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Sudan's Energy Sector: Implementing the Wealth-Sharing Agreement

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Introduction

On June 5, 2004, the government of Sudan and the Sudan People's Liberation Movement/Army (SPLM/A) signed a framework peace agreement in Naivasha, Kenya, endorsing final principles for ending a 21-year civil war that has taken 2 million lives. The accord—the result of a two-year concerted multilateral effort led by Kenya, the United States, Norway, the United Kingdom, and the United Nations—provides for sharing political power and oil revenue between the government and the southern-based rebels, and a future referendum on secession for the south after a six-year interim period. The two parties began talks on details of a cease-fire agreement on June 21 and adjourned in late July without success. The six-month pre-interim period will not begin until a cease-fire agreement has been concluded.

The current crisis in Darfur poses a grave threat to the north-south peace process and must be resolved if the protocols signed in Naivasha and Machakos are to reach the implementation phase. Although this crisis may delay the cease-fire talks and the signing of a final comprehensive agreement, it remains essential that both the Sudanese and the international community begin now to prepare for the priority implementation challenges that lie ahead.

The wealth-sharing protocol, which was agreed upon in January 2004, is pivotal to Sudan's stability in the pre-interim and interim periods, and failure to implement this component of the overall agreement successfully will pose a significant threat to the continuing peace process. The protocol outlines guiding principles for joint management of Sudan's oil revenues and operations but leaves a myriad of details to be resolved during the six-month pre-interim period. The challenges of implementation facing each of the two parties will differ and will need to be tackled with the specific needs of both sides in mind.

On July 15, 2004, CSIS, in collaboration with the U.S. Institute of Peace, held a half-day conference to profile the priorities and challenges faced by Sudan and the international community in implementing the wealth-sharing protocol agreed upon by the government of Sudan and the SPLM/A in January 2004. After presentations from representatives of each of the two negotiating parties, Roger Diwan of PFC Energy presented the current outlook for Sudan's oil sector. Endre Stiansen, senior researcher at the University of Oslo, Robert D. Ebel, lead economist at the World Bank, and Bruce Ehrnman from the U.S. Department of State outlined the negotiation process that unfolded in Naivasha and examined the next steps required during the pre-interim and interim periods to ensure successful implementation of the agreement. The final panel looked more specifically at issues of revenue and operational management and drew from the comparative experiences of other oil-producing states. Presentations were made by David Goldwyn of Goldwyn International Strategies, Ian Gary of Catholic Relief Services, Hesketh Streeter, director of International Affairs at BP, and Robert E. Ebel of the CSIS Energy Program. The following is a summary of the central arguments made by the participants.

The Parties' Perspective

SPLM/A representative, Steven Wondu, outlined four issues central to the successful implementation of the revenue-sharing components of the protocol. First is the absence of a sufficient tax base in southern Sudan, which will take several years to develop. Wondu stressed that in the meantime, the government of South Sudan (GOSS)will be under pressure to create a credible tax collection mechanism independent from that applied in the north. Although the protocol specifies the sources of tax revenue for the national, southern, and state tiers of government, these levels overlap and will generate confusion and potential conflict.

Second, serious efforts are needed to develop a robust private sector that will not only generate revenue but also relieve demand for limited government jobs. Government enterprises, by comparison, have proven unreliable sources of revenue in other developing countries.

Third, in the short and medium term, oil will remain the sole significant source of domestic revenue. The success of the entire peace agreement will depend on the parties' satisfactory implementation of the oil revenue-sharing provision, yet the formula for oil revenue sharing is complex and can be easily manipulated. The national government and the government of South Sudan will share the net revenue from oil (NRO) on an equal basis, but determining the volume of oil sold and the debit charges in the revenue account will be problematic. It is important that the government of South Sudan trust the system and not suspect foul play, and the best insurance against this is oversight by an independent third party. The wealth-sharing agreement provides for a Fiscal and Financial Allocation and Monitoring Commission whose terms of reference are limited to the supervision of the distribution, not the determination, of revenue. The commission is a part-time committee, but a full-time secretariat of technical experts drawn from both parties should be mandated to examine the nominal account entries and certify that they are accurate. This would go a long way to allay fears and build confidence.

Lastly, it is important to consider revenue distribution mechanisms and the urgent need for functioning financial institutions. The agreement requires the national government to transfer oil revenue to the GOSS and to oil-producing states promptly. Wondu asserted that to avoid delays and misunderstanding, the oil revenue account should be directly linked to the general governmental fund accounts of the three recipients—the national government, the GOSS, and the states. Yet, none of these arrangements will be possible without a banking system in the south.

Abdel Kabeir, deputy chief of mission at the embassy of Sudan, added that the wealth-sharing agreement is based on the principle that the entire country will benefit from current and potential resources that go beyond oil to include other minerals and forestry products. Because oil is subject to global market swings, and exploration and production can be highly uncertain, Kabeir argued that wealth-sharing should be linked to the national income, rather than to a single sector.

Kabeir stressed the importance of two issues: revenue flows and accountability. From the government's perspective, the agreed mechanism to handle revenue flows is very sound. Kabeir agreed with Wondu on the need for increased confidence, but asserted that the central government will not impede or manipulate income flows to the GOSS. It will be necessary to make use of existing infrastructure and not expend scarce resources on redundant projects. On accountability, the government that will be formed from the Naivasha accord will be equipped with new, clear guidelines on how wealth—both current and future—should be shared. The spirit and comprehensiveness of this agreement differ fundamentally from past agreements.

Current Status of the Oil Sector

As the largest source of revenue, oil will figure prominently in the implementation of an eventual peace accord. It is therefore critical that both parties have an accurate picture of the sector's potential—and limits. Sudan's licensed acreage is currently dominated by Asian national oil companies, most importantly China National Petroleum Corporation (CNPC), Malaysia's Petronas, and India's Oil and Natural Gas Corporation (ONGC). Western companies, which have superior technology and capital, are notably absent due to sanctions, safety concerns, and reputational risk. At present, Sudan's oil sector produces 310,000 barrels per day (b/d), with the majority coming from the Greater Nile Petroleum Operating Company's (GNPOC) Muglad basin fields in southern Sudan.

Increased future production will be driven by exploration, which is dependent on the progress of the peace process and an increase in operator safety. At the moment, Sudan's conflict keeps approximately one-half of the prospective segment of the Muglad basin off-limits to exploration. Once the peace process is successfully concluded, the government is expected to hold a licensing round for northern concession blocks (blocks 11-15) to expedite the return of Western companies.

Future production will follow one of two scenarios: (1) without exploration, production will decline rapidly after 2007; or (2) if there is successful exploration and discoveries are followed by significant capital investment, production could plateau at approximately 450,000 b/d for the next 15 years. This expected increase in production assumes the accuracy of recent CNPC reports of the discovery of several hundred million barrels in the more secure area of blocks 3 and 7 in the Melut basin. Yet, CNPC has a history of inflating reserve and production forecasts. Given current data, it is extremely unlikely that Sudan's production will ever exceed 1 million b/d—the threshold set for the oil stabilization fund.[1]

[1] (5.4) "An Oil Revenue Stabilization Account shall be established from government oil net revenue derived from actual export sales above an agreed benchmark price. The benchmark price will be established annually as part of the national budget reflecting changing economic circumstances."

Negotiations in Naivasha and Machakos

Although multiple implementation challenges remain, the talks on wealth sharing saw a new level of engagement by both negotiating parties and external actors, which proved critical to the success of this phase. First, there was a need for external, technical expertise, which came from the IMF, World Bank, and others. Second, SPLM chairman John Garang and Sudanese vice president Ali Osman Taha spent significant time at the talks and, in one-on-one encounters, broke through certain impasses and reached tough decisions. Third, the delegations themselves began to engage more fluidly with each other as the negotiation process moved forward.

A central problem remaining with the wealth-sharing and other protocols is that they focus on what is shared, but not how the revenue-sharing formulas are actually to be implemented. The parties will not address how wealth is to be shared until they negotiate the final protocol on implementation modalities. The benefit of this sequencing is that it makes an agreement possible when those final compromises are either too technically challenging or too divisive politically. A tremendous amount of work remains during the implementation phase, not the least of which is creation of a new government in the south.

The wealth-sharing protocol addresses four main issues: revenue division (including fiscal transfers between different levels of government); banking and currency; land; and foreign funding. The energy sector itself is not dealt with separately in the agreement, but rather is addressed generally under the revenue division and land issues.

When the parties tackled the division of oil revenue, the debate was informed by three factors: First, oil is the largest source of revenue for the government of Sudan. Second, most of the known oil is located in southern Sudan, and the SPLM wants to use oil revenue as an income base for an independent South Sudan. And third, both parties agree that ownership of oil follows from ownership of land. Both parties, however, have very different interpretations of this third point.

Based on the Land Act of 1970, the government regards all land where oil is currently produced and explored as government land; therefore, all oil belongs to the central government. The SPLM, however, does not recognize the 1970 law, which was formulated in the midst of the first civil war without input from the SPLM. From the SPLM perspective, land (both surface and subsurface) belongs to the local communities. It was clear from the outset of the negotiations in Machakos that the parties would not agree on this point in the near term. A compromise was necessary, and that compromise was that the ownership of subterranean resources, including oil, would remain undecided for the duration of the pre-interim and interim period.[2]

What was agreed was the *formula* for sharing the revenue from this subterranean land. Revenue from oil in southern Sudan is to be split 50-50 between the national government and the GOSS after two deductions: 100 percent of the net revenue from producing states goes to the government. The government redistributes 2 percent of the revenue from a particular producer state back to that state government. A second deduction is then made for the Oil Stabilization Account if oil prices rise above an agreed upon threshold price. The wealth-sharing agreement, however, contains very few specifics on the logistics of this stabilization fund. For instance, a benchmark price has not yet been determined. This formula is applied only to revenue from oil produced in southern Sudan. Revenue from oil produced elsewhere will not go to the government of South Sudan, unless it does so through other allocations (influenced by the work of the Fiscal and Financial Allocation and Monitoring commission) designed to ensure that revenue is distributed equitably throughout the country.

What does this mean? There are three obvious problems:

1. Income flows. How is the new national government going to mobilize revenues? The national government will face an immediate, substantial cut in income when the revenue-sharing agreement is implemented. At the same time, the government of South Sudan will face the inverse problem—a sudden surge in revenues and a lack of institutional and absorptive capacity.

2. Intergovernmental systems. How will revenue be distributed in a transparent manner? Institutions

(*Framework Agreement on Wealth-Sharing During the Pre-Interim and Interim Period.)*

[2] (2.1) "Without prejudice to the position of the Parties with respect to ownership of land and subterranean natural resources, including in Southern Sudan, this Agreement is not intended to address the ownership of those resources. The Parties agree to establish a process to resolve this issue." (*Framework Agreement on Wealth-Sharing During the Pre-Interim and Interim Period.)*

necessary for financial transfers, especially at the local level, are lacking. A transparent institutional infrastructure must be built up.

3. Institutional capacity. There is not yet a clear plan for the numerous new institutions that will be needed in the new Sudan. We know, for example, that there will be a national petroleum commission, but exactly how will it function? How will it be structured? And, how will it relate to other institutions (e.g., the existing Ministry of Petroleum and Energy)?

Five less obvious problems reside in the text of the wealth-sharing agreement and will have a significant impact on the energy sector. These include:

1. Agreement on the meaning of the text and elaboration on several implementation issues, including the structure of the stabilization fund;
2. An implementation schedule, as well as terms of reference for the various committees agreed upon;
3. Agreement on the status of existing contracts;
4. Agreement on land ownership, which will have a major impact on the energy sector in the long run. (Land commissions are to be set up in the north, south, and all disputed areas.)
5. Determination on what will happen after the six-year interim period. (There is very little on this in the agreement.)

Expansion of revenue sources remains a pressing concern for the national government, which is facing significant pressure to raise revenue in the face of the cuts that will come with implementation of the agreement. The national government is seeking to expand social services throughout the country, but this effort is hampered by a critically weak fiscal base. The broader questions surrounding taxation are just some of those that need to be tackled in the near term. Currently, the tax to GDP ratio is approximately 10 percent (prior to the impact of the revenue-sharing agreement). The average is 19 percent for developing countries, and 30 percent for developed countries—indicating the extent to which the Sudanese government must mobilize revenues through a reconfiguring of the national tax system, especially state and local taxes. The challenge of mobilizing state and local taxes will be particularly important for southern Sudan, which must avoid falling victim to the effects of "Dutch Disease," brought about when oil windfalls push up the real exchange rate of a country's currency and render other exports noncompetitive. It can provoke a rapid, distorted growth of services, transportation, and construction, while simultaneously discouraging agriculture and certain types of industrialization.

In addition to the need for revenue mobilization, there is a need for transparent distribution of these revenues. The contested areas of Abyei, Southern Blue Nile, and the Nuba Mountains will pose particular problems. These "Three Areas" technically lie in the north but share cultural and political connections with the SPLM/A. These areas will be autonomous units but will also be part of the inter-governmental transfer system.

Implementing the Wealth-sharing Agreement

As the likely source of economic development in southern Sudan, it is critical that the oil sector be harnessed in a manner that avoids the common pitfalls seen in the other African oil-producing states. Finding a way to make oil production benefit overall stability and economic development is essential in improving the lives of the Sudanese population. Revenue transparency and operational management provide two fundamental challenges to this goal, but experiences in other oil-producing countries offer lessons on policies and practices that help to mitigate related risks.

Challenges for International Oil Companies

In the event of a comprehensive peace accord and implementation of the wealth-sharing agreement, will international oil companies feel secure enough to return, spend serious dollars, and generate wealth for Sudan in the next five years? Without significant changes and clarification, probably not.

The comparative experiences of oil companies in other countries suggest several cautions. Of the international companies, however, the Chinese, Indian, and Malaysian companies are more likely than the Western majors and independents to take risks. First and foremost, companies have a very low tolerance for risking lives. They also have a low tolerance for risking capital in places where they do not already have significant investment in the ground. Moreover, companies are averse to high levels of contract risk; they need clear and sustainable fiscal and legal rules. And last, companies are reluctant to place themselves in the middle of land disputes where countries or internal groups are arguing over who has the right to develop resources. Companies realize that in many cases, litigation and reputation risks are far greater than the potential financial rewards.

In their considerations to invest and operate in Sudan, international oil companies face three central challenges:

1. Security. The greatest challenge will be in the undeveloped fields, and as long as the risk of violence remains high, international oil companies will not return. Field development will be expensive and companies will be in remote and unprotected areas. Key considerations will include: Are the companies welcome by local communities? Who will maintain security—local militias or the combined forces of South Sudan and others?

2. Fiscal and legal regime. The agreement[3] calls for respect of existing contracts and creation of a conducive policy environment to maximize investment. However, there remain many open and undecided fiscal and legal issues:

   - The agreement also says that parties may sue if they believe their rights have been violated.[4] It is unclear, however, which rights are to be protected, what constitutes a violation, and how and when these suits would be litigated. Those companies with existing operations will likely manage this risk. But for those companies just starting in undeveloped blocks, it is likely that this will need to be resolved before any substantial investment is made.

   - The agreement states that every level of government has the right to tax and issue levies. Will these apply to existing contracts? Will there be a national tax regime? A national energy policy limiting local taxes? It is difficult for companies to estimate the return on their investment without knowing the extent of their future tax obligations.

   - The agreement calls for communities to be involved in negotiation of new contracts. This is likely to be either a deterrent or at least a severe impediment to new contracts.

   - The agreement provides for land claims that can be submitted to the National Land Commission, including just compensation and nonfinancial remedies (return of land). Do these include claims on existing contracts? If so, and if they are submitted, how long will it take to resolve them?

   - A final, major contractual risk is *sustainability.* Will legal rights and fiscal terms that apply during the interim period apply if the south secedes? Without an assertion by the SPLM that they will abide by the agreed terms regardless of the referendum result, companies will be very reluctant to invest. A six-year deal is insufficient in a 30-year business.

3. Administrative capacity. The southerners in particular are going to need training and access to expertise and necessary information for participation in the National Petroleum Commission, the Land Commission, and various ministries in the national government. They will need training in industry best practices—in transparency, auditing, contracts, and management. Most importantly, they will need to secure unbiased advice and assistance at nonextortionate prices.

Transparency and Accountability

Even if all the other obstacles to peace are overcome, Sudan faces a very difficult road when it comes to turning petroleum wealth into lasting peace and prosperity. Sudan is a very difficult environment in which to achieve transparent and accountable oil revenue management, but it will be a crucial element of any lasting piece. Oil exporters in the Gulf of Guinea have failed to turn their oil booms into broad-based economic development and are instead marked by high levels of corruption, conflict, and economic decay.

Sudan must place an early emphasis on transparency and accountability to avoid falling prey to the all-too-common "resource curse." In the current policy environment, oil dependence hurts development in multiple ways. Oil booms raise expectations and increase appetites for spending. Governments dramatically increase public spending based on unrealistic revenue projections, but the quality of this spending often decreases. The volatility of oil prices, loss of fiscal control, and inflation, hinder growth, equity, and poverty alleviation. Foreign debt tends to grow faster in oil-exporting countries, mortgaging the future, and non-oil productive activities, such as manufacturing and agriculture, are adversely affected (Dutch Disease). Over time, oil revenues decrease reliance on non-oil taxes, and

[3] (4.2) "Contracts shall not be subject to re-negotiation."

[4] (4.5) "Persons whose rights have been violated by oil contracts are entitled to compensation. On the establishment of these violations through due legal process the Parties to the oil contracts shall be liable to compensate the affected persons to the extent of the damage caused."

can actually replace previously existing taxation systems — freeing oil-exporting governments from the types of citizen demands for fiscal transparency and accountability that arise when people pay taxes directly to the government.

Without improving their democratic institutions and administrative capacity, it will be difficult for Sudan to use petrodollars to fuel poverty reduction; instead, oil monies are more likely to make matters worse for the poor.

Recommendations

Even with these multiple challenges, it is possible to work within the framework of the agreement to accelerate investment and promote the effective allocation of oil resources. The current crisis in Darfur and web of U.S. sanctions mean that the implementation process will not realistically begin for at least another six months. This time must be used effectively to address some of the most pressing questions, and several recommendations stand out:

To donors and other external actors:

1. The World Bank and others need to *identify and fund a cadre of experts and trainers* to work with GOSS over the next year to train them for leadership in the oil sector at both the state and local level. Donors must ensure that there are *sufficient staff budgets*. Examples from Chad, Cameroon, and others illustrate that without strong and independently funded staffs, these commissions and auditors cannot function.

2. There must be a *strong, coherent donor policy* that insists on transparency, fair and accountable revenue management and allocation, and respect for human rights. Donors need to make clear in advance that there will be no major flows of funds without auditing of expenditures at the state and regional level—under the national government and the GOSS. Donor thresholds must be made clear up front so all parties can prepare to meet them. Donor leverage should be properly sequenced, with significant steps toward the building of good governance taking place prior to oil sector development assistance.

To the government of Sudan and SPLM:

3. The parties need to start now on development of a *national energy policy*. They need to identify the major obstacles to investment and work through a policy that is amenable to all parties and binding at federal, state, and local levels. If parties wait until the institutions are formed, it will be years before a conducive policy environment is formed.

4. The SPLM and others ought to make a statement that they will live by fiscal and legal terms regardless of the outcome of the referendum.

5. The parties need to develop an *infrastructure security policy* to make clear for investors who will provide security and how.

6. Space should be created for *civil society* groups to play a role in the monitoring of oil revenues and expenditures. This participation can be institutionalized through some of the formal mechanisms provided for in the wealth-sharing agreement (the National Petroleum Commission, Fiscal and Financial Allocation and Monitoring Commission, and Land Commissions), which so far, only provide for participation by the government, SPLM, and regional representatives.

7. It is important that transparency be pursued with *contracts* as well as revenue flows. The agreement states that those who have access to existing contracts must sign "confidentiality agreements" —not a good starting point for building a transparent oil sector. Furthermore, it will be important to verify both international oil company payments to the government and government payments to southern Sudan.

8. A policy for dealing with *oil-backed loans* should be established. A significant share of Sudan's future oil revenue is already dedicated to repaying these loans, and a transparent process will be needed to determine the extent to which future wealth is already leveraged. It is in both parties' interests to examine who has the ability and authority to take out such loans, and whether it is best to place a moratorium on them during the interim period.

9. As it currently stands, the wealth-sharing agreement does not address the specific operational modalities of the *Oil Revenue Stabilization Account* or the *Future Generation Fund*. These stabilization funds are key to Sudan's economic development and stability and will need to be carefully crafted and negotiated if they are to be effective.

10. The *revenue-sharing formula* itself may prove to be problematic. First, the 2 percent of revenue that

is to go to the producing states/regions (in proportion to each state/region's production) is likely to be inadequate. In Chad, 5 percent of revenue goes to the producing states, while in Nigeria it is 13 percent. Second, huge political questions and challenges are likely to surface when defining the various producing regions. The potential for continued local grievances will remain high.

11. Finally, it will be important to control the *expectations of political leaders* and their public rhetoric as much as possible. Some of the potential production and revenue amounts, as well as development assistance requirements, predicted by political leaders have been off the mark and will only exacerbate mistrust among various parties. Quick, visible results from oil revenue spending will be important in building confidence both between the parties and within local communities.

Thus, there are numerous issues that remain to be dealt with if the wealth-sharing agreement is to be implemented successfully. If oil revenue is not managed well, the overall peace process stands to suffer. Appropriate transparency and accountability must be built into the norms and institutions of post-conflict Sudan, and are integral to ensuring that peace between the north and south, as well as within the south itself, is not undermined.

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