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Helpdesk Research Report

Oil and gas revenue sharing

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Question

Please identify a selection of examples of revenue sharing models in the oil or gas sector in fragile or conflict-affected states, and summarise how they operate and what factors have contributed to their success or failure.

Contents

1. Overview

There are no one-size-fits-all solutions to management of natural resources, and a number of different systems are possible depending on the specific country context (Haysom and Kane, 2009, p. 29). Revenue sharing involves distributing natural resource revenues between different levels of government. In the oil and gas sector, there are several revenue sharing models in operation around the world. These range from those that favour the derivation principle i.e. each subnational government's share is related to the oil revenue originating in its territory, to those that are more like intergovernmental transfers (Ahmad and Mottu, 2002, pp. 15-16). The latter use criteria such as population, needs, or tax capacity to determine revenue share. Some models provide relatively large amounts of revenue to subnational governments and others provide relatively small amounts (Ahmad and Mottu, 2002, pp. 15-16).

Examples of revenue-sharing models in fragile and conflict-affected states include:

- **Indonesia**: The government has adopted an asymmetric revenue sharing model. The primary objective of this arrangement is to prevent resource rich conflict-affected regions from seceding. The arrangement has fulfilled this aim, although it has not succeeded in achieving the levels of equality between regions that were anticipated when it was designed.

- **Iraq**: The revenue sharing model currently applied in Iraq has suffered from ambiguity. For example, existing agreements on revenue sharing are not clear about who is responsible for the management of oil and gas revenues. Moreover, the Kurdistan Regional Government (KRG) and the federal government are engaged in an ongoing dispute over oil and gas revenues.
- **Nigeria:** The formula-based revenue sharing model adopted in Nigeria has been in place for some years. However, the model has proven to be inefficient and oil revenues have resulted in widespread corruption. Moreover, the revenue sharing arrangement has not resulted in development in the oil producing Niger Delta.
- **Sudan:** The Agreement on Wealth Sharing (AWS) was an important component of the Comprehensive Peace Agreement signed between the governments of Sudan and Southern Sudan in 2005. Implementation of the agreement, which included provisions for the equal division of oil revenues between the North and the South, was more successful than expected. However, the South is believed not to have received its fair share of revenues and relations between the North and the South deteriorated after South Sudan's independence in 2011. Oil remains a major source of tensions between the two countries.

2. General lessons learned

A number of lessons learned can be identified from the literature. These include:

- It is necessary to have a clear understanding of **exactly which natural resources are to be shared**, and which mechanisms will be used to achieve this (Wennmann, 2012, p. 245). According to a briefing paper by the Centre for Humanitarian Dialogue, strict constitutional frameworks are particularly important for ensuring this, and should clearly assign revenue bases to each level of government. They should also detail any agreed formulae for revenue transfer systems (Haysom and Kane, 2009, p. 25).

- **Ownership and management** of resources needs to be addressed. It is important to know how decisions about granting exploration and exploitation rights will be made, and who will be making them (Rustad et al., 2012, pp. 586-587). However, when these issues arise in peace negotiations it can sometimes be useful to postpone dealing with them to a later date, in order to prevent the entire peace process from collapsing (Rustad et al, 2012, p. 587).

- Issues that are deliberately left open in revenue sharing agreements, or that are negotiated separately, should be considered from a **political perspective** to avoid tensions (Rustad et al, 2012, p. 587).

- **Transparency and accountability** are key to success (Ross et al., 2012, p. 257; Haysom and Kane, 2009, p. 25). This is because they serve as safeguards against corruption and inefficiency, ensuring that the state cannot conceal revenues, or claim that they have been used for development when they have not (Rustad et al, 2012, pp. 583-584). In relation to the first point in this list, when natural resources have been a source of conflict, the constitution may also need to make provisions for enabling legislation and institutions to monitor production. The purpose of this is to ensure that local actors are not exceeding production quotas or selling illicit production outside revenue sharing agreements (Haysom and Kane, 2009, p. 25).

- Making **industry and finance experts** available during the early stages of a negotiation process can be very beneficial (Haysom and Kane, 2009, p. 26). This is important because it enables a move away from the politics of resource governance towards the technical aspects of resource governance (Haysom and Kane, 2009, p. 26). Experts can provide stakeholders with a realistic assessment of the issues involved and can deal with unrealistic expectations, especially regarding money (Haysom and Kane, 2009, p. 26). Similarly, creating information about the value and future prospects of natural resources ensures that all parties are equally well-informed (Wennmann, 2012, p. 245).

- Institutional quality is key for the successful management of resource revenues (Rustad et al, 2012, p. 589). In particular, **technical capacity** in public institutions responsible for managing resource revenues is vital for successful subnational governance of natural resource revenues (Ushie, 2012, p. 36). Institutional reform should therefore be a peacebuilding priority (Rustad et al, 2012, p. 589). A strategic approach, which focuses on those institutions that are key to sound resource revenue management may be more effective than more extensive institutional reform (Rustad et al, 2012, p. 589).

- When revenue sharing agreements constitute part of peace agreements, it is important that these **agreements are not viewed as rewards** for belligerents. This is because it would encourage other groups to exert pressure for the same benefits in the country in question, and sometimes in other countries (Rustad et al., 2012, p. 608).

3. Case studies

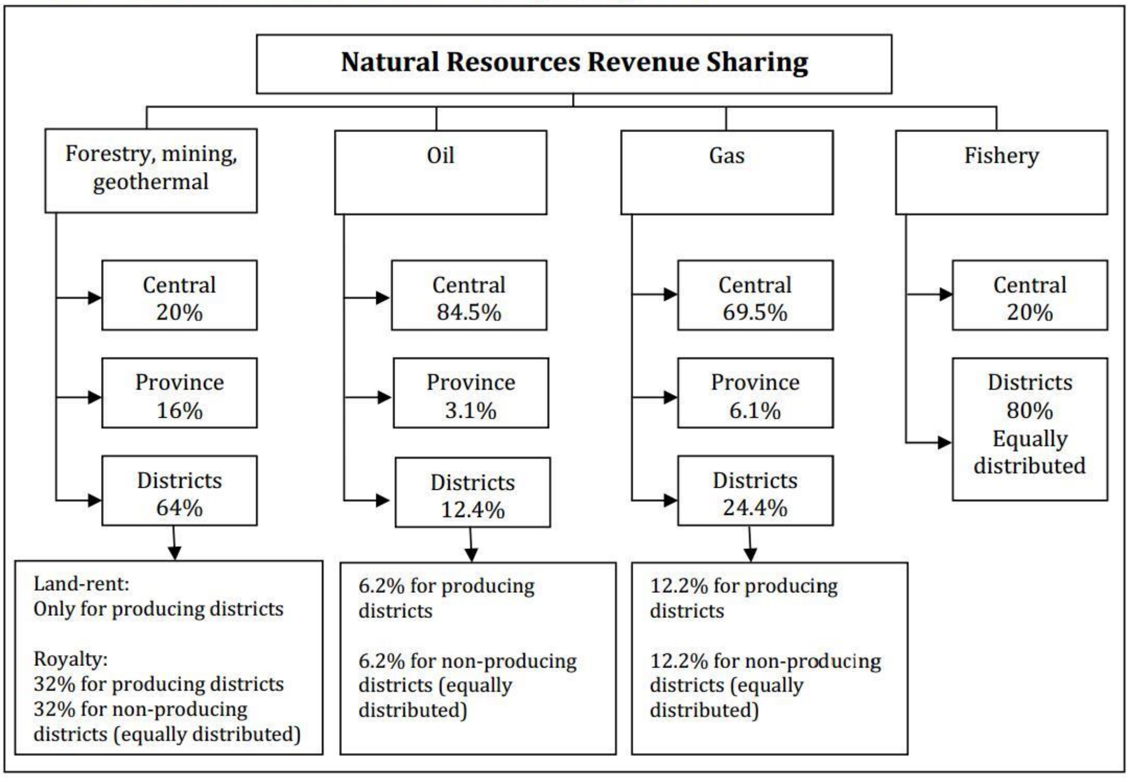
Indonesia

In Indonesia, the government has adopted an asymmetric revenue sharing model. This means that special revenue sharing arrangements are in place for the country's special autonomy regions, Aceh, Papua, and West Papua. The asymmetric revenue sharing model was introduced in Indonesia to prevent resource rich regions from seceding (Agustina et al, 2012a, p. 14).

In Indonesia, sub-national governments receive transfers from the central government under the 'balancing fund' (Agustina et al, 2012a, p. 14). These make up more than 60 per cent of their budgets and about 30 per cent of central government expenditures. Oil and gas revenues are included in these transfers, making up 11 per cent of total transfers to subnational governments, and 3 per cent of national expenditure in 2010 (Agustina et al, 2012a, p. 14). Intergovernmental oil and gas revenue sharing is based on net oil and gas revenue. The central government receives 84.5 per cent of net oil revenues from a region and 69.5 per cent of net gas revenues, while the relevant subnational government receives 15.5 per cent of net oil revenues and 30.5 per cent of net gas revenues. The revenues received by the subnational government are then divided up, with 20 per cent being allocated to the provinces, 40 per cent going to the producing district, and the remaining 40 per cent being equally distributed among the remaining districts in the province (Agustina et al, 2012a, p. 14).

Figure 1: Indonesia's revenue sharing arrangement

Chart 1. Natural resources revenue sharing arrangement



Source: UU33/2004

Source: Agustina et al, 2012a, p. 14

The asymmetrical revenue sharing arrangement means that the special autonomy regions receive a larger share of the oil and gas revenues generated within their jurisdiction. Thus, Aceh will receive 70 per cent of oil and gas revenues for the first nine years, and Papua and West Papua will each receive 70 per cent of these revenues for the first 25 years. After these periods, they will receive 50 per cent of natural resource revenues each (Agustina et al, 2012a, p. 14).

The amount of revenue shared fluctuates from year to year as it is based on actual oil and gas revenue and therefore varies with oil and gas prices. Central government transfers are made quarterly, and are based on estimated profits for the current quarter, incorporating an adjustment for the difference between actual and projected profits in the previous quarter (Agustina et al, 2012a, p. 14).

In addition to revenue sharing, oil and gas revenue is also transferred indirectly to sub-national governments through the general allocation transfer (DAU), which forms the largest government transfer to subnational entities (Agustina et al, 2012a, p. 14). This is calculated by taking into account the gap between a region's fiscal capacity and its fiscal need[1], as well as its wage bill for civil service salaries (Agustina et al, 2012b, p. 368).

[1] This is calculated on the basis of the region's own-source revenue and income from revenue sharing (Agustina et al, 2012b, p. 372).

The 2005 Memorandum of Understanding (MoU), which ended the long-standing Aceh conflict, also provided for greater transparency over the collection and distribution of natural-resource revenues, and joint management rights of oil and gas resources with the national government. The latter is significant because oil and gas management is the domain of the national government in all other provinces (Haysom and Kane, 2009, p. 31).

The asymmetrical revenue sharing arrangement has succeeded in preventing the special autonomy regions from seceding. According to UNDP guidance on preventing natural resource conflict, the Indonesian government's resource allocation strategy has reduced conflict risk levels in resource rich provinces, and has prevented violence in these areas from degenerating into full-blown wars (Hailu et al, 2011, p. 31). However, the ambiguity of some parts of the MoU on revenue sharing with Aceh has complicated its implementation. The MoU does not specify who will regulate and govern hydrocarbon revenue sources, or who has the authority to issue licenses for new explorations (Wennmann and Krause, 2009, p. 18).

One briefing paper notes that despite billions of dollars flowing into Aceh as a result of the arrangement, Aceh's oil and gas reserves are almost depleted (Haysom and Kane, 2009, p. 31). Moreover, the lack of improvement in living standards and in the quality of public services in these regions remains a cause for concern, as it could result in renewed tensions (Agustina et al, 2012a, p. 28). In addition, revenue sharing has led to significant income disparities between oil and gas producing and non-producing provinces. However, poor provinces receive significant revenues through other types of transfers, such as the DAU. This goes some way in reducing inequality between Indonesia's provinces (Agustina et al, 2012a, p. 15).

Iraq

In Iraq, the constitutional framework for oil management specifies that the federal government, together with oil and gas producing provinces and regions, has the authority to manage oil and gas extracted from present oil and gas fields on the condition that it distributes the revenues in proportion to the sizes of each region's population. Special conditions are in place for areas that were previously disadvantaged[2] (Haysom and Kane, 2009, p. 22).

One of the principal problems with Iraq's revenue sharing arrangement is that articles 111 and 112 of the constitutional framework for oil management are ambiguous (Al Moumin, 2012, p. 427). The framework is not clear as to whether all Iraqis own the country's oil, or whether the regions and governorates from which the oil is extracted have special ownership status. The framework is also unclear on how the federal and subnational governments should work together to formulate policies for oil management and oil revenue distribution. Finally, the constitutional framework for oil management does not specify which authority, national or subnational, supersedes the other (Al Moumin, 2012, p. 427). Further complicating this issue is the fact that articles 115 and 121 grant considerable authority to the regions and governorates, so these levels of government seem to have a legitimate argument for asserting their authority over oil reserves within their boundaries (Al Moumin, 2012, p. 421).

Articles 17 to 20 of Iraq's 2009 Budget Law outline the country's current revenue sharing arrangement. So-called 'sovereign expenditures' for the Council of Representatives, the administration of the national Cabinet, the Ministry of Foreign Affairs, the Ministry of Defence, oil export production, and other national government functions are prioritised. Of the remaining hydrocarbon revenues, 17 per cent is allocated to

[2] Kurds and Shiites were deprived of oil revenues under Saddam Hussein's regime (Al Moumin, 2009, p. 424).

the Kurdistan Regional Government (KRG), and the remainder is allocated to national ministries in other governorates (both hydrocarbon producing and non-hydrocarbon producing) in proportion to the population distribution and specific needs (Blanchard, 2009, p. 9). The budget law also calls for KRG government revenue to be audited to determine if any funds should be transferred to the national treasury (Blanchard, 2009, p. 9). It also enables the federal government to withhold proportional amounts of national budget transfer to the KRG if the KRG does not pay the revenues it owes to the national government (Blanchard, 2009, p. 9).

In 2010, the Iraqi parliament approved an annex to the national budget under which all governorates except the KRG would receive $1 per barrel of oil produced within their boundaries (Al Moumin, 2012, p. 427). This was an attempt to reduce tensions over revenue distribution. However, it did not specify how the funds would be collected and distributed (Al Moumin, 2012, p. 427).

Nigeria

As in Indonesia, revenue sharing has been used as a way to pacify marginalised ethnic groups in Nigeria. Notable among these are the poor communities living in the oil-rich Niger Delta (Ushie, 2012, p. 10).

In Nigeria, intergovernmental transfers come from the Federation Account, which is financed by oil revenues, the proceeds of company income tax, and custom duties and excise taxes (Ahmad and Singh, 2003, p. 12). The Nigerian parliament decides on the formula for oil revenue sharing every five years (Haysom and Kane, 2009, p. 22). The country's constitution stipulates that population, the equality of States, internal revenue generation, and land mass must all be taken into account when deciding on the formula for oil revenue sharing. A minimum of 13 per cent of oil revenue must be reserved for oil producing states (Haysom and Kane, 2009, p. 22).

However, the revenue sharing arrangement in place in Nigeria is inefficient (Rustad et al, 2012, p. 583). Nigeria's oil producing region, the Niger Delta, remains under-developed and suffers from serious unrest. Moreover, oil revenues have led to widespread corruption both within the Niger Delta and within the central government (Rustad et al, 2012, p. 583).

Sudan

While the revenue sharing model used in Sudan is not generally viewed as a success, there are elements of the process of agreeing the model which are viewed positively. The Agreement on Wealth Sharing (AWS), which constituted part of the 2005 Comprehensive Peace Agreement, was reached relatively quickly. This is largely because the agreement was a temporary one, intended to last until the 2011 referendum on South Sudan's independence. This enabled the parties involved to focus on revenue sharing and to postpone any discussion of ownership of natural resources (Rolandsen, 2011, p. 76).

The AWS stipulated that net oil revenues should be split equally between the Government of Sudan and the Government of Southern Sudan. Two per cent of oil revenues would be reserved for oil producing states in accordance with their proportion of production (Haysom and Kane, 2009, p. 22).

Oil was responsible for a number of the subsequent tensions between the Government of Sudan and the Government of South Sudan. However, one paper notes that implementation of the AWS exceeded expectations, as the Government of South Sudan received a steady flow of revenue from the Government of Sudan during the period 2005-2010 (Rolandsen, 2011, p. 77). In the aftermath of the referendum relations between the two governments deteriorated.

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