

February 16, 2016

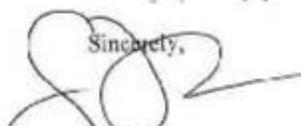
Mr. Brent J. Fields, Secretary  
Securities and Exchange Commission  
100 F Street, NE  
Washington, DC 20549-1090

RE: Rulemaking for Section 1504 of the Dodd-Frank Act, File No. S7-25-15

Dear Secretary Fields:

We would like to draw your attention to the report attached below, which we submit in response to the SEC's proposed rule to implement Section 1504 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (hereafter referred to as Section 1504). The report highlights the links between corruption, conflict, and instability that frequently exist in oil producing countries. Given our extensive knowledge of, and experience in, countries that boast significant resource endowments and are subject to significant corruption, instability, and conflict, we strongly believe that increased transparency in the oil sector is crucial to mitigating these outcomes and to promoting peace and stability. Such a result would also benefit oil companies, their shareholders, as well as citizens, and, in the long run, their governments. A strong rule to implement Section 1504, including public project-by-project disclosure with no exemptions, would be an important milestone.

Thank you for this opportunity to comment, and we welcome any questions you may have regarding this submission or its subject matter.

Sincerely,  
  
Sarah Peck

  
Sarah Chayes

#### About the authors:

Sarah Peck is a career diplomat for the U.S. government. She developed expertise on anti-corruption, governance, and development serving in the Middle East and South Asia, including at the U.S. Embassy in Afghanistan where she coordinated the Embassy's efforts to strengthen the rule of law and fight corruption in Afghanistan. She also helped establish a combined joint inter-agency task force at NATO headquarters to help the military fight corruption in Afghanistan. The views in this report are her own, and not necessarily those of the U.S. Government.

Sarah Chayes is a senior associate in the Democracy and Rule of Law and South Asia Programs at the Carnegie Endowment for International Peace. Formerly special adviser to the chairman of the Joint Chiefs of Staff, and before that to Generals David McKiernan and Stanley McChrystal, commanders of the International Security Assistance Force, she is an expert on kleptocracy. With significant time on the ground in Nigeria, she is working on correlations between acute public corruption and the rise of militant extremism. She is the author of "Thieves of State: Why Corruption Threatens Global Security."

## The Links Between Corruption, Conflict and Instability -- and the Mitigating Role of Transparency<sup>1</sup>

### Summary

The political and economic dysfunction known as the “oil curse” is a complex, structural phenomenon, caused largely by poor management or investment of oil revenues by the governments of oil-producing countries. Because this syndrome is taking an increasing toll on oil operations, the oil industry has a strong economic incentive to take affirmative steps, collectively, to mitigate it. And the industry is uniquely positioned to do so.

### Instability Hurts the Oil Industry, Its Shareholders, and Other Stakeholders

- The capital cost of developing petroleum projects has increased 300 percent since 2003, according to industry analysts. Waste, inefficiency, and delays associated with operations in unstable environments are major drivers of these increasing costs.
- These higher costs are, in the end, largely passed on to the host country governments and by extension their citizens, but they also result in lower profits accruing to the project or oil company shareholders.
- The oil industry’s business plans tend not to accurately reflect these aggregated costs, or to recognize the upsides possible if oil curse symptoms—Dutch Disease, acute corruption, and insecurity—were better mitigated.
- The most careful companies have an interest in the broader adoption of practices that promote stability, in order to level the playing field and prevent a race to the bottom that could further fuel conflict.

Much has been written about the “oil curse,” a complex of political and economic dysfunctions afflicting nearly all oil-producing countries to some degree.<sup>2</sup> The presence of oil in a country can have major benefits—and it does not automatically lead to the oil curse. But if not managed properly by the host government, the massive influx of oil revenues can distort a country’s eco-

---

<sup>1</sup> This submission is adapted from Sarah Peck and Sarah Chayes, September 2015, “The Oil Curse: A Remedial Role for the Oil Industry,” Carnegie Endowment for International Peace, available at [http://carnegieendowment.org/files/CP\\_250\\_Peck\\_Chayes\\_Oil\\_Curse\\_Final.pdf](http://carnegieendowment.org/files/CP_250_Peck_Chayes_Oil_Curse_Final.pdf); additional information about the links between corruption, conflict and instability in resource-rich countries can be found in Sarah Chayes, 2015, *Thieves of State: Why Corruption Threatens Global Security*, W.W. Norton & Company.

<sup>2</sup> This paper focuses on petroleum, rather than other extractives industries, for three reasons: (1) we wanted to focus on one industry, rather than several specialized industries, (2) the impact that could be achieved by the oil industry would be great because the worldwide amount of oil revenues dwarfs the revenues from other extractive industries, and (3) the mining industry has already undertaken voluntary collective action that could guide a similar effort by the oil industry.

conomic fundamentals, fuel corruption, and create conditions that trigger conflict. Countries with oil are twice as likely to experience civil war as those without.<sup>3</sup>

Oil industry professionals recognize that this dysfunction takes a financial toll on operations and shareholders (some 59 percent of projects came in over projected budgets, according to a 2014–2015 survey<sup>4</sup>) and delays the development of major markets for industry products. What is less well understood is the interplay between economic dysfunction, corruption, and instability or insecurity.<sup>5</sup>

We have extensively researched this interplay, and it is our considered judgement that efforts to improve governance and reduce corruption produce sustainably increased stability. Greater stability, apart from benefitting local populations and regional security, would in turn reduce operating costs for the extraction industry, increase production, and, by raising standards of living for the people in these countries, create new demand and markets. For instance, a recent study by PwC concluded that the GDP of Nigeria, Africa's most populous country, which currently suffers from rampant corruption and the rise of militant extremism, could increase by as much as 37 percent (\$534 billion, or nearly \$2000 per capita) by 2030 if corruption is addressed.<sup>6</sup>

### **Oil Dependence Compounds the Risk of Corruption**

“Dutch Disease,” or a dysfunctional economy, is not the only problem oil-producing countries may experience. Too often, oil-rich countries with opaque institutions and little public accountability may succumb to systemic corruption.<sup>7</sup> Tempted by massive funds that they control, often with little or no oversight, political elites in these countries have resorted to large-scale theft of oil revenues—and sometimes the oil itself. When royalties and taxes do reach government coffers, cronyism and fraud in the public procurement process mean that they are often diverted into the pockets of powerful elites, rather than invested in public goods. In some countries, the local content partners or purported nonprofits that receive corporate social responsibility (CSR) dollars do not provide economic opportunities or social benefits to the local population because they are elements of the patronage network controlled by corrupt officials or their family mem-

---

<sup>3</sup> Mahmoud Amin El-Gamal and Amy Myers Jaffe, “The Oil Curse,” *Oil Magazine*, October 2009, 32 (noting that oil wealth has financed an arms race in the Middle East). See also, Peter Beaumont, “The \$18bn Arms Race Helps Fuel Middle East Conflict,” *Guardian*, April 23, 2015, <http://www.theguardian.com/world/2015/apr/23/the-18bn-arms-race-middle-east-russia-iran-iraq-un>.

<sup>4</sup> EY, *Spotlight on Oil and Gas Megaprojects*, August 18, 2014, [http://www.ey.com/Publication/vwLUAssets/EY-spotlight-on-oil-and-gas-megaprojects/\\$FILE/EY-spotlight-on-oil-and-gas-megaprojects.pdf](http://www.ey.com/Publication/vwLUAssets/EY-spotlight-on-oil-and-gas-megaprojects/$FILE/EY-spotlight-on-oil-and-gas-megaprojects.pdf)

<sup>5</sup> The linkages between corruption and conflict have been written about extensively, including by this paper's co-author, Sarah Chayes, in her book *Thieves of State: Why Corruption Threatens Global Security* (New York: W. W. Norton, 2015) (referenced elsewhere in this paper) and in numerous articles.

<sup>6</sup> PwC, “Impact of Corruption on Nigeria's Economy,” <http://www.pwc.com/ng/en/assets/pdf/impact-of-corruption-on-nigerias-economy.pdf>.

<sup>7</sup> Of course, in countries with preexisting corrupt governments, incoming revenues bring new opportunities to divert revenues to private accounts and enlarge political patronage networks.

bers.<sup>8</sup> And corruption at the top of such systems is usually emulated at lower echelons, until street-level cops, teachers, and doctors become the bane of a poor population's existence.

And it's not just the populations of these countries that suffer. The private oil industry is hit too when corruption takes root in a government or a national oil company partner. Even when it doesn't involve bribes, corruption is a tax on oil operations. When local contractors exist to capture revenues for the corrupt elite, their work is often substandard, expensive, or both. This behavior increases the costs of a project (hence the term "patronage costs"), sometimes significantly. Corrupt officials frequently extract ancillary payments through customs clearance fees and warehousing fees and by modifying the terms of contracts. In 2015, Brazil erupted when the public learned that contractors of the national oil company, Petrobras, had inflated operational costs, requiring a nearly \$17 billion "write-down" of public assets.<sup>9</sup>

### **Corruption and Oil Resources Often Fuel Instability, Insurrection, and Conflict**

There is a direct relationship between acute corruption and violence that in many places is so severe that it constitutes an international security challenge. Anger at acute corruption helped spark the 2014 revolution in Ukraine; it helps explain the Iraqi army's collapse in June 2014 in the face of the Islamic State, as well as the growing strength of that jihadist group, the Taliban in Afghanistan, the spread of Boko Haram in Nigeria, and the fall of governments in Libya, Tunisia, Egypt, and Yemen. In the past decade, historic manifestations of corruption have driven indignant populations, which lack any means of imposing accountability on their governments, to a variety of extreme actions. Corruption can also fuel violent competition among evenly matched kleptocratic elites or symbiotic alliances between governments and dangerous transnational criminal organizations.

An oil company working in an acutely corrupt country may find itself caught between the government and the aggrieved population. Attacks on oil production facilities and pipelines may occur when the population blames the companies for the perceived failure to deliver prosperity. The hollowed-out, corrupt security forces in some countries may constrain the legitimate use of force to protect the oil companies or to responsibly restore order should civil unrest or insurgency occur. Militant extremists make the argument that the corruption and abuse that populations suffer are due to the moral impurity of their national governments. Only if a government is orga-

---

<sup>8</sup> Illustrating the patronage network, Russian President Vladimir Putin's boyhood friend Arkady Rotenberg was awarded at least 227 billion rubles (\$7.4 billion) worth of contracts for work related to the 2014 Sochi Olympics. Ilya Arkhipov and Henry Myer, "Putin Friend Bags at Least 21 Russian Olympic Contracts," Bloomberg, March 21, 2013, <http://www.bloomberg.com/bw/articles/2013-03-21/putin-friend-bags-at-least-21-russian-olympic-contracts>. The oil industry, both Russian and international, contributed large sponsorships to the games, the most expensive in history. Some reports estimate that a third of the money spent was lost through corruption. Yadullah Hussain, "How Russia Is Eyeing a Bigger Game Beyond the Olympics," Financial Post, January 30, 2014, [http://business.financialpost.com/news/energy/how-russias-energy-sector-is-eyeing-a-bigger-game-beyond-the-olympics?\\_lsa=c61c-e054](http://business.financialpost.com/news/energy/how-russias-energy-sector-is-eyeing-a-bigger-game-beyond-the-olympics?_lsa=c61c-e054).

<sup>9</sup> Reuters and Fortune Editors, "Petrobras Takes \$17 Billion Hit on Scandal, Promises Normality," Fortune, April 23, 2015, <http://fortune.com/2015/04/23/petrobras-takes-17-billion-hit-on-scandal-promises-normality/>.

nized according to God's law, they argue, can public integrity be guaranteed. In desperation at the lack of recourse, many are swayed by these arguments.<sup>10</sup>

### **Instability Is Spreading in Oil-Producing Countries**

Poor governance, mismanagement of oil revenues, and acute corruption on the part of host governments have all contributed to increasing political and economic instability and conflict in oil-producing countries—with enormous costs to the oil industry.

Yet the conditions that can lead to this instability may be more complex, dynamic, and costly than the industry's current risk analysis methodology suggests.<sup>11</sup> The map on p. 22,<sup>12</sup> based on a thorough assessment of an array of key risk factors conducted in early 2015,<sup>13</sup> provides a snapshot of political and economic instability in oil-producing countries.

The colors on the map correspond to the level of instability each country was facing in mid-2015, from “stable” green to “economically dysfunctional” yellow to “risky” orange to “insecure” red and black (black signifying that oil companies have experienced significant losses due to attacks, conflict, or theft—bunkering). Over half of oil-producing countries are “orange,” indicating significant risk that conditions will change in ways that negatively impact oil operations. We explain each of these categories in detail below.

Given that large petroleum endowments located onshore in stable countries are becoming a thing of the past, oil companies increasingly face a choice between technically easy—but risky—oil and technically difficult projects (such as offshore or shale reservoirs) in more stable environments.

Transparency International (TI) predicts that in twenty years, as much as 90 percent of oil production will take place in developing countries, which are often unstable and/or insecure.<sup>14</sup> Instability, along with increasing technical challenges, has caused a marked increase in the capital cost of petroleum projects over the past decade. This visible trajectory underscores the urgency of finding ways to mitigate instability. Increased transparency in the oil sector, including transparency of payments that oil companies make to governments, is an important and necessary measure to help achieve that goal.

---

<sup>10</sup> See Sarah Chayes, *Thieves of State: Why Corruption Threatens Global Security* (New York: Norton, 2015).

<sup>11</sup> We acknowledge that the oil industry has developed political risk methodology that can be extremely sophisticated. Although we are not familiar with the methodology, which varies from company to company and is not typically disclosed to the public, at a minimum, we suggest that the industry include the factors we have used, which may involve reweighting factors already considered or adding new ones. The goal for the industry would be to assess which countries are suffering from oil curse–related problems as accurately as possible, and, if needed, to include a budget in project development plans to mitigate these problems to promote greater stability.

<sup>12</sup> Some of this fiscal uncertainty may have unintended consequences: it may cause oil companies to invest in countries that are unstable, but have a good record on contract compliance.

<sup>13</sup> See Appendix C in Sarah Peck and Sarah Chayes, September 2015, “The Oil Curse: A Remedial Role for the Oil Industry,” Carnegie Endowment for International Peace, p. 39-41.

<sup>14</sup> Transparency International, “Oil and Gas,” last accessed August 25, 2015, [http://www.transparency.org/topic/detail/oil\\_and\\_gas](http://www.transparency.org/topic/detail/oil_and_gas).

## Levels of Instability in Oil-Producing Countries

### Green: Stable

Countries designated green have:

- satisfactory governance, including strong governmental institutions with effective checks and balances, as measured by the Natural Resource Governance Institute's (NRGI's) Resource Governance Index;
- effective oil policies;
- diversified economies;
- low levels of corruption and effective rule of law, as measured by TI's Corruption Perceptions Index and other research;<sup>15</sup>
- budgets that are not overly reliant on oil revenues;
- clear benefits accruing to the population as a result of the petroleum endowment;
- no indicators of insecurity or conflict; and
- low levels of volatility.

Examples include Australia, Canada, Norway, the United Kingdom, and the United States.

There are several factors that differentiate green countries from other oil producing countries, but perhaps the most important factor, and one that is directly relevant to the SEC's rule-making on Section 1504, is that government officials in these countries are subject to more public oversight to ensure that the oil income, along with other tax receipts, is spent in ways that benefit the community.<sup>16</sup>

### Green Exemplar: Norway

Norway demonstrates how a government's commitment to transparency and fiscal responsibility can support long-term stability and prosperity. Norway ranks high on governance and transparency indicators. It has responsibly administered its sovereign wealth fund to provide for future generations. Its GDP growth rate of 2.2 percent (in 2014) is low compared to some other countries, but it is consistent with European neighbors that are also recovering from the 2008 global financial crisis. Norway still has challenges: its government works continuously to diversify its economy, and high labor costs can affect its competitiveness. Nevertheless, its low Gini coeffi-

---

<sup>15</sup> We used TI's Corruption Perceptions Index and also the research conducted by Sarah Chayes for the map showing popular uprisings related to acute corruption. See Working Group on Corruption and Security, Sarah Chayes, "Corruption: The Unrecognized Threat to International Security," Carnegie Endowment for International Peace, June 2014 and subsequent unpublished research.  
[http://carnegieendowment.org/files/corruption\\_and\\_security.pdf](http://carnegieendowment.org/files/corruption_and_security.pdf)

<sup>16</sup> Ross, 228.

cient—a common measure of income inequality—shows that Norway is investing its oil revenues in the welfare of its people. Even after the oil price collapse in 2014, Norway’s budget breakeven point is consistently below world oil prices. Norway’s population enjoys an excellent standard of living with high per capita income and a life expectancy of eighty-two years.<sup>17</sup> Norway faces a very low risk of conflict.

Norway’s strong democratic institutions are the primary reason the country benefits from its oil resource. This situation is unlikely to change; thus, Norway’s volatility is low (see table 1 below).

Table 1. Norway

FACTOR	RATING	COMMENTS
Government	5	Strong, democratic government
Oil Policy	5	Noted for effective sovereign wealth fund management
Economy	4	Slow recovery after 2008 global financial crisis; no evidence of Dutch disease
Corruption	5	TI high rank for transparency
Well-being	5	High
Risk of Conflict	5	Very low risk
Volatility	N/A	Low
Total Score	29 out of 30	Green

Note: Countries are ranked from 1 to 5 in each category, with 5 being the highest score. Additional information about these scores appears in table 7.

© 2015 Carnegie Endowment for International Peace

### Yellow: Economic Dysfunction

Countries designated in yellow are worse off on the instability scale. They may have some or all of the following indicators:

- symptoms of Dutch disease, including contraction of the agricultural and manufacturing sectors of the economy, rising unemployment, excessive budgetary dependence on oil revenues, and bloated government payrolls;

<sup>17</sup> It is worth noting that Norway’s average upstream production costs are higher than some of the other countries in this survey thanks in part to these wealth transfers to its population. Countries with lower operating costs may not be providing similar benefits to their populations, which can increase instability

- problems managing oil revenues, including an inadequate sovereign wealth fund;
- a fiscal breakeven point that is higher than current world oil prices;
- evidence of corruption as measured on the TI index and other indicators;
- weak or authoritarian government; and
- relatively low risk of conflict (for example, the government has a monopoly on the legitimate use of force).

Yellow countries include Brazil, Ghana, Kuwait, Malaysia, and Trinidad and Tobago, which is said to be a “poster child” of Dutch disease.<sup>18</sup>

In yellow countries, the population not only fails to benefit from the resource, it may actually be worse off because of it. These countries are therefore susceptible to civil unrest that may worsen over time.<sup>19</sup> These symptoms are compounded when corruption or authoritarian governing systems are present. Ultimately, these problems can lead to more serious dysfunction, including conflict.

### **Yellow Exemplar: Malaysia**

Malaysia is often said to be a rare success story among petroleum-rich countries, and it is one of the more successful economic performers in Asia, with a GDP growth rate of 6 percent in 2014. According to the World Bank, Malaysia’s population is comparatively well-off with per capita income (adjusted for purchasing power parity) of \$22,850 in 2014 and average life expectancy of seventy-five years as of 2013.<sup>20</sup>

However, Malaysia has seriously mismanaged its two sovereign wealth funds and was caught unable to stabilize its economy when oil prices fell in 2014. Analysts have urged the country to take steps to improve the transparency and management of its sovereign wealth funds. Its prime minister is embroiled in a series of corruption scandals.<sup>21</sup> The country is facing political and economic problems as a result. In August 2015, tens of thousands of protesters took to the streets calling for the prime minister to step down amid allegations he transferred \$700 million from the indebted 1Malaysia Development Berhad (1MDB) sovereign wealth fund into his per-

---

<sup>18</sup> Note that most orange, red, and black countries are also experiencing economic dysfunction, but are not designated yellow because they also suffer from other more severe conditions. Note also that many green countries are experiencing Dutch disease in their oil-producing regions, but are not suffering overall economic dysfunction because their economies are large and diversified.

<sup>19</sup> Ross, 227, n10

<sup>20</sup> World Bank, “World Development Indicators: Malaysia,” last accessed August 25, 2015, <http://databank.worldbank.org/data/reports.aspx?source=2&country=MYS&series=&period> .

<sup>21</sup> Praveen Menon, “UPDATE 5-Malaysia’s PM Denies Fraud, Says Ex-PM Mahathir Fomented Crisis,” Reuters, July 3, 2015, <http://www.reuters.com/article/malaysia-1mdb-idUSL3N0ZJ1GD20150703> .

sonal account.<sup>22</sup> The county's political uncertainty is reflected in a 7.5 percent risk premium (see chart).<sup>23</sup>

These characteristics put Malaysia at the top end of the "moderate" volatility window. However, the immediate risk of conflict remains low (see table 2).

Like Malaysia, Brazil is ranked yellow. But Brazil is further along the instability scale because acute corruption within its oil industry has caused political upheaval, economic dysfunction, and popular protests. In 2015, the magnitude of the losses (some estimate over \$17 billion to date) in the Petrobras scandal enraged an already-skeptical population; over 1 million people took to the streets.<sup>24</sup> The economy has suffered, with annual GDP growth of 0.1 percent in 2014 and projected to fall further in 2015. The scandal has caused widespread economic loss to oil company workers and the businesses that cater to them,<sup>25</sup> and there is increasing evidence of capital flight as the middle class tries to preserve its savings.

Despite the country's oil wealth, moreover, the population is largely poor— Brazil has one of the highest rates of income inequality in the world and the highest Gini coefficient of the countries surveyed. Brazil's fiscal breakeven price is \$76 per barrel, higher than world oil prices in mid-2015, perhaps reflecting the high costs of corruption.

Given these factors, any company that partnered with Brazil's oil industry likely experienced high corruption-related costs. Some were caught in the wave of prosecutions that followed the discovery of the corruption.

Despite these serious problems, the strength of Brazil's institutions, in particular a relatively independent judiciary, as well as public pressure for reform, may stave off actual conflict. Therefore, its level of volatility is assessed as moderate (see table 3).

---

<sup>22</sup> BBC News, "Malaysia Protests Against PM Najib Razak Draw Thousands," August 30, 2015, <http://www.bbc.com/news/world-asia-34093338> .

<sup>23</sup> We used the risk premium research prepared by Aswath Damodaran at New York University's Stern School of Business. <http://pages.stern.nyu.edu/~adamodar/>.

<sup>24</sup> Jonathan Watts, "Brazil Elite Profit From \$3bn Petrobras Scandal as Laid-off Workers Pay the Price," Guardian, March 20, 2015, <http://www.theguardian.com/world/2015/mar/20/brazil-petrobras-scandal-layoffs-dilma-rousseff> .

<sup>25</sup> See for example Jeb Blount, "As Petrobras Scandal Spreads, Economic Toll Mounts for Brazil," Reuters, 20 April, 2015, <http://www.reuters.com/article/2015/04/20/us-brazilpetrobras-impact-idUSKBN0NB1QD20150420> .

Table 2. Malaysia

FACTOR	RATING	COMMENTS
Government	3	Partial success according to NRGi index
Oil Policy	4	Weak, with problems managing wealth funds
Economy	4	Experiencing economic dysfunction, evidence of Dutch disease
Corruption	3	Middle rank on TI index
Well-being	4	Comparatively good income, health, education
Risk of Conflict	5	No precursors or conflict
Volatility	N/A	Moderate
Total Score	23 out of 30	Yellow

Note: Countries are ranked from 1 to 5 in each category, with 5 being the highest score. Additional information about these scores appears in table 7.

© 2015 Carnegie Endowment for International Peace

Table 3. Brazil

FACTOR	RATING	COMMENTS
Government	4	Satisfactory overall, according to NRGi, but "enabling environment" ranked weak
Oil Policy	2	Rampant corruption within national oil company
Economy	3	No Dutch disease but experiencing economic dysfunction
Corruption	2	Middle rank on TI index, but assessed weaker because of acute corruption in national oil company and elsewhere
Well-being	2	Wide disparity between rich and poor
Risk of Conflict	4	Low risk of conflict due to strong judiciary and other institutions
Volatility	N/A	Moderate
Total Score	17 out of 30	Yellow

Note: Countries are ranked from 1 to 5 in each category, with 5 being the highest score. Additional information about these scores appears in table 7.

© 2015 Carnegie Endowment for International Peace

### **Orange: Politically and Economically Risky**

Orange countries are characterized by complex, volatile, and unpredictable conditions, making the risk of unexpectedly high operating costs, disruption, or project failure greater than is often perceived. As a result, the production cost per barrel of oil tends to be higher than in green and yellow countries. Corruption, authoritarian governance, and poor economic policies impose hardship on local populations and make these countries more susceptible to conflict. The key factors may include some or all of the following:

- symptoms of Dutch disease, including contraction of the agricultural and manufacturing sectors of the economy, rising unemployment, excessive budgetary dependence on oil revenues, and bloated government payrolls;
- inadequate oil policies;
- unsustainably high fiscal breakeven points;
- “failing” governance according to the NRGI;<sup>26</sup>
- serious levels of corruption, both specifically associated with national oil companies and more broadly;
- increased risk of conflict as a result of acute corruption, sometimes leading to popular protests, and/or a combination of risk factors that, when combined with oil, have been found to statistically increase the likelihood of civil war, such as low per capita income, economic shocks, high population density, and a prior history of civil war;<sup>27</sup> and
- a moderate to high level of volatility.

Orange countries include Bahrain, Cambodia, Equatorial Guinea, Kazakhstan, Mozambique, Russia, and Vietnam.

### **Orange Exemplar: Russia**

Russia is experiencing authoritarian governance (rated “failing” by NRGI), acute corruption, economic crisis (the combination of the sharp drop in oil prices and Western sanctions over the Ukraine crisis led to severe economic shock), and many of the precursors of conflict (including intimate involvement in the conflict raging next door in Ukraine). These conditions, coupled with sanctions, which have caused costly disruptions for Western oil companies,<sup>28</sup> make Russia a high-risk prospect for the oil industry.

---

<sup>26</sup> The Natural Resource Governance Index, [www.resourcegovernance.org/rgi/countries](http://www.resourcegovernance.org/rgi/countries) .

<sup>27</sup> Ross, 146-7.

<sup>28</sup> Bloomberg, “Exxon Now Has More Exploration Holdings in Russia Than in the U.S., Despite Sanctions,” March 15, 2015, <http://fuelfix.com/blog/2015/03/03/exxon-now-has-more-exploration-holdings-in-russia-than-in-the-u-s-despite-sanctions/#26896101=0> .

The country's economic and political problems can be traced in large part to acute corruption, which analysts estimated in 2013 costs the country about \$300 billion a year, a full 16 percent of its GDP.<sup>29</sup> Such corruption causes massive losses in the oil and gas sector. For example, in 2011, Gazprom alone lost \$40 billion to corruption and inefficiency, Anders Åslund of the Peterson Institute for International Economics estimated.<sup>30</sup> These losses likely translate into increasing costs for Western oil companies operating in Russia (and also for China, which is increasingly investing in the Russian oil sector).

The high levels of corruption, coupled with economic distress, could spark conflict, as it did in Ukraine.<sup>31</sup> While massive protests against election fraud in 2011 and 2012 were put down and defused by nationalist rhetoric, the Russian public remains critical of worsening conditions in the country; some popular protests in early 2015 about local grievances, corruption, and election fraud reflected a darkening public mood.<sup>32</sup>

Like many orange countries, conditions in Russia are volatile—and they could worsen significantly, and quickly (see table 4 below).

---

<sup>29</sup> "Bloomberg View: Putin's Phony War on Corruption," Bloomberg, May 9, 2013,

<http://www.bloomberg.com/bw/articles/2013-05-09/bloomberg-view-putins-phony-war-on-corruption> .

<sup>30</sup> Anders Åslund, "Why Gazprom Resembles a Crime Syndicate," Moscow Times, February 28, 2012, <http://www.themoscowtimes.com/opinion/article/why-gazprom-resembles-a-crime-syndicate/453762.html> .

<sup>31</sup> Russia is also experiencing major insurgencies in Chechnya, Dagestan, Ingushetia, and other parts of the South Caucasus. Some would argue that for this reason, Russia is already "red."

<sup>32</sup> Kathrin Hille, "Protests Bubble Up Across Russia in Sign of Public Discontent," Financial Times, April 9, 2015, <http://www.ft.com/intl/cms/s/0/8a2c2802-ded2-11e4-852b-00144feab7de.html#axzz3z8rZtnSG>.

Table 4. Russia

FACTOR	RATING	COMMENTS
Government	1	Failing according to NRG
Oil Policy	3	Partial success according to NRG, but corruption within national oil sector
Economy	2	Experiencing severe economic dysfunction and Dutch disease
Corruption	1	Poor rank on TI index
Well-being	3	Educated population, mid-ranking Gini score
Risk of Conflict	2	Presence of conflict precursors
Volatility	N/A	High
Total Score	12 out of 30	Orange

Note: Countries are ranked from 1 to 5 in each category, with 5 being the highest score. Additional information about these scores appears in table 7.

© 2015 Carnegie Endowment for International Peace

### Red: Insecure

Countries designated in red are actively insecure. Key factors may include:

- symptoms of Dutch disease, including contraction of the agricultural and manufacturing sectors of the economy, rising unemployment, excessive budgetary dependence on oil revenues, and bloated government payrolls;
- inadequate oil policies;
- unsustainably high fiscal breakeven points;
- “failing” governance according to the NRG;<sup>33</sup>
- high levels of corruption, both specifically associated with national oil companies and more broadly; and
- active insecurity, including the presence of and attacks by ideological insurgent groups, violent coups, and/or civil war. Examples of red countries include Cameroon, the Democratic Republic of the Congo, Egypt, Sierra Leone, and Venezuela.

<sup>33</sup> The Natural Resource Governance Index, [www.resourcegovernance.org/rgi/countries](http://www.resourcegovernance.org/rgi/countries).

Insecure countries (noted in red on the map below) are characterized by failing or kleptocratic governments, widespread poverty, and shortened life expectancy. In addition, their populations suffer from the negative externalities of conflict, including high threats of injury, death, and property loss. In countries that have been unstable for a lengthy period, oil operations are often located offshore to mitigate the risks to the industry. When operations are located onshore, oil companies work in insular security compounds that have little contact with the surrounding communities. The practice of operating offshore or in secured compounds significantly increases production costs due to the higher costs of security, the need to build sophisticated infrastructure, higher salaries for expatriate personnel, increased outlays for social spending to secure local support for operations (the so-called social license to operate), and losses associated with delays and disruption.

### **Red Exemplar: Egypt**

Egypt demonstrates how suddenly a country can transition from orange to red, with devastating economic consequences. The Arab Spring was sparked in Tunisia when a despondent street vendor set fire to himself in late 2010 to protest acute corruption. Popular uprisings quickly spread across the Middle East, resulting in economic shock and political upheaval in Egypt. The Tahrir Square demonstrations in Cairo show that a corrupt government that seems stable often is not. Since 2011, Egypt has experienced popular uprising, the overthrow of its longtime dictator, democratic elections, more popular protests, a military coup, and a government crackdown. During that period, Egypt has experienced a below-trend GDP growth rate of around 2 percent, and the country has become indebted to international energy companies to the tune of about \$8 billion, which it has struggled to pay back. Egypt is currently battling a jihadist insurgency in the Sinai and has suffered attacks on its tourist infrastructure.<sup>34</sup> Its estimated country risk premium of 17 percent reflects its insecurity.

Because of the presence of an insurgency and what may be increasing insecurity, Egypt's volatility is high (see table 5 below).

---

<sup>34</sup> See for example Mokhtar Awad and Brian Katullis, "Countering Islamist Violence Rising in Egypt," Wall Street Journal, August 1, 2015, <http://blogs.wsj.com/>.

Table 5. Egypt

FACTOR	RATING	COMMENTS
Government	1	Failing according to NRGi index
Oil Policy	3	Weak
Economy	2	Experienced economic shock
Corruption	2	Low rank on TI index
Well-being	2	2011 popular uprising, indicator of high levels of dissatisfaction
Risk of Conflict	1	Violent coup, experiencing violence and insurgent groups
Volatility	N/A	High
Total Score	11 out of 30	Red

Note: Countries are ranked from 1 to 5 in each category, with 5 being the highest score. Additional information about these scores appears in table 7.

© 2015 Carnegie Endowment for International Peace

### **Black: Substantial Conflict-Related Losses to Oil Companies**

Black countries, like red countries, are experiencing political-economic dysfunction and active conflict, but they have advanced on the instability scale because oil companies have experienced significant economic losses as a result of the conflict. Losses and disruptions include:

- riots;
- attacks on oil facilities and pipelines;
- bunkering, or the theft of crude from pipelines or at the wellhead;
- attacks on personnel;
- significant unplanned shutdowns; and
- undesired divestitures.

Black countries include Iraq, Libya, Nigeria, Sudan, and South Sudan. These countries demonstrate that the oil curse is a curse for the oil industry as well as for the people living there.

### **Black Exemplar: Nigeria**

Nigeria is a cautionary tale. Its history illustrates the instability that can intensify over time.

The discovery of major oil reserves in 1956 should have situated Nigeria for long-term economic growth and prosperity. However, political struggles for power and allegations of corruption triggered the first of many violent coups in 1963. Rather than providing the country with economic independence, the establishment of the Nigerian National Petroleum Company in 1977 ushered in an extended period of economic contraction, acute corruption, and increasing insecurity.

In recent years, Nigeria's economy had become less volatile, with an annual GDP growth rate of 6.2 percent, higher than those of the other countries surveyed. However, the recent collapse of world oil prices has significantly slowed Nigeria's economy, which was already suffering from Dutch disease and all its ills. Despite oil revenues of over \$1 trillion over the past fifty years, the majority of Nigerians still live below the poverty line, according to the World Bank.<sup>35</sup>

These disastrous results are largely due to the corruption—much of it oil related—for which Nigeria has become sadly infamous. Perhaps the most egregious example was the late 2013 discovery that some \$18 billion in oil revenues had failed to reach government coffers over a nineteen-month period.<sup>36</sup>

Several forms of oil-related violent instability have plagued Nigeria, including the Biafran War, which raged from 1967 to 1970, and repeated coups, which can be partially ascribed to competition for control of oil resources. Beginning in 2006, the Movement for the Emancipation of the Niger Delta (MEND) began attacking oil installations and disrupting operations. A 2009 amnesty program tamped down the worst of the violence, but since then the tapping of pipelines and theft of crude, sometimes by the barge-load, has cost millions of barrels. Though estimates vary and may be impossible to verify, a figure of \$6 billion a year lost to bunkering can be considered conservative.<sup>37</sup> Resulting oil spills have degraded the Niger Delta, poisoning the people and destroying croplands and fish stock.

Even the Boko Haram insurgency, which broke out in 2005 in Nigeria's impoverished northeast, far from the country's oil fields—and which has transfixed the world with its brutal attacks, mass kidnappings, and revival of the slave trade—is seen by many Nigerians as a reaction to the government's extreme corruption. Though Boko Haram has not directly attacked oil installations, its resilience and potential reach make it a factor in the industry's security modeling.<sup>38</sup>

Compounding the corruption and insecurity, Nigeria's oil policies and contract performance are among the worst. Pending oil legislation with uncertain implications for the sector, along with the

---

<sup>35</sup> World Bank, "Nigeria," last accessed August 25, 2015, <http://data.worldbank.org/country/nigeria> .

<sup>36</sup> See also Aaron Sayne, Alexandra Gillies and Christina Katsouris, "Inside NNPC Oil Sales: The Case for Reform in Nigeria," Washington: Natural Resource Governance Institute, August 2015.

<sup>37</sup> See for example Christina Katsouris and Aaron Sayne, "Nigeria's Criminal Crude: International Options to Combat the Export of Stolen Oil," Chatham House, September 2013, [https://www.chathamhouse.org/sites/files/chathamhouse/public/Research/Africa/0913pr\\_nigeriaoil.pdf](https://www.chathamhouse.org/sites/files/chathamhouse/public/Research/Africa/0913pr_nigeriaoil.pdf) or Emily Mangan, "Primer on Nigeria's Oil Bunkering," Council on Foreign Relations, August 4, 2015, <http://blogs.cfr.org/campbell/2015/08/04/a-primer-on-nigerias-oil-bunkering> .

<sup>38</sup> Sarah Chayes, "How to Reverse Nigeria's Oil Curse," Carnegie Endowment for International Peace, June 2, 2015, <http://carnegieendowment.org/2015/06/02/how-to-reverse-nigeria-s-oil-curse/idzm>.

threat that some existing fields might be nationalized, the government's nonpayment of millions (and perhaps billions) of dollars of royalties to oil companies, and a dysfunctional rule of law environment have made Nigeria synonymous with the term oil curse. None of these circumstances is lost on the oil companies. Beginning in 2010, but at an accelerating rate since 2014, Chevron, ENI, Shell, Total, and other international oil companies launched a program of divestiture from their onshore blocks.

Due to corruption and poor policies, the fiscal breakeven cost per barrel in 2014 was a whopping \$122 according to press reports.<sup>39</sup> When oil prices fell below \$50 in 2014, and Nigeria's sovereign wealth fund was found to lack sufficient funds to counter the lost revenues, Nigeria's government was forced to sharply cut its budget, leaving thousands of civil servants unpaid. Despite the election of a reform-minded president in March 2015, we assess that conditions are unlikely to improve in the near term. The problems are too entrenched to shift quickly (see table 6).

Table 6. Nigeria

FACTOR	RATING	COMMENTS
Government	1	Failing
Oil Policy	1	Massive corruption within oil industry, \$18 billion in revenues missing in 2012-2013
Economy	3	Evidence of Dutch disease
Corruption	1	Poor rank on TI index
Well-being	1	Majority of people live below poverty level; other indicators (health, education) poor
Risk of Conflict	1	High levels of violence and insurgent activity
Volatility	N/A	Low
Total Score	8 out of 30	Black

Note: Countries are ranked from 1 to 5 in each category, with 5 being the highest score. Additional information about these scores appears in table 7.

© 2015 Carnegie Endowment for International Peace

## A Comparison of Instability Indicators in Oil-Producing Countries

These six countries illustrate the instability that can be triggered by the influx of oil revenues: economic dysfunction sets in or intensifies, governance weakens or becomes corrupt, and in-

<sup>39</sup> Contrast this fiscal breakeven cost to Nigeria's average project operating costs, which for mature Nigerian onshore projects is below \$10 per barrel.

stability increases. As corruption and abuse of power mount, people suffer. Some are pushed to extreme reactions, causing conditions on the ground to deteriorate. Companies experience increased production costs, delays, and complex, unpredictable conditions that complicate oil production and reduce profits.

### **The Bottom Line: Instability Increases Costs for Everyone Concerned**

Oil industry professionals recognize that economic and political instability takes an economic toll on operations and need attention. What is less well understood is the precise nature of this instability and the cumulative costs it imposes on oil operations as well as international security—or that this instability is not just a fact of life, but can intensify when oil revenues flow into a country. While the industry’s planners are adept at factoring in the cost of mitigating technical risks or providing security, they are less able to accurately quantify many of the other high costs associated with the nontechnical context affecting a project.<sup>40</sup> And, of course, the long time-frame for contract negotiations, exploration, and production coupled with volatile conditions in many countries only adds to the uncertainty of cost estimating. As a result, many oil projects incur serious cost overruns and delays, especially “megaprojects” and those in unstable countries. Research shows that the larger the project and the more unstable the country, the greater the risk of failure.<sup>41</sup> This increasing failure rate has implications not only for companies, but for their investors as well.

Neeraj Nandurdikar, director of the Oil & Gas Practice at Independent Project Analysis, estimated in 2015 that the capital cost of finding and developing petroleum projects has increased 300 percent since 2003, due in large part to waste, inefficiency, and delays associated with instability.<sup>42</sup> Another analyst warns that these rising costs—which he puts at nearly 11 percent annually since 2000—are unsustainable: as capital expenses have increased, oil production has decreased by nearly 5 percent annually since 2009.<sup>43</sup> As of early 2014—even before the fall in oil prices—profitability was down by 10–20 percent.<sup>44</sup>

There is evidence that companies have not fully incorporated these risks into their cost estimates. In a 2014 report, *Spotlight on Oil and Gas Megaprojects*, EY (formerly Ernst & Young) cited an industry-wide “optimism bias,” or a tendency to underestimate costs, especially in pro-

---

<sup>40</sup> EY, *Spotlight on Oil and Gas Megaprojects*, 8. See also summary of findings: [http://www.ey.com/Publication/vwLUAssets/EY-spotlight-on-oil-and-gas-megaprojects/\\$FILE/EY-spotlight-on-oil-and-gas-megaprojects.pdf](http://www.ey.com/Publication/vwLUAssets/EY-spotlight-on-oil-and-gas-megaprojects/$FILE/EY-spotlight-on-oil-and-gas-megaprojects.pdf) (citing a 2011 Independent Project Analysis industry study, which found that 78 percent of upstream megaprojects faced cost overruns or delays, a deterioration from 2003, when 50 percent of the projects were over budget or late).

<sup>41</sup> See EY, *Spotlight on Oil and Gas Megaprojects*. Note that “large” projects can be measured not only in terms of cost or oil volumes, but also by extraction costs, time to bring online, and other factors.

<sup>42</sup> Interview with Neeraj Nandurdikar, May 19, 2015

<sup>43</sup> Steven Kopits, Managing Director of Douglas-Westwood, “Oil and Economic Growth: A Supply-Constrained View,” presentation at Center on Global Energy Policy, Columbia University, February 11, 2014, slides 40–43. View the entire presentation at [http://energypolicy.columbia.edu/sites/default/files/energy/Kopits%20-%20Oil%20and%20Economic%20Growth%20\(SIPA.%202014\)%20-%20Presentation%20Version%5B1%5D.pdf](http://energypolicy.columbia.edu/sites/default/files/energy/Kopits%20-%20Oil%20and%20Economic%20Growth%20(SIPA.%202014)%20-%20Presentation%20Version%5B1%5D.pdf)

<sup>44</sup> Kopits, “Oil and Economic Growth,” presentation, slide 45.

jects with large endowments,<sup>45</sup> as the cause of the frequent inaccuracy in cost estimating.<sup>46</sup> The optimism that projects will stay within the approximately 20 percent potential cost overrun range that planners usually forecast is not borne out by the numbers. As the report warned: “These repeated failures do raise serious questions as to the oil and gas industry’s ability to develop accurate, unbiased FID [final investment decision] budgets/schedules and subsequently to deliver to them.”<sup>47</sup>

There is no doubt that the oil industry suffers the consequences of these conditions; disruptions can be so costly that projects become economically unfeasible, as has been the case in Nigeria and elsewhere since at least 2005.<sup>48</sup> Moreover, it is hardly alone. When corruption leads to conflict, other stakeholders are impacted, starting with the local population and the business community. Violence can spread across borders. The oil companies may be seen to represent the countries where they are domiciled, and other interests of those countries may come under attack. When conflict becomes serious, it may require outside military intervention. In this way, the problems become a security challenge to the global community.<sup>49</sup> The costs from corruption-induced instability, in other words, go far beyond those incurred by oil companies. Such costs are often borne by governments and citizens, both those living in resource rich countries and those living in a multinational oil company’s country of origin. **Increased transparency under section 1504 of the Dodd-Frank Act is a remarkably low-friction/high value means of mitigating these effects.**

And doing so is in the strict economic interest of the businesses involved. Higher operating costs translate to a rising breakeven price per barrel for proposed projects. That reality, especially at a time of volatile markets and low oil prices, has serious implications for a company’s range of investment options.

Moreover, the impact of a lengthy disruption due to these factors goes far beyond the mere dollar figure—as the industry has discovered in the domains of environment and safety, where public relations impacts have compounded the immediate cost of accidents. As public awareness of the security implications of corruption grows, the intangible cost to companies of disruptions due to corruption-related conflict is likely to increase. Reputational damage can take years to repair.

### **Who Pays for These Losses?**

---

<sup>45</sup> Optimism bias is a global phenomenon and is not unique to unstable oil-producing nations. The bias may result in approval for economically unfeasible projects on the theory that the more oil is present, the more likely the company can amortize the costs over time.

<sup>46</sup> We understand “optimism bias” to mean that industry planners tend to recommend projects with large endowments even if the environment is unstable, typically underestimating the attendant costs and delays that are common in these environments.

<sup>47</sup> EY, *Spotlight on Oil and Gas Megaprojects*, 7.

<sup>48</sup> Kopits, “Oil and Economic Growth” presentation, slides 44, 46, 47, and 49.

<sup>49</sup> See for instance Secretary of State John Kerry’s remarks at the 2016 World Economic Forum, in which he labeled the fight against corruption “a first-order, national security priority” given that it “has grown at an alarming pace and threatens global growth, global stability, and indeed the global future.” John Kerry, “Remarks at the World Economic Forum,” 22 January 2016, <http://www.state.gov/secretary/remarks/2016/01/251663.htm>.

Most, though not all, of these increased costs are recovered from the host government through the cost recovery process, in which the bulk of the first oil produced by a well is earmarked for the oil company to recover its capital expenditures, with a much smaller proportion of the returns going to the host country government.

These arrangements mean that host governments (and therefore their populations) bear much of the expense of the industry's inaccurate cost estimates—and by extension of some of the damage caused by the governments' own practices.

However, the companies (and their investors) may also shoulder financial loss if higher costs take longer than expected to recover because of the time value of money and lost opportunity costs. The commercial terms of PSCs, for example, are such that the higher costs penalize both the oil company and the state. Thus, if costs rise, the oil company must carry these costs much longer, even while the state is receiving oil revenue. Consequently, while the state does eventually have to allow recovery of those costs, the oil company sustains major financial impacts that reduce profits and returns on investment. In addition, the companies may see lower returns on investment if costs continue to rise after initial capital investments have been recovered.

As profits fall, share prices may be affected. The Petrobras scandal illustrates the impact that corruption can have on shareholders. The company is listed on the New York Stock Exchange. When news of the scandal broke, U.S. shareholders lost significant value as share prices fell 43 percent. Institutional investors have filed lawsuits in the United States seeking to recover their losses.<sup>50</sup>

### **Benefits of Section 1504 of the Dodd-Frank Act**

Although the benefits of the new reporting requirements under Section 1504 are not yet fully known, making it challenging to accurately quantify them, the new data is likely to have positive impacts on various stakeholders, including companies, investors, host-governments, and their citizens. The data could be analyzed by the industry and its shareholders to gain a better accounting of the unquantified project costs associated with operating in unstable environments. This may lead to better cost estimating, which could in turn result in more responsible, less risky, investment in new oil projects, as well as more thoughtful application of efforts aimed at counteracting oil curse phenomena.

The increased transparency could also help to mitigate many of the risks highlighted in this study as a result of decreased corruption, which in turn could lead to decreased political instability. A more welcoming resulting environment could reduce the risks to companies of undesired divestitures of company assets or unplanned production shut-downs.<sup>51</sup> More broadly, more ac-

---

<sup>50</sup> Madison Marriage, "Petrobras Scandal Prompts Wave of Investor Lawsuits," *Financial Times*, April 5, 2015, [www.ft.com/intl/cms/s/0/95233aec-d942-11e4-a8f1-00144feab7de.html#axzz3eZjOzsBn](http://www.ft.com/intl/cms/s/0/95233aec-d942-11e4-a8f1-00144feab7de.html#axzz3eZjOzsBn).

<sup>51</sup> Forced oil production shut-downs have occurred, for instance, in Nigeria, where companies like Chevron and a subsidiary of Royal Dutch Shell were at times forced to suspend production equivalent to several hundreds of thousands of barrels of oil per day in the mid-to-late 2000s as the result of violence and sabotage stemming from frustration over corruption and poor governance. Since 2011, several multinational oil companies have experienced significant shut-in production in Libya as a result of violence whose root causes include citizen frustration over severe corruption in the oil sector.

countable and trusted governments and therefore increased political stability would lower the incidence of sudden regime change or violent conflict, leading to fewer combat and civilian casualties and decreased military spending, including potentially by the US government and its allies. When considering the net benefits of its rule to implement Section 1504, the SEC should consider these broader societal benefits that could result from increased transparency in the oil sector.

## Spreading Instability in Oil-Producing Countries

*Corruption, conflict, and economic loss since 2008*

