EXAMINING THE CRUDE DETAILS

Government Audits of Oil & Gas Project Costs to Maximize Revenue Collection

Executive Summary

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The petroleum sector offers governments huge potential revenues that could be invested in poverty alleviation and inequality reduction, but those revenues must first be collected. Taxes are levied on profits, but companies may seek to reduce their taxes by deducting ineligible or exaggerated costs, often paid to related parties. Governments' essential tool to combat petroleum cost overstatement is the right to audit costs, but there is limited data on whether governments use this right effectively. Cost auditing practices in Ghana, Kenya, and Peru suggest that governments face significant challenges. Oxfam proposes recommendations to address these challenges and ensure that governments collect the taxes owed for the exploitation of their finite, non-renewable petroleum resources.

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For further information on the issues raised in this paper please email advocacy@oxfaminternational.org

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Cover photo: Caption: An oil pump along the coast of Peru outside Lobitos (Rafael Storch).

SUMMARY

Raising revenues through taxes and other means is a critical government function. Governments need revenue to finance expenditures such as infrastructure investments and social services, including healthcare and education. Progressive taxation and progressive public spending are at the heart of fighting inequality and ending poverty.[1] In many developing countries, however, despite concerted effort, revenue collection remains too low. The African Development Bank says African countries will need to increase the average ratio of taxes to gross domestic product (GDP) to 25 percent,[2] up from 19.2 percent today,[3] if they are to finance the continent's infrastructure and human development needs.

The extractive industries—oil, gas, and mining—present an enormous opportunity to mobilize greater domestic revenues that could be used to close the gap between rich and poor. The petroleum sector in particular often generates enormous profits, and governments, as custodians of the resource, are entitled to the lion's share. Even where oil and gas companies already contribute considerably to government revenues, it is possible that they should be contributing more. In practice, however, it is far from simple for developing-country governments to adequately administer their petroleum fiscal regimes and collect all that is due. Tax authorities may lack the necessary legal and regulatory tools, expertise, or information; furthermore, conflicting incentives or political pressures may complicate their mandate to maximize revenue collection.

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Inflated company expenditures are a major threat to government revenues from oil and gas. The more costs that companies report, the less profits there are to tax, which means less revenue for government. Developing countries stand to lose the most from cost overstatement given their outsized reliance on corporate income tax.[4] Companies may also seek to deliberately evade or avoid paying taxes. Avoidance is the use of legal (as opposed to illegal) methods to minimize the amount of income tax owed by a multinational corporation (MNC). An oil company's recent tax scandal in Australia confirms that where companies obtain goods, services, and debt from other related companies held by the same MNC, there is a risk they will inflate the cost to reduce their own profits and shift profits offshore.[5]

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Oxfam and its allies have pushed to improve the fiscal governance of extractive industries, including through greater transparency and oversight.[6] As shown by Oxfam's past work assessing risks to revenues,[7] one critical area in need of strengthening is the effectiveness of government fiscal audits.

Petroleum-producing countries must ensure they capture an appropriate share of the value of their oil and gas if they are to meet domestic revenue mobilisation (DRM) targets—otherwise millions could be lost. In two separate examples, auditors found that oil and gas companies had overstated their costs by $127 million in the Republic of Congo and by

$81 million in Uganda. Substantial revenue was lost as a result—$63.5 million in Congo and $24 million in Uganda (see "Introduction"). This study identifies several challenges to effective petroleum cost auditing in Ghana, Kenya, and Peru, which may also be relevant to other petroleum-producing countries:

- **Laws determining the treatment and eligibility of petroleum costs are inadequate, and changes may be difficult to apply.** An audit is only as effective as the law it seeks to enforce. Legal loopholes and costs that are prone to abuse may limit auditors' ability to protect government revenues.
- **Institutional fragmentation hinders effective revenue administration.** Cost audit rights are often dispersed across multiple government agencies, sometimes with conflicting mandates. Inadequate coordination inevitably leads to duplication of effort and uncertainty for investors with respect to the final determination of gross income.
- **Auditors lack sector-specific knowledge and expertise.** The lack of regular risk assessment relating to the petroleum sector reflects tax authorities' limited appreciation of the special characteristics of the industry. Despite this gap, neither Ghana nor Kenya has made use of the option reserved for them in many petroleum agreements to outsource – partly at the contractor's expense – inspection of the company's accounts to external auditors.
- **It is difficult to obtain data to benchmark petroleum costs.** Reporting requirements are unclear or incomplete, preventing governments from accessing certain information from companies. Still, efforts are underway globally to expand the pool of publicly available data specifically for petroleum costs.
- **Audits are too late.** There is a tendency to prioritize auditing only once oil is flowing, long after development of the oil field has started. By that time, the government's audit rights may have expired and companies' legal obligation to keep records may have run out.
- **Transparency and public accountability are absent with respect to cost auditing.** The information available publicly does not provide a sufficient basis by which to judge how governments are using their cost-auditing rights. Unless a case goes to court, citizens have no idea whether a government is auditing costs or what the results might be. Supreme audit institutions (SAIs), national legislatures, independent commissions, and Extractive Industries Transparency Initiative (EITI) multistakeholder groups could all potentially review cost-auditing practices, but these actors have not commonly done so.

RECOMMENDATIONS

Based on analysis of these recurring challenges, this report makes a series of recommendations that would help Ghana, Kenya, and Peru and other petroleum-producing countries facing similar challenges to better limit the risk of cost overstatement through effective audit practices.

1. LAWS: Review and strengthen legal controls on petroleum costs. Carefully design laws that determine the treatment or eligibility of costs so that auditors have the necessary legal tools to protect government revenues.
2. COORDINATION: Clearly define which government agencies are responsible for cost auditing, and strengthen interagency coordination on petroleum revenue administration. Coordination mechanisms should facilitate the exchange of information and expertise across government, including from national oil companies.
3. CAPACITY: Develop the technical expertise and sector-specific knowledge to detect and mitigate cost overstatement in the petroleum sector. An informed, risk-based approach to auditing is especially important for resource-constrained countries, to ensure that limited human and financial resources are judiciously invested.
4. INFORMATION: Take steps to increase the information available to verify and appraise petroleum costs. Innovative ways to exchange anonymized cost information between petroleum producers should be explored as a means of increasing benchmark data.
5. TIMEFRAME: Ensure that audit time limits and record-keeping requirements are long enough and that costs are audited as soon as possible after they occur. Governments should audit as soon as possible when petroleum company activity begins rather than waiting for revenues to start flowing, by which time audit rights may have expired.
6. ACCOUNTABILITY: Publicly disclose audit activities and their results, and strengthen the capacity of oversight actors to monitor the government’s use of cost audit rights. A transparent and accountable audit process is a precondition for effective cost auditing; without this, it is impossible to determine whether governments are fulfilling their responsibility to protect petroleum revenues.

Checklist for monitoring government petroleum cost audits

- ✓ Does government have the legal right to audit costs? Is this right adequate, or are there gaps?
- ✓ Is there a clearly defined list of expenditures eligible for cost recovery and/or tax deduction?
- ✓ Is the responsibility for cost auditing clearly assigned to one government agency? Does this agency have the appropriate mandate and expertise to carry out cost audits?
- ✓ If audit rights are dispersed, is there an overarching coordination mechanism? Do these agencies systematically share information and expertise that may be relevant to cost audits?
- ✓ Do the government agencies responsible for cost auditing have enough auditors with the requisite industry knowledge and expertise?
- ✓ Is there regular risk assessment specific to the petroleum sector?
- ✓ Are information and reporting requirements adequate?
- ✓ Can government access information from other jurisdictions, as well as benchmark data?
- ✓ Do audits happen regularly enough according to time limits and record-keeping requirements?
- ✓ Is the NOC contributing information and expertise to government cost audits? Is it subject to the same reporting and financial standards as other private oil and gas companies?
- ✓ Does the government publish information on auditing activities and results?
- ✓ Do audit findings result in adjustments to tax and/or production share due?
- ✓ Are there oversight bodies monitoring the use of cost-auditing rights?

Civil society can demand greater transparency and monitor the use of cost audit rights.

Summary of Recommendations by Actor

Governments

LAWS	• Provide a clear definition of ring-fencing in the law. • Publish guidance for taxpayers on fiscal elements likely to be misinterpreted. • Adopt and implement strong transfer pricing rules, in addition to exploring alternative tax policy rules that may be easier to administer. • Carefully consider eligibility of costs for cost recovery and/or tax deduction. • Ensure any fiscal stabilization clauses are limited in time and scope.
COORDINATION	• Allocate cost-auditing responsibility to one agency or formalize cooperation between agencies. • Encourage strong oversight by SAIs, but not direct auditing. • Ensure that national oil companies (NOCs) share joint venture (JV) audit results with cost-auditing agencies. • Enact a law to create an interagency committee with a stable budget.
CAPACITY	• Allocate an adequate number of staff to petroleum cost auditing. • Develop specialized knowledge of the petroleum industry. • Consider soliciting independent, external auditors to conduct cost audits.
INFORMATION	• Enforce clear, standard reporting requirements for use in risk assessment. • Adopt transfer pricing documentation rules, including a requirement for local and master files.
TIMEFRAME	• Ensure that the time limit for conducting an audit is not impractically short • Audit costs even before revenues start to flow. • Preapprove budgeted petroleum expenditures of oil and gas companies.
ACCOUNTABILITY	• Publish audits and an annual report describing use of cost audit rights and results. • Build industry knowledge of SAIs for more effective monitoring. • Create opportunities for public dialogue on cost-auditing effectiveness.

Civil society

LAWS	• Challenge government stabilization clauses that are ill-defined.
COORDINATION	• Monitor interagency coordination and resourcing for cost auditing.
CAPACITY	• Advocate for a clear risk assessment strategy from cost-auditing agencies.
INFORMATION	• Urge government to conduct public bid rounds for oil, gas, and mining rights.
TIMEFRAME	• Keep careful track of expiration of audit rights and record keeping, pushing for contract disclosure to ensure a clear understanding of audit rights.
ACCOUNTABILITY	• Lobby government to report publicly on audit results. • Monitor cost auditing, promoting women's participation in oversight. • Demand greater transparency from, and oversight of, NOCs. • Integrate information on cost auditing into the scope of the Extractive Industries Transparency Initiative (EITI).

International development partners

LAWS	• Discourage government stabilization clauses that are ill defined.
COORDINATION	• Provide technical and financial support to interagency committees.
CAPACITY	• Support government requests for capacity development and co-sourcing auditing.
INFORMATION	• Support access to commercial databases and exchange of information.
TIMEFRAME	• Keep careful track of expiration of audit rights and record keeping.
ACCOUNTABILITY	• Use leverage to insist on rigorous cost audits, the publication of audits, and public reporting and oversight of the audit process and outcomes. • Collect quantitative data on the use of cost-auditing rights.

Oil and gas companies

LAWS	• Request guidance from tax authorities on ambiguities.
COORDINATION	• Engage cooperatively with government, requesting guidance as necessary.
CAPACITY	• Help government understand the oil and gas business, e.g., via joint workshops.
INFORMATION	• Comply with reporting and disclosure requirements and information requests.
TIMEFRAME	• Respond quickly and cooperatively to requests for audit.
ACCOUNTABILITY	• Consider reporting publicly on the scrutiny tax payments have undergone. • Adopt and publish tax principles to guide companies' engagement with revenue administration agencies.

NOTES

[1] See generally, Oxfam, The Commitment to Reducing Inequality Index 2018, October 8, 2018, https://policy-practice.oxfamamerica.org/publications/the-commitment-to-reducing-inequality-index-2018/

[2] African Development Bank. (2018). African Economic Outlook 2018, https://www.afdb.org/fileadmin/uploads/afdb/Documents/Publications/African_Economic_Outlook_2018_-_EN.pdf.

[3] OECD (Organisation for Economic Co-operation and Development), Revenue Statistics in Africa, 2017, https://www.oecd.org/tax/tax-policy/revenue-statistics-africa-2017-infographic.pdf. IMF, *Regional Economic Outlook for Sub-Saharan Africa* (Washington, DC, 2017), https://www.imf.org/~/media/Files/Publications/REO/AFR/2017/May/pdf/sreo0517.ashx. This cites 17.0 percent as the average tax-to-GDP ratio for the region in 2017 and concludes that for most countries an increase of 3–5 percentage points is feasible. IMF, *Regional Economic Outlook: Domestic Revenue Mobilization and Private Investment* (Washington, DC, 2018), https://www.imf.org/~/media/Files/Publications/REO/AFR/2018/May/pdf/sreo0518.ashx?la=en

[4] UNCTAD, *World Investment Report 2015: Reforming International Investment Governance* (Geneva, 2015), p. 182, https://unctad.org/en/PublicationsLibrary/wir2015_en.pdf

[5] P. Wells, “Chevron Loses Landmark Tax Case on Transfer Pricing,” *Financial Times*, April 20, 2017, https://www.ft.com/content/9eaef50e-264f-11e7-a34a-538b4cb30025

[6] Oxfam’s work on extractive industries covers a range of thematic issues, including tax and transparency, but also issues of community consent: “Oxfam advocates for just government policies and corporate practices in the oil, gas, and mining industries, and supports the right of communities to participate meaningfully in decisions about the development of natural resources.” Oxfam America, “Resource Rights,” https://policy-practice.oxfamamerica.org/work/resource-rights/. Oxfam’s Extractive Industries Global Program is active in 30 countries. Oxfam, “Extractive Industries Global Program” (map), http://eimap.oxfam.org/. For more information on Oxfam’s strategy on extractives, see Oxfam’s Oxfam International, Achieving Natural Resource Justice: Extractive Industries Global Program Strategic Plan 2016 – 2019, https://www.oxfamamerica.org/explore/research-publications/achieving-natural-resource-justice/

[7] See, e.g., Oxfam, *Mapping Risks to Future Government Petroleum Revenues in Kenya* (Oxford, 2016), https://www.oxfam.org/sites/www.oxfam.org/files/file_attachments/rr-mapping-risks-petroleum-revenues-kenya-060516-en.pdf

Photo: ExxonMobil's Heritage oil platform in the Pacific Ocean (Glenn Beltz).

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