LEGISLATION

The challenges of state and local participation

Government imposed requirements for state and local participation in oil and gas developments in Africa raise various challenges, explain Akin Gump's *John LaMaster*, *Marc Hammerson* and *Caroline-Lucy Moran*.*

In recent years there has been a marked intensification of international oil and gas industry activity across African regions, including recent focus on the potential of the east coast (Mozambique, Kenya, Tanzania and Somalia) and the pre-salt plays of West Africa (Angola, Gabon and the Republic of Congo). There has also been increased activity in 'frontier' states (Namibia and Liberia) and those seeing revival following periods of political instability (Côte d'Ivoire and Egypt).

This upswing in international oil company (IOC) interest brings into renewed focus the means by which African governments may seek to maximise the benefits of oil and gas investment to their host states. These efforts include government-imposed requirements for 'state participation' and 'local participation'.

State participation in the oil and gas industry is the legislated or otherwise mandatory requirement that the state or a state-owned entity, such as the national oil company (NOC), can participate in oil and gas activities as a working interest or participating interest owner. Local participation is the requirement that local people or entities that are not state-owned can participate as direct or indirect working interest or participating interest owners.

Both state participation and local participation raise various challenges for IOCs. For example, they reduce the levels of IOC equity and control. Furthermore, both participation regimes are subject to the risk of political instability and regulatory uncertainty, and may give rise to anti-bribery and corruption issues. For IOCs, these challenges must be considered and addressed as part of the wider risks associated with doing business in Africa.

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> **PWC[1]**

Challenges and risk mitigation

The extent of mandatory state participation and/or local participation must be evaluated by an IOC. An IOC's decision regarding where to invest its limited capital involves consideration of the political stability of the host state, security issues and, perhaps most fundamentally, economics. The requirement that an IOC carry a NOC or local participant during the exploration phase will significantly increase the IOC's initial costs. Consequently, in an assessment by an IOC of investment opportunities, overly favourable economic terms for state and/or local participation in one host state can be a factor that drives the IOC's investment from that host state to another.

Another key challenge a prospective IOC investor faces is the risk of regulatory uncertainty. This risk, which pervades the African oil and gas industry, has been identified by commentators as the greatest constraint (ranking above corruption) to IOC development, particularly in countries that are in the process of developing or revising their petroleum regimes.[1] This has been seen most prominently in recent years in the case of Nigeria's Petroleum Industry Bill (PIB), first tabled in 2008 but not yet enacted, which will further enshrine local participation. Regulatory uncertainty also exists in Nambia, where The New Equitable Economic Empowerment Framework (NEEEF) has been enacted as a 'framework' rather than a law, with the result that the Namibian government has wide latitude in the actual implementation of local participation.

IOCs can mitigate the risks of regulatory uncertainty to some extent through contractual provisions in their petroleum agreements with the host state. One aspect of regulatory uncertainty is the risk of changes in law or changes in interpretation of laws. Sovereign nations always have the right to change their laws; however, it is possible to mitigate the consequences of changes through stabilisation clauses. There are two main types of stabilisation clause – 'freezing provisions' and 'economic equilibrium provisions'. Freezing provisions provide that only laws in force as at the date of agreement shall have effect regarding the agreement. Due to concerns regarding enforceability of freezing provisions, it is now more common to see economic equilibrium clauses. These provide that in the event of a change of law that alters the economics for the IOC, then the government and the IOC agree to negotiate amendments that will restore the economic equilibrium of the original agreement.

Corruption risks

Local participation and state participation also raise the risk of corruption. The introduction of a NOC as an additional participant increases an IOC's interaction with the government and with government officials. This may become problematic with newly established or ambiguous regulatory requirements that raise questions surrounding payment arrangements. Notably, officers of NOCs are considered to be 'foreign public officials' for purposes of the UK Bribery Act 2010 and the US Foreign Corrupt Practices Act 1977 (FCPA).

A common scenario is where the government requires local participation as a condition to acquiring a petroleum agreement. For example, the government may require the inclusion of indigenous persons/entities as joint venture partners, or that the IOC conducts its operations through a local subsidiary with local shareholders. The risks are magnified where the government designates or 'recommends' the specific persons to be involved and where payments to local persons are required.

In such a scenario, an IOC could be in violation of anti-bribery legislation such as the FCPA and Bribery Act. For example, in Nigeria, it has been observed that historically, since 1991 and across successive governments, the award of petroleum assets to indigenous oil companies 'appears to have been largely influenced by the extent to which prominent shareholders have been connected to the government' rather than on technical competence and expertise.[2]

There is also a related risk associated with government requirements regarding local participation called 'fronting'. Fronting is an abuse of empowerment legislation by using qualifying local persons to meet the literal requirements of the legislation, while circumventing the purpose, spirit and goals of the legislation, such as where indigenous shareholders have no meaningful economic interest in that enterprise. Fronting has been identified by the South African Department of Trade and Industry as a fraudulent violation of the Broad-Based Black Economic Empowerment, and it is likely the same approach will be taken with similar local participation initiatives.

There are several ways for IOCs to address the corruption risks associated with local participation. For example, IOCs should conduct thorough due diligence investigations of their local partners. If the local participation includes companies, trusts or other entities, then each of the shareholders, directors, trustees, beneficiaries and other associated persons should also be investigated. It is recommended to use external consultants to conduct the due diligence, and specialists with in-country experience can be best placed to produce the most thorough report. The investigation should include whether any of the relevant persons are government officials or are related to government officials, and the criminal records and business reputations of the relevant persons.

The existence of legislation that gives rise to the local participation requirement also helps to address the risks associated with local participation, because it helps to demonstrate that there is a legislative legitimacy underlying the requirement. It is advisable to obtain an official written request for the local participation from the relevant minister, which makes it more transparent and not 'secret' like a classic bribe.

It is also recommended that IOCs enter into written agreements with their local participants, containing usual and customary representations, warranties and covenants regarding anti-bribery and corruption matters. In many cases, the standard AIPN model form joint operating agreement (JOA) containing usual and customary anti-bribery and corruption provisions will not be enough, because the only parties to the JOA will be the direct participating interest holders. Whereas IOCs should also have direct contractual representations, warranties and covenants regarding anti-bribery and corruption matters from not only the direct local participants but also from their respective shareholders, directors, trustees, beneficiaries and other associated persons.

As state and local participation become increasingly prevalent, IOCs must employ robust procedural and contractual mechanisms to best address and mitigate the resulting risks. By employing this approach, most IOCs will find the challenges of state participation and local participation to be manageable opportunity costs, rather than barriers to doing business in Africa. ●

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1. PWC report, *On the brink of a boom: Africa oil and gas review*, PWC, July 2004, p8.
2. Uchenna Jerome Orj, 'Towards sustainable local content development in the Nigerian oil and gas industry: an appraisal of the legal framework and challenges – Part 1', *International Energy Law Review*, 2014, p5.