and joint ventures with Statoil, were almost certain to be respected. This secure and predictable system has meant that oil companies are more willing to make large investments and enter into joint ventures on the NCS¹¹¹. The Norwegian legal system also reassured oil companies that if issues did arise with the state, there would be recourse to justice. Thus Norway's status as a stable democracy gave foreign oil companies confidence and encouraged them to invest from the early stages of petroleum activities. Since Statoil relied upon foreign companies, the political situation in Norway contributed significantly to the success of Norwegian DSP.

Resource base and geographic location

Norway's proximity to the European market and the high value of its resource base also made it an attractive investment prospect. The estimated ultimate petroleum potential of

¹¹⁰ Noreng (1981) p74

¹¹¹ Al Kasim (2006) p129

the NCS is 13.1 billion standard cubic meters of oil equivalents, making the country very rich in petroleum¹¹². The timing of the first discoveries also coincided with high oil prices following the first dramatic rise in prices from 1973¹¹³. Norway also had relatively easy access to the European market, with discoveries in close proximity to the continent¹¹⁴. This guaranteed the sale of produced petroleum to offset exploration, production and transportation costs. This is of particular significance for gas. Norway's geographical location made it possible to sell the gas without excessive investment in pipelines to transport it to the continent. Thus investment in the NCS was more likely to be profitable than in a country with a less valuable resource base and high transportation costs to a distant market.

¹¹² Hansen and Rasen (2012) p26

¹¹³ Al Kasim (2006) p137

¹¹⁴ Noreng (1980) p74

Chapter 6: Lessons that can be learnt by developing countries from the Norwegian model of direct state participation

This thesis has shown that DSP helped the Norwegian government to realise the benefits of its petroleum resources and thereby avoid the resource curse. This suggests that the system has at least the *potential* to address the resource curse elsewhere. The problem for developing countries is that they do not have the same advantageous starting point as Norway when establishing their petroleum sectors. They lack many of the ‘building blocks’ identified in Chapter Four that facilitated the legal framework for DSP to function effectively. The question is what lessons can be learnt by countries that lack these ‘building blocks’ from the legislative design Norway used for structuring and regulating its NOC. Which features should be transferred to developing countries to give DSP the best chance of preventing the resource curse?

Firstly, it will be demonstrated that DSP *should* be used by developing countries because it is more appropriate than the alternative system: a liberalised petroleum sector. A liberalised sector has its advantages, but these advantages do not necessarily benefit the citizens and, moreover, certain fundamental benefits of using a NOC are lost. This focuses the question because it is no longer an issue over *whether* developing countries should use a NOC, but *how best* to manage that NOC. This leads to the second point of analysis: which legal features of Norwegian DSP could enable the system to work in developing countries? Each legal aspect of Norwegian DSP will be assessed to understand whether it could in fact assist developing countries in preventing the resource curse. Thirdly, the Norwegian model will be analysed in comparison with Precept 6 of the NRC. While the Norwegian model complies on the whole, certain legal norms are not in line with the Norwegian system. This suggests that the universally applicable principles of Precept 6 could be adjusted to take account of the fact that these legal norms did function effectively in Norway and thus may also function effectively elsewhere.

6.1 The use of national oil companies: Statoil in context

Many resource-rich countries have chosen to use a NOC. Norway is far from unique in this

sense. According to a 2007 study, nine of the top ten oil companies in terms of oil reserves, and all top ten in terms of gas reserves, are NOCs¹¹⁵. Of world proven oil reserves of 1,148 billion barrels, approximately 77% of these resources are under the control of NOCs with no equity participation by foreign IOCs¹¹⁶. Moreover, most of these companies are located in developing countries. Thus DSP is already a central part of many domestic oil sectors and fundamental to resource management on a global scale.

The popularity of NOCs in the petroleum sector grew out of a desire to establish greater national control over this strategic resource. Initially, private oil companies had dominated the industry, but, after World War II, the prevailing view was that states could and should take control over their own resources. This was articulated in the emergence of the principle of Permanent Sovereignty over Natural Resources in international law and direct participation through ownership was seen as a key part of this¹¹⁷. For example, in 1968 OPEC, issued a ‘Declaration of Petroleum Policy in Member Countries’, which encouraged members to develop their petroleum directly, resulting in the establishment of a number of NOCs in these countries. Statoil was established in this context, along with several other NOCs throughout the late 1960s and 1970s.

However, these state-owned enterprises were criticised as being commercially inefficient and, following a decline in the price of oil, many chose to privatise their NOCs during the 1980s and into the 2000s¹¹⁸. While Norway chose to partially privatise its NOC, others fully liberalised the industry, most famously Great Britain. While there has been a resurgence in the popularity of NOCs, this criticism remains relevant today. It is concerns over finance that are the key arguments against deciding to directly participate in petroleum activities.

6. 2 A national oil company vs. a liberalised petroleum sector

Petroleum operations are highly expensive and return on investments cannot be guaranteed. Where return is generated, it can take many years before a field becomes commercial. The main issue in petroleum operation is that resources cannot be directly

¹¹⁵ Kyepa (2012), Pirog (2007)

¹¹⁶ Jaffe et al (2007) p3

¹¹⁷ Mcpherson (2003) p1

¹¹⁸ Warshaw (2012) figure 2.2 p45

seen - they can only be inferred from data and surveys during the exploration phase¹¹⁹. Thus, petroleum activities involve a high degree of financial uncertainty. As a result, using state funds and taxpayers money to participate directly as an investor is a high-risk activity. This is exacerbated in developing countries that, at the outset, lack financial security and the technological and managerial skills to create a well-functioning NOC. Leaving this risk to the private oil companies by liberalising the petroleum sector and taxing their income could, in terms of revenue, benefit the country more than using a state-owned company.

6. 2. 1 The problems associated with using a NOC

Commercial inefficiency

State-owned oil companies are considered costly and commercially inefficient in comparison to private oil companies¹²⁰. This is confirmed by research and empirical evidence¹²¹. Moreover, NOCs that are privatised have shown significant improvements in their performance¹²². Indonesia's NOC, Pertamina, is illustrative of this lack of operational efficiency. A management audit of Pertamina by PwC in July 1998 exposed losses of over \$2 billion per year. Figures also show a significant efficiency gap: Pertamina's direct production costs were US\$ 5.50, whereas the industry average is US\$ 1.20¹²³. The Nigerian NOC, NNPC, also shows significant wastage, with estimated losses at between US\$ 800 million and US\$ 1 billion annually¹²⁴. This begs the question whether private oil companies are in fact a more appropriate solution to the resource curse in developing countries.

A key cause of this efficiency gap is the different incentive structures of private and public enterprises. The objective of a private oil company is to maximise shareholder value, to ensure profitability in the short and long term. There is a motive to achieve productive efficiency to hold down costs to enhance profitability¹²⁵. This requires sound technical, financial and labour management. NOCs, on the other hand, are not subject to market

¹¹⁹ Al Kasim (2006) p130

¹²⁰ Mcpherson (2003) p2

¹²¹ Pirog (2007) p10, C. Wolf (2008) p19, Eller et al (2007)

¹²² Wolf and Pollitt (2008)

¹²³ Mcpherson (2003) p4

¹²⁴ World Bank Group, NNPC Management Audit, December 2000, see Mcpherson (2003) p4

¹²⁵ Pirog (2007) p5

forces to the same degree. Efficiency suffers because there is an absence of the spur of competition¹²⁶. NOCs tend to be over-staffed and paid more than market wages, are prone to corruption and patronage and show poor financial management¹²⁷.

Cost requirements

The government must provide the funds to establish and run the NOC. If the company is to have a chance of functioning well, this will require significant capital investment in its initial set up, administration and operational activities. A developing country may be unable to afford this monetary burden. For instance, Nigeria has consistently defaulted on its contributory payments to its NOC in joint ventures over the years¹²⁸. Moreover, in comparison to the requirements of other sectors, such as education, health and infrastructure, the budgetary demands of a NOC are very large¹²⁹. It may be difficult to justify such a capital-intensive investment in countries where citizens see that their government is unable to fulfil other fundamental needs.

Statoil was a costly, but relatively efficient NOC. In countries that lack the skills, institutions and knowledge necessary to ensure commercial efficiency, state ownership could result in financial losses. Moreover Statoil, being entirely not partly state-owned and a fully operational company not just a holding company, is a particularly capital intensive and challenging model to replicate. Thus, the risks may outweigh the benefits in creating a NOC modelled on Statoil in less developed countries.

6. 3 A liberalised petroleum sector: could this be a more appropriate solution?

In a liberalised petroleum sector, all oil companies are privately owned and the government generates revenue via taxation and royalties alone. This both avoids the financial risk of direct participation and could increase government-take if the oil profits can be channelled into the state treasury.

¹²⁶ Stevens (2003) p15

¹²⁷ Stevens (2003) p16, Humphreys et al (2007) p27, Tordo et al (2011) p37-39

¹²⁸ Ogunlade (2010) p6

¹²⁹ Mcpherson (2003) p7

6. 3. 1 The advantages

Commercial efficiency

According to efficiency rankings in a study by Eller et al, the largest privately owned IOCs are the most efficient companies, in terms of revenue per employee and revenue per unit reserves, while NOCs tend to be in the bottom 20% of efficiency rankings. The average technical efficiency rankings of private oil companies were also significantly higher than NOCs¹³⁰. It follows that a private oil company will tend to generate a higher return on capital than a state oil company of a similar size and operations¹³¹. These findings are also reflected in a study by Wolf, which suggests that preference for state oil will come at an economic cost¹³². This means that government take from a given resource base could be higher in developing countries if all oil companies operating on its continental shelf are private enterprises.

Lower financial risk

In a liberalised sector the state avoids the costs of establishing and running oil operations itself and receives a steady and fairly predictable source of income. Effective fiscal policy can be used to maximise the government's share of oil rents. Neutral taxes and tax incentives can also help stimulate and sustain further petroleum development projects. Tax deductions mitigate high tax rates and encourage further exploration activities¹³³. Focussing on enforcing well-designed tax laws could be a more appropriate use of public funds in developing countries¹³⁴. The state could capitalise on the commercial efficiency of the private sector and focus on channelling these reserves into more pressing obligations to its citizenry¹³⁵.

6. 3. 2 The disadvantages

The problem of institutional capacity

¹³⁰ Eller et al (2007) pp 11-14

¹³¹ Jaffe et al (2007) p3

¹³² Wolf (2008)

¹³³ Ogunlade (2010) pp15-16

¹³⁴ Mcpherson (2003) p 8, Ogunlade (2010) p14

A liberalised sector requires strong institutional capacity and good governance in order for the state to receive the financial benefits of using this model. The government must be able to formulate and execute an effective fiscal policy and enforce its petroleum regulations. This can be particularly challenging in countries with weak institutions and little experience of dealing with powerful, multinational oil corporations. Thus it may not in fact offer a better solution for developing countries. Private oil companies generate more profit, but unless the government has a fiscal policy and institutions that capture an optimum share of this profit, the commercial efficiency of private oil companies does not benefit the country in question.

Tax administration and imposition are highly demanding tasks for state institutions. Assessing the tax liabilities of each oil company is a complex task and there is a risk of tax evasion. For example, in Nigeria, the lack of strong and independent regulations through the Federal Inland Revenue Service and Department of Petroleum Resources, allows the IOCs to interpret tax rules in an aggressive manner without being challenged¹³⁶. Even in countries that have the necessary capacity, tax avoidance is still a problem. In the case of *State of Alabama v Exxon Mobil Corp* (no. Cv-99-2368) Exxon was found guilty of illegally deducting production costs from royalty payments, resulting in \$63.6 million in unpaid royalties. In developing countries the risk of tax evasion is more acute because they do not have experienced bureaucrats to administer the complex tax structures¹³⁷. This could amount to significant losses in state revenue.

Thus, as with DSP, for a liberalised petroleum industry to benefit the state, it requires strong administrative capacity to regulate the private oil companies, oversee operations and take a fair value of the produced petroleum. Without this capacity, the asymmetries between IOC and government are likely to be exploited, to the detriment of the wider population.

The lack of a broader purpose: profit making or policy instrument?

A liberalised sector also leaves a gap in achieving any wider purpose with a country's oil

¹³⁵ Ogunlade (2010) p14

¹³⁶ Emelife et al (2012) p720

industry. Profit making is only one argument in assessing the appropriate legal structure for resource extraction and fails to capture the broader purpose of a NOC¹³⁸. The fundamental reason for state ownership of an oil company is to achieve aspirations that might not otherwise be attainable through taxation and regulation alone¹³⁹. Without a NOC, the state loses its ‘window to the industry’ and the opportunity to achieve wider benefits related to preventing the resource curse.

Statoil made a significant contribution to the government’s objectives for its petroleum sector. These benefits have been explained in Chapter Three and are likely also to be important for developing countries. These benefits are also reflected in the NRC, Precept 6. They include:

- Exerting direct control over the pace of resource development, securing supply, or achieving other national objectives
- Providing a viable vehicle for the country to build its own expertise and professionalism in the resource sector
- Developing domestic capacity and supporting development of domestic linkages between the resource and other sectors

These outcomes of DSP are based on research from natural resource sectors worldwide, which indicates that other countries also use a NOC to achieve broader objectives. For example, under-developed economies will be looking to build-up related domestic sectors and increase employment through their NOC. Generating know how is likely to be of particular importance. Direct experience through an NOC helps to overcome the information asymmetries that exist between the state and the oil companies¹⁴⁰. With little oil expertise, these countries are vulnerable to agreeing poor terms that undervalue the worth of their resources. It is also considered important by many developing countries to assert their sovereignty over natural resources and a NOC facilitates this sense of ownership¹⁴¹. The popularity of NOCs in developing countries suggests that the priority of governments in these countries will continue to be more in line with the opportunities

¹³⁷ Humphreys (2007) p25

¹³⁸ Tordo et al (2011) pp39-40

¹³⁹ Ogunlade (2010) p18

¹⁴⁰ Humphreys et al (2007) p4

¹⁴¹ Ogunlade (2010) p21

offered by using a NOC than relying on private companies. Thus, it is perhaps unrealistic to suggest that a developing country should not directly participate in petroleum activities. The analysis is not so much *if* a country should chose to use a NOC, but how it should be structured and regulated in order to realise the potential benefits.

6.4 Lessons that can be learnt form the Norwegian legal framework for its national oil company

This section will identify and analyse the key features of Norway's legal framework governing Statoil that could be transferred to resource-rich developing countries to help prevent the resource curse. The analysis will build on the factors that were identified in Chapter Four as being key to Statoil's success. The general finding is that the framework Norway used helped to mitigate the risks of using a NOC by structuring the internal and external legal framework in a manner that mimicked certain aspects of a liberalised sector. DSP certainly has the potential to help overcome the resource curse in developing countries and the following legal features should be used as part of this solution.

6.4.1 Internal legal framework

Reform of Statoil: 100% state-ownership to part-privatisation

Statoil was fully state-owned in the infant years of Norway's petroleum industry, but during the mature phase it was partly privatised. This reflected the changing interests of the government. It was important to first build up a strong NOC, and then partly privatise it when the new priority was to maintain control and efficiency. In effect, the government restructured the law and legal status of Statoil according to the role it was to play for the country. This provides a useful template for developing countries.

The priority of the early years was to exploit petroleum resources, but simultaneously ensure that the petroleum industry worked for the benefit of the Norwegian people. The state had to ensure that national interests were the guiding principles that prevailed in the industry¹⁴². A 100% state-owned NOC was the best means of ensuring this because it gave more direct influence in petroleum operations than regulations alone could bring. Complete

state-ownership is the most appropriate solution at the outset when direct national control is the priority.

When circumstances changed, however, the role of Statoil and consequently its legal foundations also had to be reconsidered. From the late 1980s, maintaining outside investment and optimising the commercial efficiency of Statoil became the priority. Statoil was seen as having served its initial purpose; it now needed to focus on maximising return on the state's investment. As a result the government introduced two main reforms. Firstly, Statoil's financial privileges were removed because they were seen as a hindrance to the state's current economic priorities. Mandating certain privileges for a NOC is important during the early years to build up a strong company and mitigate the investment risks for the state. It is important though to recognise when these privileges are no longer appropriate and introduce reforms to bring the NOC in line with private oil companies. However, this reform alone is unlikely to be sufficient to truly improve the commercial efficiency of a NOC.

Partial privatisation was the government's second solution to make a more significant impact on the commercial efficiency of Statoil. The result was greater productivity as a result of being guided by market forces, rather than bureaucratic logic. For the state it meant increased revenue as the company's biggest shareholder. Wolf and Pollitt studied the results of partial privatisation and found that Statoil improved its internal efficiency and financial performance significantly. Moreover, a calculation of the net present value of social benefits from part-privatisation came to between NOK 165.8 and 182.4 billion in 2001 money. Wolf and Pollitt conclude that '*oil privatisation, if implemented appropriately within a competitive petroleum sector, can generate substantial improvements in corporate performance and efficiency, as well as in social welfare*'¹⁴³. This clearly implies that other countries would be wise to follow this example of building up a competent NOC, then privatising at the appropriate time.

The advantages of privatisation have also been demonstrated outside the Norwegian context. Brazil provides a useful example. Like Norway it partly privatised its NOC, Petrobras, and the state maintained a majority of shares. This was implemented during a

¹⁴² Vik (2007)

¹⁴³ Wolf and Pollitt (2009)

period of reforms to liberalise its petroleum industry in order to improve economic efficiency, increase revenue and attract foreign investment. Although it is difficult to attribute one cause, following liberalisation and part privatisation, Petrobras has improved its financial performance and increased its operations overseas¹⁴⁴. This indicates that the Norwegian strategy of building up an oil company and then reducing state participation is replicable elsewhere.

Following part privatisation, the Norwegian system more closely resembled a liberalised petroleum sector. The financial and political interests of the state were implemented solely through taxation and concession rules, laws and regulations¹⁴⁵. Yet it was only after twenty years of direct experience in petroleum activities that the government decided it could rely on its laws and institutions alone to influence the industry. This process was, in a sense, the completion of the separation of functions model. Statoil became a *purely* commercial enterprise, with no role in furthering the state's interests in licence groups, while the regulatory role of the state increased. New 100% state-owned institutions were created in management positions. Petoro took over responsibility for the SDFI and Gassco took over as operator of the pipeline network. Regulations and corresponding institutions were now highly competent and experienced in managing the petroleum sector. It is only after direct, hands-on experience that a government will be able to rely on its regulations and fiscal policy alone to manage the petroleum sector.

Norway's particular method of managing DSP, by first building up a strong NOC to serve national interests, then privatising when circumstances are appropriate, provides a useful model for developing countries. By directly participating, a government can develop the necessary expertise to be able to rely solely on regulations and fiscal policy at a later stage.

Limited commercial function

The NRC strongly endorses a limited, commercially oriented mandate for a NOC. This has worked well for Norway because it focussed Statoil on its responsibility for the state's commercial interests. It should be considered though whether this is in fact 'best practice'

¹⁴⁴ Adilson (2012) p539

¹⁴⁵ Vik (2007) p32, Austvik (2012) p319

for all NOCs. It could be argued that giving the NOC a broader mandate would simultaneously increase the benefits of using a NOC.

A NOC is clearly tied to national interests, but what is in the ‘national interest’ for a developing country may differ from that of a developed country. It could be more appropriate for a NOC to pursue non-commercial functions where government institutions fail to fulfil their welfare duties. NOCs are often used to pursue a broad range of national, social and political objectives that go well beyond the original purpose of generating revenue for the government¹⁴⁶. Examples include the provision of infrastructure, such as schools, hospitals, roads and water supply, social programmes and subsidising energy prices¹⁴⁷. This would appear to accommodate a broader range of needs and benefit a greater section of the population than a limited commercial mandate.

However, research has shown that imposing a variety of objectives on a NOC conflicts with value creation and hampers profits¹⁴⁸. Non-commercial functions impose additional costs and tasks that are unrelated to generating revenue. A number of these social programmes have themselves been criticised for being ineffective, inefficient or sources of patronage¹⁴⁹. Venezuela’s NOC, PDVSA, provides a useful example of the effects that social objectives can have on the performance of a NOC. Between 1976 and the early 2000s, PDVSA was a capable, high performance company. In 2003 President Chavez increased state influence over the company and converted it from a commercially oriented NOC to pursue social objectives. These included funding and managing social programmes, known as Bolivarian missions, such as improving inner city health care, literacy and food distribution networks. Although there is some indication that these social programmes contributed to a decline in poverty, the unpredictability and weight of these obligations reduced PDVSA’s capacity to maintain operations and investments¹⁵⁰. Partly as a consequence of this, PDVSA’s performance has weakened¹⁵¹. It is generally agreed that government is better placed to perform these social duties.

¹⁴⁶ Tordo et al (2011) p37

¹⁴⁷ Tordo et al (2011) p37

¹⁴⁸ Grayson (1981) p14

¹⁴⁹ Stevens (2003) pp15-17

¹⁵⁰ Hults (2012) p455

¹⁵¹ Tordo et al (2011) pp36-40

While it may be tempting for developing countries to broaden the mandate of their NOC, they would be wise to introduce commercial functions only. The government is best placed to decide how to use the revenue generated from oil companies and this revenue is likely to be greater where the NOC is not involved in these political decisions.

Transparency rules

Norway had a clear and strict set of transparency laws governing Statoil. In addition, Norway's legal system meant public institutions could be held accountable for their actions. These laws helped to prevent corruption within the Norwegian petroleum sector and enhanced the confidence of those investing on the NCS. In addition, the Norwegian system of separating functions between government agencies complemented these transparency rules. It acted as a system of checks and balances, with each separate institution providing oversight of another. This mitigates against any opportunities for corruption within public institutions. There is little to debate over whether these rules should be replicated in resource rich developing countries. The petroleum industry is frequently marred by 'rent seeking' behaviour because of the wealth involved and developing countries that often have existing problems with corruption are particularly vulnerable to this. Thus, while the success of any system will ultimately depend on the integrity and competence of the individuals employed within the framework, laws that aim to ensure accountability and transparency should always be implemented.

6.4.2 External legal framework

Hybrid governance: Norway's joint venture system

Statoil entered into joint venture agreements with private oil companies. This represents a hybrid legal framework, half way between liberalisation and nationalisation. The oil companies were taxed and regulated independently, while Statoil co-operated with these companies to achieve a broader mandate on behalf of the state. This helped to improve Statoil's efficiency by introducing an element of competition. It also mitigated against the financial risk involved for the state in establishing a NOC and investing directly in petroleum activities.

The joint venture system improved Statoil's efficiency. Working in partnership with private oil companies simulated an environment of competition. It provided the ability to benchmark the performance of Statoil by comparing its financial and operating performance with that of the IOCs. Furthermore, the IOCs took the role of operator in joint ventures during the early years, which helped to ensure that efficiency standards were close to IOC levels¹⁵². Although Statoil was not truly in competition with other oil companies because it was guaranteed an interest in each licence group, it was still able to learn from other oil companies and faced pressure to perform at a similar level.

Where a NOC operates in a nationalised petroleum sector, it is not exposed to any element of competition. This has been identified as a key reason for the low levels of commercial efficiency in NOCs¹⁵³. For example, Mexico is the only major Latin American country that doesn't allow IOCs to participate in oil activities with its NOC, Pemex. This has contributed to the commercial inefficiency and poor financial performance of Pemex¹⁵⁴. In contrast, Brazil's NOC, Petrorbras, began with a monopoly over the oil sector, until 1997 when its petroleum industry was opened to foreign investment. Private sector companies can now compete against Petrobras for exploration and production licences. This opened Petrobras to competition and induced the company to reorganise itself to improve its operational and financial performance¹⁵⁵. This contributed to its reputation as a particularly successful NOC. These two cases illustrate that it is important for a country's laws to allow foreign investment and some element of competition with the NOC.

The presence of private oil companies in joint ventures reduced the amount the state had to contribute to exploit its petroleum reserves. The IOCs paid substantially for their licences and in taxation. This revenue could then be used by the state to finance its own operations. The carried interest and sliding scale provisions additionally helped to reduce the cost required to run Statoil. These fiscal and licensing provisions can be implemented outside the Norwegian system, provided they are not excessive in a manner that outweighs the rewards for IOCs.

In countries that lack financial capital, but aim for the petroleum industry to benefit the

¹⁵² Mcpherson (2003) p4

¹⁵³ Mcpherson (2003) p4

¹⁵⁴ Tordo et al (2011) p42

¹⁵⁵ Adilson (2012) p517

broader economic development of the country, a joint venture system mitigates the investment risk while potentially improving efficiency.

Separation of functions

The Norwegian Model of separating commercial, regulatory and policy-making functions into separate legal entities is a distinctive feature of how DSP is structured. It is regarded as best practice in resource management and endorsed by the NRC. The legal features and advantages of this system have been described in section 5.2. In summary, it removes conflicts of interest, increases state control of the NOC, enables the NOC to focus on commercial functions and the regulator to focus on moderating petroleum activities¹⁵⁶. However, the model requires significant expenditure and capable civil servants. In countries that lack human capital and revenue this model may not be appropriate.

Thurber et al suggest that attempts at this ‘ideal’ model in countries that lack the requisite building blocks are fruitless and even counter-productive¹⁵⁷. For example, Nigeria has attempted a tripartite system during reforms in both the 1980s and 1990s, with the Department of Petroleum Resources as the independent regulator. These periods of regulatory independence rapidly deteriorated and the Department of Petroleum Resources was eventually abolished. Nigeria is again planning to adopt a model that mimics the Norwegian system in its 2008 Petroleum Industry Bill, which is yet to become law. There is little hope of its success considering the extent of corruption, political meddling and resistance to providing a regulatory body with sufficient funding. The Department was always unable to procure sufficient resources to oversee and control the oil industry¹⁵⁸. In countries where the factors that enabled the tripartite model to function in Norway are missing, there may be little prospect that implementing this legal structure will be worthwhile.

It may be more economical to consolidate limited employees and revenue into one entity. For example, Angola has never attempted to create an independent regulator and has succeeded in the absence of checks and balances. Sonangol, Angola’s NOC, is the sector

¹⁵⁶ Thurber et al (2011) p7

¹⁵⁷ Thurber et al (2011) p19

¹⁵⁸ Thurber et al (2011) p19

manager, regulator and operator. It has primary responsibility for building the oil sector, policy-making and implementation in the petroleum industry, providing government revenue, issuing licences and conducting negotiations with the oil companies¹⁵⁹. In spite of these conflicting interests, Sonangol has developed a successful petroleum sector, which contrasts sharply with the rest of the struggling Angolan economy. Rather than undermine the development of the sector, the choice to consolidate the little talent and revenue it did have in to one entity seems to have contributed to its success¹⁶⁰. Foreign oil companies invested in Angola and the petroleum sector grew, even through a civil war. This suggests that creating separate entities may not be necessary to create a well-functioning petroleum sector. The question remains however whether Angola's system would have functioned better using the Norwegian Model.

A system of DSP where commercial, regulatory and policy-making functions are all consolidated into one legal entity is, however, much more vulnerable than a tripartite system. The success of a single entity is highly dependent on the competence of decision-makers with authority over the NOC. A system without checks and balances risks those with power making unwise decisions that are not monitored independently, which is a fundamental purpose of separating functions: no particular interest is allowed to dominate. In Angola the risk remains that the leaders of Sonangol fail to adequately discharge both the regulatory and commercial functions. Moreover, with the lack of an arms length relationship between the government and the NOC, government leaders may also come to abuse their power over the company. The NOC is liable to become politicised. This can be seen in Malaysia, where the NOC is sole regulator and manager of the sector, under the direct and binding control of the Prime Minister. It did have a reputation as one of the best-managed NOCs, but has become increasingly subject to political meddling and used as a 'cash cow' as it became more profitable¹⁶¹. An independent regulator serves to mitigate these risks.

Perhaps the solution for countries that lack revenue and human capital initially is to implement a structure that represents a middle way between a tripartite and one entity system. Brazil's petroleum industry began with a NOC that combined commercial and

¹⁵⁹ Heller (2012) pp836-838

¹⁶⁰ Thurber et al (2011) p17

¹⁶¹ Lopez (2012) p811

regulator functions in one entity. The tripartite system was introduced once Brazil gained the revenue, capacity and expertise to do. It now has a highly successful petroleum industry and NOC, which has, in part, been attributed to implementing this new system¹⁶². Thus, while the separation of functions model used in Norway should not be recommended as the only option for all countries, it is a more robust system that ought to be used once the necessary 'building blocks' have been developed.

6.5 Precept 6 of the Natural Resources Charter: does the legal structure of Norwegian direct state participation comply?

Section 2.4 clarified the rules under Precept 6. They are promoted as universally applicable principles to ensure good resource management of a nationally owned resource company. While the legal organisation of Norwegian DSP is in line with the majority of these principles, there is some discrepancy in the legal relationship between Statoil and the state. Furthermore, Statoil's relationship with other IOCs was not one of 'genuine competition' in the early years, again suggesting some difference in the way Statoil was managed compared to the ideal that the NRC promotes.

Precept 6 states that the NOC should be organised as a '*separate legal entity*' and with '*governing and management boards separate from the government*'. Statoil's legal status between 1972 and 2001 as a 100% state-owned company, with the state as the only shareholder, inevitably meant that it was not truly 'separate' from the government: it was part state entity and part commercial entity. The government was able to direct Statoil's major decisions as its only shareholder and with the Minister for Petroleum and Energy its general assembly. Furthermore, the Article 10 reporting requirements meant that the government had the opportunity to scrutinise and perhaps adjust the company's future plans. This was intended to ensure political oversight of Statoil, with transparency being ensured via a formal and visible process that had to be followed by the state when providing directions to Statoil. However, this formalised link was supplemented by considerable informal ties between the leaders of Statoil and the Norwegian government. For example, Arve Johnsen, Statoil's first CEO, was formerly deputy minister in the labour government. He was known for being politically astute with strong personal ties to those in government. These informal links to power reached a point where many considered that

¹⁶² Tordo et al (2011) p62

the company's actions could not truly be challenged, culminating in the Mongstad scandal and Arve Johnsen's resignation. These formal and informal links meant that there was not a true division of functions between government and NOC. Until Statoil was partly privatised in 2001, the arms length relationship between government and NOC that the NRC promotes did not truly exist in Norway.

Secondly, Precept 6 states that the NOC should be '*in open and genuine competition with other companies*'¹⁶³. While Statoil did operate alongside IOCs in a competitive environment, it was not truly on a level playing field with these other oil companies. Statoil's privileges during the early years gave it certain competitive advantages over and above its foreign counterparts. The company was guaranteed a 50% interest in all licence groups and had the option to increase this interest if a field was deemed commercial. This gave the company a clear advantage in licensing and access to acreage. It was also given a priority in the sought-after and influential role of operator, again giving Statoil priority over foreign oil companies. Thus, until these privileges were removed, it was a part of Norwegian petroleum law that Statoil was *not* in genuine and open competition with other oil companies.

While both these factors mean that the management of Statoil was not totally in line with the NRC, they were implemented for good reason. During the early years of Norway's petroleum industry, the state did not have the necessary finance or expertise to establish a strong NOC. The privileges were necessary because Statoil was a weak company relative to the IOCs, and needed to become competent in a relatively short space of time. Once this had been achieved, Statoil's privileges were removed and it operated in a more genuinely competitive environment with other oil companies. Statoil's formal links to the state were also necessary during the early years. The objective in establishing a NOC was to uphold national interests in petroleum operations. To ensure this, the government needed to maintain a degree of political influence over the company. Once the objectives had been achieved, the formal links were removed by partly privatising Statoil. Even the informal ties served a purpose: it was Arve Johnsen that lobbied hard to secure Statoil's privileges and other advantages during Statoil's formative years.

¹⁶³ Collier et al (2010) p11

Thus, while the NRC mandates certain universally applicable principles that are, on the whole, in line with the Norwegian experience, these two concepts may need to be revised. It is unrealistic to expect a complete separation between NOC and government. The state *must* exercise a degree of influence to ensure the company upholds the state's objectives. It is also necessary to grant certain advantages to the NOC, since it must be enabled to catch up to the strength and competence of the IOCs in order to achieve the government's objectives. Both of these aspects of a NOC's legal organisation will need to be reformed in line with Precept 6 once their purpose has been served, but during the early years at least it may be more astute to follow Norway's example.

6.6 Conclusion

In conclusion, the Norwegian Model of DSP should be used in resource-rich developing countries as part of the solution to the resource curse, but only where there is a genuine attempt to abide by the key legal features of this model. The main features include a limited commercial function, transparency requirements, separating functions between government entities and operating in partnership with foreign oil companies. Furthermore, for the company to remain effective and efficient, legal reforms must be implemented as circumstances in the oil sector change. Although this model would be a challenge to replicate in a developing country, its particular design would help to limit the problems often associated with state-owned companies and capture some of the benefits of a liberalised model. It must though be tailored to the specific needs and political, economic and cultural realities of the country in question. Few countries will possess the same initial advantages as Norway and must make the system work in the context of limited funds, expertise and weak institutions. Moreover, to succeed DSP must also be complemented by good resource management at each important stage in the decision-making chain, from extraction to the use of revenue. After all, DSP is only *part* of the solution to the resource curse.

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