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CENTER ON GLOBALIZATION
AND SUSTAINABLE DEVELOPMENT

**SAO TOME AND PRINCIPE
OIL REVENUE MANAGEMENT LAW**

Oil-Revenue Management Team of the
Columbia University Consulting Group
to H.E. The President of Sao Tome and Principe

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EXECUTIVE SUMMARY

This memorandum summarizes key decisions that Sao Tome and Principe will have to take to enable the drafting of the desired oil revenue management law. Page references are to the full Columbia University Oil Law Memorandum, which follows this summary.

1. Whether To Establish an Oil Fund

The Columbia Group strongly recommends the establishment of a “locked box” oil fund to be held in an international financial institution, e.g., U.S. Federal Reserve, with all oil revenues including distributions from the JDA paid directly into that account (see pp. 7-8 of the full Memo).

2. Who Should Manage the Oil Fund

The Oil Fund would be best supervised and managed by a governing committee representing all of Sao Tome and Principe’s major political institutions, e.g., Council of State (p. 9).

3. What Restrictions Should Be Placed on the Oil Fund

We recommend that:

- (i) all investments be in highly secure government securities, e.g. U.S. Treasury Bonds (pp. 9-10),
- (ii) withdrawals be made only by transfer to the .budget accounts of the Treasury (pp.10, 13), and
- (iii) no borrowing against the Oil Fund be permitted (p.10).

4. Who May Authorize Withdrawals.

Transfers from the Fund to the National Budget should be authorized by a “Disbursement Authority” (p.12). The Disbursement Authority could be the Central Bank or a group of government ministries and representatives of other political institutions (p.13). No spending decisions should be made by the Disbursement Authority. The Disbursement Authority should only authorize the transfer to the national budget account. Accordingly, sole authority to make transfers should not be lodged in the Minister of Finance.

5. How Much May Be Withdrawn.

The amount to be withdrawn should rest on technical judgments made by the Disbursement Authority or limited by rule, e.g., no more than the lesser of 25% of original receipts or current holdings (pp. 11-12). A rule may be preferred for initial period when only revenues are signature bonuses.

6. Whether to Restrict Budget Uses and If So To What.

We recommend that transferred amounts be restricted to certain uses, e.g., education, health, infrastructure, or matched to a national development law (pp.3-4). Some amounts could be reserved for the region of Principe or local governments or for direct distribution to the population, if sufficient oil revenues permit, e.g., after production commences (pp. 14-15).

7. What Measures Should Be Taken To Ensure Transparency.

We strongly believe all oil revenues and their uses should be fully transparent (pp.5-6, 10). All deposits, holdings, withdrawals and other activity of the Oil Fund should be public and subject to audit (p. 10); all decisions and budgets including budget of JDA should be public (p.5). To enhance availability of information, a Public Information Office should be established where such information should be lodged; all information should also be available by Internet (p. 5-6).

8. What Measures Should Be Taken To Insure Public Oversight.

To insure that the law is enforced, we recommend establishing a government Oversight Authority (pp. 15-19). This might be composed of existing authorities or it could be a new body (pp. 18-19). The Oversight Authority should (i) have full access to information including subpoena power, (ii) issue regular public reports, and (iii) have power to take legal action to void action not conforming to the requirements of the Oil Law. The Authority might also have review authority over the budget to be sure it conforms to the use restrictions in the law (p.17).

9. Whether in Addition To The Oil Law A Constitutional Amendment Should be Adopted.

In addition to the Oil Law, we believe the Oil Commission should consider adopting a Constitutional Amendment to further protect oil revenues and prevent abuses (p.3).

23 February 2004

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TABLE OF CONTENTS

I. INTRODUCTION	2
II. PRELIMINARY ISSUES	3
II.1 LAW OR CONSTITUTIONAL AMENDMENT?	3
II.2 RELATIONS WITH THE NATIONAL DEVELOPMENT PLAN	3
II.3 RELATIONS WITH THE JOINT DEVELOPMENT AUTHORITY	5
II.4 TRANSPARENCY ISSUES: THE ESTABLISHMENT OF A PUBLIC INFORMATION OFFICE	6
II.5 TRANSITIONAL ARRANGEMENTS	7
III. ESTABLISHING AND MANAGING AND OIL FUND	8
III.1 MANAGING OIL RECEIPTS: ARGUMENTS FOR AN OIL FUND	8
III.2 PAYMENTS TO THE OIL FUND.....	8
III.3 MANAGING THE OIL FUND	9
IV. DISBURSEMENT DECISIONS FROM THE OIL FUND	11
IV.1 DISBURSEMENT AUTHORITY	11
IV.1.1. Purpose.....	11
IV.1.2. Recommendations.....	13
IV.2 APPROVED USES	15
IV.2.1. Development Priorities.....	15
IV.2.2. No Government Borrowing against Future Transfers from Oil Fund.....	15
IV.2.3. Direct Distribution	15
IV.3 DEVELOPMENT OVERSIGHT COMMITTEE	17
IV.3.1 Mandate.....	18
IV.3.2 Capacity and Power of the Oversight Body	19
IV.3.3 Composition of the Oversight Body.....	20
IV.3.4 Relations Between the Disbursement Authority and the Development Oversight Committee.....	21
IV.4 LAW'S IMPACT ON BUDGETARY PROCESS	22

SAO TOME AND PRINCIPE OIL REVENUE MANAGEMENT LAW

I. INTRODUCTION

This memorandum has been prepared by the Columbia University oil team to provide the officials in Sao Tome and Principe involved with the preparation of a national oil revenue management law, and their consultants, with perspectives on issues to be addressed as drafting of the new law continues. We also offer some suggestions and recommendations for how we think oil revenues could be governed for the greatest benefit of the people of Sao Tome and Principe. We hope this document can be a useful resource as Sao Tome and Principe embarks on its new oil era.

This memorandum specifically addresses only revenue management issues. We understand that a separate law will need to be prepared with respect to the establishment of an oil regulatory agency to oversee drilling and production operations and the awarding of contracts in the Exclusive Economic Zone. In addition, there may need to be conforming changes in other existing laws.

The experience of other oil-exporting nations shows that oil brings enormous challenges to countries whose governing institutions are weak. Dangers associated with oil can be minimized only if decision-making power is divided in such a way that different institutions provide checks and balances on each other. The public must also be sufficiently informed to be able to exercise genuine democratic oversight.

Our discussions show several ways in which these principles could be implemented in Sao Tome and Principe's oil revenue management law. The choice of institutions will, of course, rest with the Sao Tomean authorities. When you evaluate these proposals, and if you decide to pursue the options we discuss here, we are always available to provide further detail regarding how these options can be implemented in Sao Tome and Principe.

Our recommendations center around three core issues:

1. We recommend that Sao Tome and Principe establish an **Oil Fund** as the vehicle for prudent and transparent macroeconomic management. All oil-derived revenue, without exception, should be paid into this fund, which itself should not have spending authority. To be used for expenditure, funds would have to be transferred from the Oil Fund to the Ministry of Finance. That Ministry should, as today, have the authority to allocate government expenditure, but the decision regarding how much to transfer from the Oil Fund to the national budget in any given year should be vested in a different institution from the Ministry of Finance itself.
2. We recommend that the law ensure that the oil revenues be spent in a way that promotes the **social and economic development** of Sao Tome and Principe. We, therefore, recommend that the law require a certain amount of the resources to be spent in accordance with clearly defined development priorities. The Ministry of Finance should still have the responsibility to allocate spending to specific projects, but should be held to do so in a way that meets the priorities set out by the law.

3. We recommend a significant strengthening of the institutional framework for **oversight, transparency and information**. We recommend the creation of a public information office with which records of all transactions governed by this law should be lodged. There should also be established a Development Oversight Committee, charged with monitoring that the development priorities set out in the law are indeed complied with.

II. PRELIMINARY ISSUES

II.1 LAW OR CONSTITUTIONAL AMENDMENT?

Given the central importance of oil revenues to the future economy of Sao Tome and Principe, it may be desirable to **adopt a Constitutional Amendment** addressing certain key elements of the oil revenue management law.

In addition to the oil revenue management law, a constitutional amendment would significantly strengthen the controls over the collection and use of oil revenues, and would limit the ability of any party or subdivision of the state, now or in the future, to arbitrarily or unilaterally change the rules governing the oil fund.

In the unlikely event that an unconstitutional government attempts to seize power in Sao Tome and Principe, such an amendment might also help protect Sao Tome and Principe from the seizure of funds, especially if the funds are held in an international institution outside of Sao Tome and Principe.

An amendment could reaffirm key principles of the oil revenue management law: that all petroleum resources and the revenues derived from them are the property of the people of Sao Tome and Principe, that all revenues from such resources must be deposited in the oil fund, that all transfers from the oil fund to the general funds of the Treasury must be approved by an appropriately designated institution, that the activities of the oil fund, including all deposits and withdrawals shall be public, that monies from the oil fund can only be made available for particular uses, and that pledges or other encumbrances on the petroleum resources of the state and the assets of the oil fund are prohibited. The Constitutional Amendment could be drafted in parallel with the drafting of the law and passed in conjunction with the oil law.

II.2 RELATIONS WITH THE NATIONAL DEVELOPMENT PLAN

One purpose of the Oil Revenue Management Law (the “Law”) is to provide a **framework for the efficient and effective use of Sao Tome and Principe’s future revenues** derived from the oil resources in order to relieve poverty, promote development, and enhance the well-being of all present and future citizens of Sao Tome and Principe.

Experience around the world shows that once oil revenues start flowing, governments find it difficult to avoid a diversion from development projects to spending for political advantage. To ensure that the potential hydrocarbon resources benefit the people of Sao Tome and Principe, it may be desirable to **link the oil law to expenditure priorities**.

These priorities should promote the economic and social development of the country, and could use the United Nations' Millennium Development Goals as guidelines. Particularly if the law has a strong legal status as recommended in Section 0 above, this can help ensure that in future years, oil revenues will not be diverted away from priority sectors.

Two options are the following:

1. The law could be linked to a “**Master Development Plan.**” In such case, the oil law would state that a certain percentage of revenues are dedicated for uses identified by the National Development Plan, which is itself established by a Decree of the National Assembly.
2. Alternatively, the law could itself contain a clause restricting the sectors for which oil revenue can be used. For example, the Chad law (see Box 1 below) indicates simply that a particular share of the financing has to be dedicated to a set of priority sectors including social and infrastructural development.

To help ensure good use of the revenues in Sao Tome and Principe these priority sectors could be more closely identified and lower limits could be placed on the expenditure in each sector. Hence, for example, the law could stipulate that at least 80% be dedicated to priority sectors, with at least 10% dedicated to education, 10% to health and so on.

Whichever approach is adopted, the law should both protect against misuse of the funds and take account shifting priorities over time.

If the first option is followed, this can be done by revising the Master Development Plan after specified periods (for example, every five years) and again subject to parliamentary approval.

If the second option is followed, this can be done by stipulating a procedure for amending the distribution of percentages after specified periods (again, every five years) while protecting against the risk of opportunistic revision of the law. This could be ensured by, for example, requiring a majority of 2/3 in the National Assembly to amend the law.

Finally, there should be an independent **oversight mechanism** that ensures the compliance of the budgetary authorities with the priorities set out in the development plan or the oil law itself. We recommend that the law should establish a Development Oversight Committee, which we describe in further detail below.

Republic of Chad LAW No. 001/PR/99, “GOVERNING THE MANAGEMENT OF OIL REVENUES”

[Revenues from] dividends and royalties, deposited into special accounts provided under paragraph 2 of Article 3 above, shall be allocated as follows:

- a) Eighty per cent (80%) are intended for expenses associated with priority sectors [Public Health, Social Services, Education, Infrastructure, Rural Development (Agriculture and Livestock), Environment and Water];
- b) Fifteen per cent (15%) are intended for operating and investment costs of the State, for a five year period from the production date;
- (c) Five per cent (5%) of the royalties are intended for decentralized communities of the producing region, in accordance with the provisions of Article 212 of the Constitution;

This amount may be modified by decree every five years depending on available resources, needs and absorption capacity of the region.

Box 1

RECOMMENDATIONS:

- ❖ We recommend that the law state in its **preamble** that all oil resources are to be held and used for the benefit of the people of Sao Tome and Principe, and that revenues from such sources may only be used in accordance with the law.
- ❖ The law should contain an operative clause establishing procedures for the drafting and endorsement of long-term development plans and strictly tying the uses of oil funds to priorities identified in those plans. It should stipulate a **minimum percentage** of oil-derived revenue that must be devoted to projects in the plan, as well as procedures for changing that percentage.
- ❖ We recommend that the Assembly **pass a National Development Plan that will be in effect for the next national budget cycle under the oil law.**
- ❖ The law should establish a **Development Oversight Committee**, whose role and authority is discussed in Section 0 below.

II.3 RELATIONS WITH THE JOINT DEVELOPMENT AUTHORITY

The Joint Development Zone will be, in the short term, the sole source of revenues for Sao Tome and Principe's Oil Fund. It may also account for the largest amount of revenue over time. It is, therefore, important to establish ways to ensure transparent relations with the Joint Development Authority ("JDA"). For example, all revenues payable by the JDA to Sao Tome and Principe could be paid directly into Sao Tome and Principe's Oil Fund, and subsequent transfers could be made from the Oil Fund to the national budget in accordance with the oil revenue management law. **This would facilitate full transparency in the use of oil funds and provide for unified treatment of all oil revenues.**

In addition, the oil revenue management law could, and we believe should, set out the major elements of governmental policy with respect to the Joint Development Zone and the Joint Development Authority.

These policies would govern the actions of the Sao Tome and Principe representatives to the Joint Ministerial Council. To be sure, action by the JDA must be agreed to by both Nigeria and Sao Tome and Principe. But given the "good governance" nature of the basic policies, we would expect the Joint Ministerial Council to agree on their application to the Joint Development Zone to the extent that such policies are not already in place.

Among the basic principles of the oil revenue management law which should govern Sao Tome and Principe's actions in the JDA would be those regarding **financial accounting** and **independent audits** of the activities of the JDA, including payments to the JDA from the oil companies and the guarantee of public access to such information.

To facilitate increased transparency the oil revenue management law could, in addition, require Sao Tome and Principe's representatives on the Joint Ministerial Council have the JDA make public key information of the JDA— such as minutes of meetings, resolutions passed by, and proposed budgets of the JDA—and make this information available through institutions such as a Sao Tome and Principe Public Information Office (see below).

Alternatively, or in addition, Sao Tome and Principe could, as a matter of policy, make such information received from the JDA public as part of its own policies of transparency.

II.4 TRANSPARENCY ISSUES: THE ESTABLISHMENT OF A PUBLIC INFORMATION OFFICE

The oil revenue management law can be used to ensure that a maximum of information is made public and accessible. Doing this gives the people of Sao Tome and Principe the information that is needed for what is ultimately the most effective form of oversight: popular oversight.

RECOMMENDATION

- We recommend that all transactions of the Oil Fund and the Ministry of Finance, as well as the decisions made by the other bodies referred to in the law (the National Petroleum Council, the National Petroleum Agency, the Development Oversight Committee, the National Assembly, the *Tribunal de Contas*, perhaps the local authorities, and this office itself) be put in the public domain, in a form that makes it realistically accessible to ordinary citizens. In particular:
 - ❖ The law should create a **Public Information Office** (PIO), and impose on all the relevant bodies and actors the duty to lodge with the PIO full information about the decisions related to this law. The PIO should be charged with, and given adequate financing for, ensuring that this information is available. The PIO should report on any shortcomings by other parts of government in the duty of lodging all relevant information with the PIO. They should also encourage the collection and organizing of government information beyond what is legally mandated. They should make the information available in both physical (in an easily accessible office) and electronic form (on line). They should make it possible for non-residents of Sao Tome town to order relevant information to be sent to them, e.g. through the offices of the district authorities.
 - ❖ In addition, the Commission should consider:
 - Establishing the PIO within an already existing government agency:
 - The PIO could, for example, be made a sub-division of the National Statistics Office, which is already charged with information collection and dissemination. If this solution is chosen, the Office must be guaranteed the additional funding necessary to meet its new responsibilities.
 - Another possibility would be for the existing Sao Tomean Central Information Office to be improved, expanded, and granted more meaningful resources to enable it to carry out these additional duties.
 - Granting the PIO the authority to subpoena information from the relevant authorities according to the provisions in this law, in situations where those authorities do not voluntarily report as required.
 - Requiring the head of the PIO to give regular testimony to the National Assembly and the Development Oversight Committee (described below) regarding the compliance of the country's authorities with the information disclosure provisions of the law.
 - Making the transactions to and from the Oil Fund freely accessible in the public domain. This could be done by requiring that the selected fund managers enable unlimited Internet access to Fund statements. In this way, any person may check the daily balance of the Fund and monitor all transactions.

II.5 TRANSITIONAL ARRANGEMENTS

It is likely that in the near future, oil revenues to Sao Tome and Principe will come in two very different forms:

- A relatively small lump sum payment from signing bonuses available in the immediate future, and
- Larger revenue flows that may not become available until 2008-2009.

The institutions called for in this document will most likely not be functional in time for the first inflow of oil-derived funds. Moreover, some of those initial funds have already been committed in the Sao Tome and Principe national budget for the 2004 fiscal year.

RECOMMENDATION:

We recommend that the promulgation of the oil law be formally linked to two other resolutions by the National Assembly:

ONE:

The National Assembly should make a one-time resolution determining the total amount of the signature bonuses received from the current JDA licensing round to be transferred to the national budget and used by the Ministry of Finance for fiscal year 2004.

The remainder of the signature bonuses – the entire amount not expressly authorized for expenditure in this resolution – should be immediately made subject to the provisions of this law, as should all future oil-derived revenue to Sao Tome and Principe.

While some of the signature bonuses will, therefore, cover committed expenditure plans for fiscal year 2004, the oil revenue management law will apply to all future budgets, beginning with the budgetary process for fiscal year 2005. The law should require all stated institutions to be functional within that time frame.

TWO:

As described above, we recommend that the law tie a proportion of the funds to spending aimed at the sustainable development of the country.

The structure of oil revenue management called for in the law, therefore, necessitates the passing by the National Assembly of a National Development Plan.

It is highly desirable that the oil revenue management law and the National Development Plan be passed simultaneously.

If that should prove impossible, the law should stipulate a “fallback option,” stating in detail which criteria should be applied to the spending of oil-derived revenues until the National Assembly passes a development plan. This fallback option could be the specific distribution of percentages to priority sectors as in Chad, which was described above. A temporary clause of the

law could contain such a distribution of percentages, which would be superseded by an Act of the National Assembly adopting a National Development Plan.

III. ESTABLISHING AND MANAGING AND OIL FUND

III.1 MANAGING OIL RECEIPTS: ARGUMENTS FOR AN OIL FUND

The law will need to provide for mechanisms to govern a set of key functions. Chief among these are the following:

- (a) Overseeing the day-to-day management and investment decisions regarding oil revenues;
- (b) Insulating the annual injections of oil revenues to the national budget from the year-to-year volatility of oil revenues earned;
- (c) Choosing the appropriate level of the annual oil-financed spending, and
- (d) Ensuring that disbursements of oil revenue are in accordance with national development priorities.

Multiple approaches are possible, they are basically:

1. Whether to have a separate Oil Fund into which oil revenues would be paid, with monies subsequently being transferred from the fund to the national budget for expenditure as provided in the governing instruments, or
2. Whether to have monies directly deposited in a special reserve account held by the national budget. In principle monies could be managed in the same fashion through either approach.

RECOMMENDATION:

Although multiple approaches are possible, we strongly recommend the establishment of a separate Oil Fund to be governed by the oil revenue management law. A separate fund managed by an international financial entity, selected by Sao Tome and Principe, into which all oil revenues are initially deposited would provide maximum transparency with respect to Sao Tome and Principe's oil revenues and their disposition. It would better protect the funds, and it would permit more control over their withdrawal and use, including various governmental checks and balances.

III.2 PAYMENTS TO THE OIL FUND

The oil revenue management law should list all sources of payments into this Oil Fund. This will include Joint Development Zone revenues, as well as all payments associated with the Exclusive Economic Zone. The list should include, at least, all of the following:

- (a) Distributions from the Joint Development Authority
- (b) Sao Tome's share of sale of crude oil and gas

- (c) Signature bonuses
- (d) Royalties
- (e) Rents
- (f) Proceeds from sale of assets
- (g) Taxes
- (h) Fees
- (i) Duties
- (j) Return on investment

An example of a clause listing payments to the Norwegian fund is given in Box 2.

Government of Norway Act no. 36 relating to the Government Petroleum Fund (1990)

The Fund's income consists of the cash flow from petroleum activities ... and the net results of financial transactions associated with petroleum activities. The cash flow is the sum of

- Total tax revenues and royalty deriving from petroleum activities collected pursuant to Petroleum Taxation Act and the Petroleum Act
- Revenues deriving from tax on CO2 emissions due to petroleum activities on the continental shelf
- Revenues deriving from the State's direct financial interest in petroleum activities, defined as operating income and other income less operating expenses and other direct expenses
- Central government revenues from net surplus agreements associated with certain production licences
- Dividends from Den norske stats oljeselskap A/S
- Transfers from the Petroleum Insurance Fund
- Central government revenues deriving from the removal or alternative use of installations on the continental shelf
- Any government sale of stakes representing the State's direct financial interest in petroleum activities

Box 2

III.3 MANAGING THE OIL FUND

A critical aspect of the oil revenues management law is determining who should be members of the supervisory board that will exercise control over the oil fund, and how the fund should be managed.

Responsibilities include general oversight, and decisions regarding the choice of a depository institution, the choice and oversight of investment managers for the Oil Fund, and most importantly, decisions regarding distributions from the Oil Fund to the national budget or, in the case of direct distribution, to the citizens of the country.

Not all of these functions need to be in the same entity. Some of them might be performed conjointly with various parts of the government. Whatever the entity it will be important that it be broadly representative of all of the institutions and groups within Sao Tome and Principe.

RECOMMENDATIONS:

ONE:

Separate authorities should be established for overseeing decisions regarding the management of the Oil Fund, and the more technical decisions regarding appropriate levels of disbursement from the Oil Fund. We discuss the disbursement authority in the next section.

TWO:

A Governing Committee should be established so that the management of the fund is committed to a widely representative institution, including members from the Sao Tomean Government, the National Assembly, and the Presidency.

One possibility would be to use the Council of State provided for in the Constitution. Although apparently the Council of State has not been active, its membership appears to include all of the major elements of government, as well as other important members of the community.

Depending upon its size, the Governing Committee could carry out its responsibilities directly, or it could annually elect a governing committee from among its members for annual terms.

The Governing Committee should be responsible for establishing the account and the selection and overseeing of the Oil Fund's investment managers. The Governing Committee would be responsible for making public receipts and disbursements and other financial activity in the account, and where there is discretion in its investments, explaining investment decisions that have been taken.

If a private entity is used, the Governing Committee should also be responsible for having an independent audit of the account.

THREE:

The Location of Oil Fund. should be outside of Sao Tome and Principe. We recommend that the fund be held at either the Federal Reserve Bank of New York, the Bank of International Settlements, or a major money center bank.

At least during the initial period of operation, we recommend using the Federal Reserve Bank of New York, as we believe that they would be the most efficient alternative available..

FOUR:

- (a) **Investments should be restricted to virtually risk-free securities in order to project the Oil Fund,** e.g., government backed securities. Investments should not be made in Sao Tome and Principe. There may be an appropriate role for government lending or support of local entities, but that should be done through the general budget and the National Development Plan, not through the Oil Fund
- (b) If the fund grows, it will be necessary to put in place a more flexible set of rules governing investment, and the council or committee will have to have authority to retain

investment advisers and to establish benchmarks or other standards to judge the performance of those advisors. We believe that this can be left to later elaborations of the oil law.

FIVE:

Disbursements by the account holder should only be name to the Sao Tome and Principe Treasury/national budget, and only in accordance with instructions from Sao Tomean authorities as provided for in the law itself. We provide further information regarding disbursement authority in Section 0.

Other than authorized expenses of the depository institution, we would expect no disbursements except to the Treasury/national budget. To the extent that the Governing Committee incurs expenses, those expenses should be provided for in the general budget and not paid for directly from the Oil Fund.

SIX:

Prohibition on Government Borrowing. To further protect the fund and the fiscal integrity of the budget, it would be desirable to prohibit borrowing against the fund or future fund revenues.

SEVEN:

Public audits and reports. All account activity including deposits, expenses and withdrawals, and investment holdings should be made public through quarterly financial reports. Accounts would be subject to an independent and public audit. The Governing Council, and if possible, the bank itself, should be held to lodging all relevant information with the Public Information Office in a timely manner.

IV. DISBURSEMENT DECISIONS FROM THE OIL FUND

IV.1 DISBURSEMENT AUTHORITY

IV.1.1. Purpose

Any oil revenue management law must take account of the possibility of radical changes in the oil revenues accruing to the country over time.

During an initial period of three to five years, Sao Tome and Principe will only have available to it the revenues accruing from the signature bonuses paid on blocks from the Joint Development Zone, possibly augmented in the latter part of the period by signature bonuses from contracts on blocks within the Exclusive Economic Zone.

In later years, Sao Tome and Principe may receive very much larger revenue flows, greatly enhancing the opportunity for development, but also greatly increasing the management burden. From an economic point of view, oil revenues are destabilizing for three reasons:

- ❖ The volatility of oil prices, the productive cycle of the oil industry (which can feature large upfront payments, then a long period of cost recovery before large profits start to flow);

- ❖ The dislocating effects on a poor economy of sudden large inflows of oil money, or the sudden drop in revenues as the oil era comes to an end;
- ❖ Added to these concerns is the destabilization of economic policy: Experience shows that it is extremely hard to maintain prudent fiscal management when oil revenues are soaring, and even harder to cut back on profligacy when they are plummeting.

A primary purpose of the oil revenue management law is, therefore, to provide for a mechanism to determine how much the country should spend in a given year.

This determination should be independent from short term fluctuations of oil-derived revenues.

Prudent macroeconomic policy requires that the level of oil-derived revenues injected into the economy be stable from year to year, or increasing/decreasing at a regular and modest rate. It is crucial to ensure that the level of injection be decided with regard to the most effective time profile of spending, which must respect the following concerns:

- ❖ Spending should be insulated from year-to-year fluctuations in revenues (stabilization)
- ❖ Spending decisions should take into account the limits to how much money can be productively invested in a short amount of time, and the possible negative effects on future productivity of other sectors (sterilization to minimize “Dutch Disease” or wasteful spending).
- ❖ Future generations also have a claim on the resources, yet current development needs are urgent. In effect, the Oil Fund should serve as a mechanism for savings, particularly at times when revenues exceed the absorptive capacity of the country or by virtue of a deliberate decision to reduce current expenditures in order that the benefit of oil revenues will continue to be available even after the exhaustion of a country’s oil resources.

The authority to decide how much money can be disbursed in each year should be placed where it can be made with

- the most technical macroeconomic competence
- the least pressure to overspend, and
- the most transparency and publicity vis-à-vis society at large.

Moreover, there should be limits on the ability to of the government to borrow for deficit spending, since it could otherwise always nullify an imposed limit on spending by financing deficits with future oil earnings as collateral.

Since such arrangements may overly insulate the decision-makers from the democratic process, it is imperative that the law provides for regular reporting to and possibility of censure by public institutions like the National Assembly. This function could be implemented in a variety of ways:

- ❖ The law could contain an explicit rule (a formula) for how much of the oil revenues can be spent in a given year;
- ❖ The decision could be left at the discretion of the government or parliament, like the determination of the budget deficit in an ordinary budgetary process;

- ❖ The decision could be separated from budgetary decisions of how to allocate public expenditures and given to an institution independent of the Ministry of Finance. It would be natural to give this to a body with the required technical expertise, such as the Central Bank, perhaps in conjunction with other government officials with all participants required to approve the transfer amount.

Box 3 illustrates the first two options with examples from Alaskan and Norwegian oil revenue management legislation.

Alaska: Formulas

At least twenty-five percent of all mineral lease rentals, royalties, royalty sale proceeds, federal mineral revenue sharing payments and bonuses received by the State shall be placed in a permanent fund, the principal of which shall be used only for those income-producing investments specifically designated by law as eligible for permanent fund investments. All income from the permanent fund shall be deposited in the general fund unless otherwise provided by law. (Constitution of Alaska, IX.15)

(a) The earnings reserve account is established as a separate account in the fund. Income from the fund shall be deposited by the corporation into the account as soon as it is received. Money in the account shall be invested in investments authorized under AS 37.13.120.

(b) At the end of each fiscal year, the corporation shall transfer from the earnings reserve account to the dividend fund established under AS 43.23.045 , 50 percent of the income available for distribution under AS 37.13.140. (Alaska law pertaining to the permanent fund, AS 37.13.145: “Disposition of income”)

Norway: Discretion of parliament

The Fund’s capital may only be used for transfers to the central government budget pursuant to a resolution by the Storting (Norwegian parliament). The Fund’s capital may not be used in any other way, nor may it be used to provide credit to the central government or to private sector entities.

(Norwegian Act no. 36 of 22 June 1991 relating to the Government Petroleum Fund)

Box 3

IV.1.2. Recommendations

We recommend that the authority to make disbursements from the Oil Fund in every fiscal year should be vested in an institution with a certain degree of independence from the Ministry of Finance. We shall refer to this as the “disbursement authority.” This institution should have the sole authority to authorize transfers from the Oil Fund into the Ministry of Finance national budget account.

The disbursement authority should make a technical decision every year about the *maximum* permissible disbursement from the Oil Fund. Its decision should respect guidelines passed by the National Assembly regarding the relative weight of the various objectives (stabilization, sterilization, saving for future generations).

Thus the oil revenue management law should require the National Assembly to issue such guidelines, and the disbursement authority would be charged with translating the guidelines into concrete decisions, given a technical analysis of the objectives and the state of the economy.

The disbursement authority should regularly testify to the National Assembly in a public session where it would justify its decision and present a three-year projection of future disbursements, as well as of future macroeconomic developments. This would resemble the testimonies regarding

monetary policy decisions made by central bankers to national legislatures in many countries around the world.

We suggest two options for where the law may vest the disbursement authority:

- **The Central Bank.** The nature of the decision will be similar to decisions about monetary policy, which is already within the Central Bank's remit. This institution may, therefore, be best technically equipped to make a technically sound decision based on the National Assembly's guidelines.

It will also more likely to be insulated from political pressure than other economic policy institutions, especially compared to the Ministry of Finance, since the Central Bank has no decision-power over how the revenues are allocated to various uses. Another advantage is that no new institution would have to be established.

- **Alternatively,** a separate National Disbursement Committee could be established, which would include the Minister of Finance. The advantage of including the Minister of Finance is that the optimal level of oil-derived spending is related to the allocation of spending on various projects, which is the responsibility of that Ministry.

Thus such a National Disbursement Committee would be better able to reconcile decisions about spending allocations and spending levels than a completely independent institution.

A National Disbursement Committee would, however, need to have strong representation from other institutions, so as to counteract the inevitable pressures on the Minister of Finance (and other ministries) to spend the oil revenues too fast.

If this option is chosen, it is imperative that the law identify the other members of the Disbursement Committee, which would most likely include the Governor of the Central Bank, members of the National Assembly experienced in economic policy, and members of the National Assembly belonging to the opposition political parties.

As stated above, the disbursement authority should have sole power to authorize transfers from the Oil Fund. We recommend the following restrictions on the disbursement authority's authority to execute transfers:

- **No Deficit.** The Oil Fund cannot be used to make loans to the government of Sao Tome and Principe. Any transfers should constitute revenues on the general budget.
- **Consistent with Maximum.** Transfers cannot exceed the disbursement authority's own declared maximum authorized disbursement *or* the (non-oil) deficit on the budget passed by the National Assembly, whichever is smaller. That is, if the National Assembly passes a budget that uses less oil-derived revenue than the maximum permitted, the excess amount cannot be transferred but is retained in the Oil Fund. The excess amount, if it remains unspent by the end of the fiscal year, should not to be added to the maximum authorized amount for following years.
- **Single Payee.** The Fund can make payments to the account of the Ministry of Finance/national budget exclusively. Any expenditure financed by transfers from the Oil Fund must go through the general budget.

- **Approved Uses.** Payments can only be made for expenditures consistent with the expenditure priorities identified in the oil law (or the national development plan). In addition it could be required that the budget be subject to review by a **Development Oversight Authority** (further described below), indicating that planned expenditures are in accordance with approved as outlined in Section 0.
- **Transparency.** To institutionalize a culture of transparency the law could stipulate that payments may only be made subsequent to the lodging of expenditure plans by the Ministry of Finance and of the analysis underlying the disbursement authority's decisions to the **Public Information Office**.
- **Depository Institution/ Trustee.** The depository institution or the trustee, if the Oil Fund uses a trustee, should be permitted to make transfers only on the basis of documents executed in accordance with the requirements of the law.

IV.2 APPROVED USES

IV.2.1. Development Priorities

As discussed in Section 0, the oil revenue management law should indicate the share of revenues to be allocated to central government expenditure for the purposes of achieving Sao Tome and Principe's development goals.

This should be done by formally linking the law to a National Development Plan or through an explicit allocation to priority sectors in the law itself.

It is imperative that this provision in the law be enforced and be seen to be enforced. We therefore recommend the establishment of a **Development Oversight Committee**, whose role and authority is discussed in detail in Section IV.3 below.

IV.2.2. No Government Borrowing against Future Transfers from Oil Fund

The disbursement authority's power to regulate the level of oil-derived revenues to be injected into the economy in any one year would be completely thwarted if the government is free to borrow against future oil revenues.

If the law does locate the power to decide overall levels of oil revenue spending outside of the Ministry of Finance, it must also reduce the latter's power to borrow. The law should therefore stipulate that as long as the balance in the Oil Fund is positive, the government is not allowed to borrow to finance deficit spending over and above what is financed by transfers from the Oil Fund.

IV.2.3. Direct Distribution

Two other types of payments can also be considered:

- direct distribution to citizens, and
- payments to regions.

The law should determine whether a proportion of the amount transferred from the Oil Fund for spending in a given year should be devoted to any of these purposes.

We are not making any recommendations in this regard, but we have set out below certain possibilities that Sao Tome and Principe may wish to consider when oil revenues bulk larger.

IV.2.3.1. Distribution to Individuals

The revenues from oil exploration will in all likelihood come to constitute a very large share of Sao Tome's GDP.

While the central government has urgent needs of financing for development spending, there is also a case for avoiding the strong concentration of economic and political power that would be entailed by channeling the entire oil revenue through central government spending.

The oil management revenue law could provide for mechanisms that would allow for distribution to individuals in the future when oil revenues are expected to be much higher.

A partial cash distribution of oil revenues could have desirable economic effects, including:

- ❖ A more liquid local credit market, deeper financial infrastructure and more savings, encouraging private investment
- ❖ Devolving some spending decisions to individuals who may be better informed than the government about some investment decisions
- ❖ Providing a guarantee that *all* citizens benefit from the oil revenues
- ❖ Distribution could be made conditional on certain basic requirements that would advance the development of the country, such as sending children to school, or participating in basic family health programs. It could also be paid only to adults, in order not to lead to an increase in Sao Tome's already high birthrate.

To implement a system of direct distribution the oil revenue management law could provide for mechanisms to determine a percentage of the transfers from the Oil Fund to be retained for government expenditure. This percentage could initially be set to 100% but lowered according to clearly defined procedures, if distribution should be deemed desirable. (Alaska requires that at least 25% of oil-derived revenues be paid into a "permanent fund," the net income from which is distributed among residents.

This is equivalent to letting the national government retain no more than 75%. Distributing revenues directly will require the prior development of an infrastructure for distribution, including complete lists of eligible payees, and, possibly, the establishment of back accounts for all eligible citizens.

By informing each citizen of the size and variability of oil-derived revenue, a distribution system may establish incentives for increased transparency. An increased understanding of the opportunities and challenges related to oil revenues would give the public a stronger incentive to monitor the government's management of those revenues, as would the increased sense of ownership that might be created by people knowing their per capita share of the transfers and balance in the Oil Fund. This would in turn increase the government's incentive to manage the revenues in an efficient manner, and to be seen to do so, which would promote transparency.

We emphasize however that these benefits could be had without actually distributing any money to individuals. Instead, the law could achieve a similar effect by simply requiring the government

to regularly publish and disseminate the per capita value of transfers from the Oil Fund to the government budget, as well as the total balance in the Oil Fund.

IV.2.3.2. Transfers to Regions

Many oil-rich countries have seen their natural resource wealth become a focus of inter-regional conflict. In Sao Tome and Principe, the regional government of Principe has expressed concern that Principe will get less than a fair share of the oil revenues even though the Joint Development Zone offshore oil is geographically closer to the island of Principe than to the island of Sao Tome. .

Since the Constitution of Sao Tome and Principe provides for local authorities to make separate budget and spending decisions, the question arises how these authorities should be financed once the central government's main source of income derives from oil. One may consider these options:

- ❖ Negotiations between local and central authorities on a year-to-year basis, where the local authorities present their budgets and the central government transfers block grants to finance them. This would be a continuation of the current practice as regards Principe.
- ❖ Fixed percentages of the transfers from the Oil Fund to the Ministry of Finance could be earmarked for funding local and regional authorities. These percentages would be fixed in this law, as would the procedures required for amending them.

IV.3 DEVELOPMENT OVERSIGHT COMMITTEE

Central to the success of Sao Tome and Principe's use of oil revenues will be guarantees that oil revenues will only be disbursed for uses that are in accordance with national priorities.

For this there is a need for some form of oversight authority.

Most of the supervision and oversight should come through reinforced structures of government that are recognized in the law and constitution of Sao Tome and Principe, including the courts, the Tribunal de Contas, the National Assembly, and the Council of State.

But many countries, particularly when embarking on a new phase in their history have had recourse to new institutions, whose composition and powers are specially formulated to cut across existing institutions and break with entrenched habits. Some are permanent bodies while others exist for a fixed time.

The examples include independent electoral commissions, ombudsmen, investigative commissions, constitutional courts, and human rights commissions in addition to special oversight bodies for particular state institutions. The composition of these bodies is structured in order to ensure competence and public legitimacy. The mandate may vary, but the powers must be sufficient to enable independent action, subject to appropriate oversight.

The law will need to identify the functions and powers of the authority as well as its composition and internal governance structures.

RECOMMENDATION:

A Development Oversight Committee should be established by the oil revenue management law.

This Committee should be given the responsibility for vetting proposed budgets according to technical, development-related criteria. It should also be required to publicize proposed budgets as well as its own decisions (including dissenting opinions if decisions are made by majority vote) and be given the mandate to stimulate public discussion about contentious issues and publicize instances of abuse.

If the capacities and reputations of existing state institutions are deemed inadequate to the task, the Oversight Committee should also be given responsibility for auditing the actual use of budgeted funds and ensuring that instances of misuse or corruption are publicized and pursued in court. Consideration should be given to empowering the oversight body to respond to citizen complaints of irregularities within its mandate.

While it is important to avoid the unnecessary creation of new public institutions, especially given the lack of material resources and human capital at Sao Tome and Principe's disposal, it would be a mistake to reject the creation of a well-staffed independent oversight body with a broad and robust mandate simply because of the costs involved. Unless existing institutions can be shown to be adequate to the task of performing oversight functions well and with integrity (and will be *seen* as doing so), expanding the mandate and capacity of the oversight body to include activities beyond vetting proposed budgets may be a better option than handing such functions over to existing institutions.

Such decisions are obviously best made in Sao Tome and Principe.

IV.3.1 Mandate

There are a number of oversight functions that are desirable, some of which occur prior to the release of funds and others that occur subsequent to expenditure decisions.

- **Ratification.** The oversight body may be tasked with ensuring that proposed expenditures of oil revenues comply with the developmental priorities set down in the oil law before the budget is approved. In this case, no expenditure of oil revenues would be possible until the oversight body determines that spending proposals adheres to priorities.
- **Auditing the use of oil revenues.** It is important that the use of oil revenues is monitored to ensure that such use is actually in accordance with the budget approved by the oversight body and the National Assembly. This involves a range of functions, from ensuring that monies are directed to their intended projects to monitoring the selection of contractors to carry out project-related work. Whatever institution is accorded this role will need a mandate with broad investigatory powers and the resources to carry out such investigations.
- **Investigating Allegations and Complaints.** The legitimacy of the Oil Fund may be threatened both by real and imagined claims of malfeasance. The oversight body could be charged with investigating and responding to complaints, generated internally or from outside Sao Tome and Principe.

RECOMMENDATION:

The criteria the oversight body will use in vetting budget proposals should be set down in law, either explicitly or with reference to the National Development Plan.

The oversight committee would examine the budget and judge whether it complies with the requirements of the law before the law is approved by the National Assembly.

It should also be responsible for vetting the National Development Plan itself in accordance with the fundamental criteria set forth in the oil revenue management law. If it finds that these are the case, it should have the authority to declare the relevant resolutions of the National Assembly (the budget or the development plan) not in compliance with the law.

IV.3.2 Capacity and Power of the Oversight Body

The Oversight Body must be given powers and capacity commensurate with its mandate and the goal of helping to legitimize the operation of the oil revenue management law.

The Oversight Body should be held to the highest standards of transparency and publicity to which Sao Tome and Principe has already committed itself. Its decisions should be made public, with the opportunity for the publication of dissenting opinions by members.

Some other factors to consider include:

- Issuance of Regular Public Reports.
- Investigative powers that include automatic access to documents, locations and individuals relevant to their mandate.
- Fixed budget or budget formula provided in law.
- Full time staff with appropriate skills.
- Subject to judicial or administrative supervision, the power to sanction violations.

RECOMMENDATION:

Care should be taken to ensure that the work of the oversight body is done in as transparent a manner as possible. The oversight body should also play a role in increasing the transparency of the spending of oil revenues. This, however, should not be the sole responsibility of the oversight body. The government should therefore be required, at a minimum, to make public all budget proposals when they are submitted to the oversight body.

The oversight body must be given resources adequate to complete its work. Especially because the oversight body's members will most likely serve on a part-time basis, this will mean providing the institution with staff capable of carrying out its functions. The oversight committee's budget should be insulated from political pressure to the greatest possible extent.

IV.3.3 Composition of the Oversight Body

The composition of the oversight body should reflect its independence and competence. This can be achieved in different ways through varying reliance on the nominating procedure, the nominating authority (or authorities), criteria for selection, and rules that apply to members.

In some countries, for example, the nominating procedure may involve public vetting of candidates. The authority for naming members may be distributed among different institutions – both governmental and non- governmental.

Some laws lay out specific criteria for members, detailing for example the education, gender, or professional background required for one or more members.

Finally, members may be held to high standards to insure continued accountability and prevent conflicts of interest.

We would be happy to provide examples from other countries, if they are useful.

Some general guidelines include:

- **Non-governmental participation.** An oversight body dominated by representatives of government and the parties represented in the Assembly would be unlikely to meet or provide the public legitimacy sought from an independent oversight body.
- **Optimizing the size of the oversight body.** Too small a group could lend itself to collusion, while a body with too many members could prove unwieldy and unnecessarily expensive. An appropriate size is likely to be around 7 to 11 members.
- **Ensuring the technical capacity of the oversight body.** Provision might be made to ensure that a fixed number of seats on the body are allocated to individuals with relevant technical expertise.
- **Bolstering public confidence in the oversight body.** Public perceptions of the oversight body will have a great deal to do with the body's membership. Care should be taken to select a slate of members who will enhance public confidence in the oversight body's integrity and technical capacity. Giving attention to diversity, as well as the reputations and independence of the various members are important here.

Some options to consider:

- **Members of the oversight body could be named in several different ways.**

One option would be to empower different institutions to name different seats. For example, a fixed number of seats could be appointed by the National Assembly (from different political parties), by the President, by the churches, the courts or and by professional associations.

The law may also establish qualifications for different seats (e.g., one seat to be filled by an economist, one by an accountant, two by Deputies from the National Assembly, one by the head of the Central Bank, etc.).

- **Regional Representation.**

The difficulty in determining the composition of the body is in finding ways to identify individuals who are both independent of the elected officials that determine authority but that do not thereby undermine regular democratic procedures.

One possibility is to draw a share of members from regional or district governments, whose members have somewhat different concerns to members of the National Assembly but who themselves have been appointed through democratic processes.

- **Naming an “outside” (i.e., foreign) member**

Having an outside member or members could enhance the oversight body’s credibility and reduce the likelihood of corruption and/or collusion within the oversight body itself. The outside member could be a representative of an international organization or a technically qualified civilian. This has been done in a number of countries in commissions intended to control corruption, investigate past abuses or prosecute special crimes.

- **Including representatives of civil society**

The oversight mechanism created by Chad’s oil revenue management law has the inclusion of civil society as its bedrock principle. Although the existence of functioning democratic institutions in Sao Tome and Principe may allow one to rely more fully on existing bodies, civil society participation could help ensure the true independence of the oversight body and help to lend legitimacy to the body’s work.

- **Full Time and Part Time Members**

It may be desirable to have credible public figures as members on a part-time basis, while others may serve as full-time members.

RECOMMENDATION:

The members of the oversight body should be selected in a manner that ensures that, as a group, they will be diverse, independent, and technically capable. We urge that serious consideration should be given to appointing an “outside” (i.e., foreign) member with full voting rights. The question of civil society participation should be the subject of further discussion within Sao Tome and Principe.

IV.3.4 Relations Between the Disbursement Authority and the Development Oversight Committee

The Oversight Body should be appropriately integrated into the legal structure of the oil law so as to balance independence with accountability. For example, the following procedures may be considered:

- Once the National Assembly passes a budget, it should be vetted by the Development Oversight Committee for compliance with the law.

The body could make its decisions on the basis of majority rule, consensus, or super-majority. The oversight body would be required to provide a reasoned opinion in cases of rejection, and could be called to testify before the Assembly to provide their reasons for rejection in still greater detail.

Budgets rejected by the committee would be void, and the disbursement authority would not be allowed to sign transfers from the Oil Fund to the Ministry of Finance until a new budget is had been passed and accepted by the Development Oversight Committee.

To avoid the possibility of an intractable deadlock, the Ministry should be allowed access to a mechanism to appeal the oversight body's decision in cases where its effort at drafting a budget for oil expenditures is rejected more than once. Such appeals could be to the National Assembly, with the assembly given the power to override the oversight body's decision by supermajority, to the Supreme Court, or to another state institution.

- Alternatively, proposed budgets could have to be vetted by the Development Oversight Committee before being passed on to the National Assembly for a vote. Budgets rejected by the committee would be sent back to the Ministry of Finance to be re-drafted, taking into account the objections of the oversight body. After a specified number of rejections, the Ministry of Finance should have access to similar appeals mechanisms as outlined above. The disbursement authority would not be allowed to sign transfers from the Oil Fund until a budget had been passed according to these procedures.

IV.4 LAW'S IMPACT ON BUDGETARY PROCESS

If the Oil Law requires that the Development Oversight Committee approve of the national budget, then the decision to spend any oil-derived revenue will involve at least four actors:

- The disbursement authority, based on an expert evaluation of absorptive capacity, expected future oil prices/revenue, their possible variances, and a technical analysis of the general priorities/guidelines passed by the National Assembly, sets a maximum level of transfers from the Oil Fund. It is not permitted to execute the transfers until the level has been confirmed by the actions of the other three actors.
- In accordance with provisions of the law for sectoral and regional allocations of funds, the Ministry of Finance (and possibly other regional financial authorities) will produce a plan for the expenditure of oil revenues, as part of its regular budget. (The remainder of the budget will concern spending of other, non-oil-derived, revenues, to which this law does not apply.)
- The National Assembly debates and amends or passes the budget.
- The Development Oversight Committee makes a ruling regarding whether the proposed or passed budget is in accordance with the development priorities established in the law. This may be timed to happen before or after the National Assembly vote.

Since actions by the disbursement authority will depend on the nature of a budget proposed by the Ministry of Finance, passed by the National Assembly, and approved by the Development Oversight Committee, the law will need to provide the rules for how these four bodies interact. These rules should indicate the appropriate timing of the action by each of the bodies as well as provide provisions for the case in which the Development Oversight Committee rules against the Ministry of Finance or the National Assembly.