



Shared value, shared responsibility

A new approach to managing contracting chains in the oil and gas sector



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Authors

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Acronyms and abbreviations

API	American Petroleum Institute
CLO	community liaison officer
EBRD	European Bank for Reconstruction and Development
EIA	environmental impact assessment
EPC	engineering, procurement and construction
ESIA	environmental and social impact assessment
FEED	front-end engineering design
GRI	Global Reporting Initiative
HSE	health, safety and the environment
IFC	International Finance Corporation
IFI	international financial institution
IOC	international oil company
IPIECA	International Petroleum Industry Environmental Conservation Association
ISO	International Organization for Standardization
NGO	non-governmental organisation
NOC	national oil company
OGP	International Association of Oil and Gas Producers
OHSAS	Occupational Health and Safety Advisory Services
PSA	production sharing agreement
SME	small and medium enterprises

About the authors

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Executive summary

As the oil and gas industry pushes into ever more sensitive areas, the risks are increasingly being handled by complex chains of contractors. Effective management of contracting chains – from early assessments to communication and oversight – is critical to ensure good social and environmental performance. This responsibility should be shared throughout the contracting chain, across company departments, and between government and industry, with space for independent third-party oversight.

From the deep waters of the Russian Arctic to the tar sands in the Congo Basin, new technological challenges and natural hazards are fast becoming the norm in the oil and gas industry. High prices and concerns about energy security have driven expansion of the industry into regions that carry heightened technological, political and social risks. Less well known are the challenges the industry faces as a result of its complex contracting chains. While most people are familiar with a handful of brands such as BP, Shell and ExxonMobil, at least 70 per cent of a typical oil or gas project is contracted out to lower-profile service providers and their subcontractors.

The fallout from the April 2010 Gulf of Mexico disaster has shone a spotlight on alleged systemic failures and ongoing difficulties in these contracting relationships – and on their importance for good environmental and social performance. **Shared value, shared responsibility** draws on three years of research and interviews within the sector to highlight an array of critical challenges facing oil and gas companies involved in complex supply chains, and to identify urgent and longer-term actions for progress.

Complex chains pose new challenges

Many risks and opportunities in the oil and gas industry relate to the work of major service contractors such

as Halliburton, Transocean, Schlumberger and AMEC. These specialised companies have global reach and revenues as high as US\$15-20 billion annually. At the same time, an increasing number of contractors and subcontractors based in host countries are securing contracts with major oil and gas projects.

Complex contracting chains raise a number of questions:

- Who is responsible for ensuring that contractors and subcontractors are properly prepared to address all risks, however unlikely?
- What actions must an operating company take to check that its contractors and subcontractors can meet their contractual requirements and that they work to international good-practice standards?
- How can high standards for environmental and social performance be maintained, even when speed and low cost of delivery are priorities?

Shared value: local content and local benefits

As the governments of oil-producing countries, from Nigeria to Kazakhstan to Venezuela, seek greater control of their oil and gas resources, there are pressures to expand the role of local businesses in contracting chains. ‘Local content’ rules aim at socio-economic gains for host countries, but raise new issues for operating companies, whose ability to meet local procurement targets depends on the capacities of the local workforce.

Specialised contractors are increasing in number within some oil-producing countries, with rising demand from large-scale projects. In many regions of the world, however, the targets may be unrealistic. The challenge is to optimise local content in oil and gas projects – and thus share their value – while also

preserving high standards of health and safety, environmental protection and societal wellbeing. **Shared value, shared responsibility** focuses primarily on construction activities, which have the greatest impact on local environments and communities. The role of national oil companies (NOCs) is worthy of more analysis, but this lies beyond the scope of this report.

Shared responsibility: building relationships beyond legal contracts

The primary tool for managing contractor responsibilities and performance remains the legal contract. In practice, this means that focus tends to be greatest on the relationship between operating companies and first-tier contractors, while effective management of the rest of the contracting chain receives less attention. The contracts themselves tend to incentivise cost and speed of delivery, which may come at the expense of environmental and social performance.

Divisions between business functions are another potential obstacle to effective management of contractors. Different departments — such as project management, procurement, local content, health, safety and environment (HSE) and external affairs — must operate in harmony and align their objectives, policies and initiatives. Improvements in internal corporate synergy and organisational effectiveness are essential. Responsibility also needs to be shared with other stakeholders. This requires meaningful engagement with government, communities, civil society organisations and others with beneficial knowledge, skills or relationships.

Risk management in practice

Shared value, shared responsibility emphasises the growing importance of ‘managerial responsibility’ — the extremely difficult task of applying standards and implementing procedures across the entire contracting chain to ensure good performance. Managerial responsibility extends over and above legal requirements;

demands more than the adoption of standards and procedures on paper; and requires that consultation with stakeholders results in conscious efforts to address the issues raised.

Good communications, training, oversight and corporate culture are often taken for granted in complex situations involving many organisations and an array of obligations. Failure to attend to these needs carries risks such as increased costs and delays, increased financial liability, contractual disputes, negative social and environmental consequences, community tension, reputational damage and, ultimately, loss of investment opportunities.

The challenges

The specific problems faced by international oil companies (IOCs) and their contractors in upholding their various responsibilities vary from one situation to another. We have identified three broad sets of factors that hamper effective chain-wide performance:

- 1. Lack of a sense of shared responsibility throughout the contracting chain and across stakeholder groups.** Responsibilities are typically fragmented across a project. There is a need for shared ownership of activities and outcomes overall, rather than just the individual tasks taken on by each partner.
- 2. Inadequate implementation of systems and procedures to enforce standards and incentivise good performance.** It is not enough simply to adopt standards and policies on paper; they have to be implemented and enforced.
- 3. Cultural and contextual challenges in widely differing regions of the world.** Companies must come prepared to address the many contextual factors in a new country, including the perception that international best practices do not always apply.

Taking action

We propose seven key actions primarily aimed at operating companies and lead contractors. The actions also offer guidance for governments, civil society organisations and others who seek to collaborate with companies or to provide oversight of oil industry activities.

Action 1: Collaborate on early-stage planning and assessments. Assess workforce capacity, enterprise development opportunities, stakeholder expectations and local content strategy; agree on environmental and social obligations, standards and evaluation methods.

Action 2: Invest in capacity building in underdeveloped local markets. Fund programmes to build local capacity, including public-private joint initiatives; engage with and support local business associations and networks.

Action 3: Encourage uptake of standards through procurement processes. Ensure health, safety, environmental and social expectations are included in prequalification and tender processes; make sure tender processes are open, transparent and free of corruption.

Action 4: Ensure that contracts incentivise good practice. Balance incentives for cost, schedule and responsible practices, including provision of dedicated funds for environmental and social measures; work with lead contractors to align expectations of environmental and social performance and ensure that they do the same with subcontractors.

Action 5: Build capacities and trust on the job. Where required, assist contractors in developing and funding environmental and social management plans; consider longer-term contracts to support capacity development.

Action 6: Establish excellent communication and oversight throughout the chain. Ensure open lines

of communication and feedback mechanisms; coordinate oversight activities to lessen confusion and overlap; support local community liaison officers.

Action 7: Build trust and accountability with external stakeholders. Encourage public reporting using recognised guidelines (e.g. of the Global Reporting Initiative or the International Petroleum Industry Environmental Conservation Association); encourage good practices in public engagement and resolution of grievances; encourage independent oversight by third-party organisations.

Future vision

Success in delivering good social and environmental outcomes will strengthen the industry's 'social licence to operate' and its ability to respond effectively to stakeholder expectations. But it will require a concerted effort across the industry, both top-down and bottom-up, and across stakeholder groups.

Shared value, shared responsibility does not attempt to prescribe specific remedies at this stage — these must result from dialogue and efforts to create common solutions over time. However, we do offer our own vision for what some of those solutions could usefully address.

This includes developing a culture of shared ownership and responsibility throughout contracting chains; an increased emphasis on communication and long-term outcomes; an industry-wide effort to raise capacities and participation among local firms; and a commitment from all companies in the chain to engage meaningfully with external stakeholders, ensuring that issues and concerns are addressed appropriately and adequately.

Shared value, shared responsibility has been developed through dialogue and consultation with a range of stakeholders, and this report aims to stimulate further dialogue. We welcome your comments, arguments and suggestions on making these and other good practices a common and permanent feature of oil and gas contracting chains in years to come.

1

PART 1

Why good contracting chain management is essential

1.1 The oil and gas industry in an age of complexity

As the oil and gas industry expands its horizons and increases in complexity, the risks and challenges of extracting hydrocarbons are becoming ever greater. Many of these challenges relate to the collaborative efforts between international oil companies (IOCs) and their contractors and subcontractors to deliver projects on the ground.

In this report we argue for a range of good practices and wider recognition of the ‘shared responsibility’ necessary to complement the trend toward increasingly complex and distributed systems for managing environmental and social risks in the industry. We also argue that the current state of affairs underscores the need for meaningful engagement and collaboration between industry players and other stakeholders, including government, local communities, civil society organisations, consultants and researchers.

1.1.1 New frontiers, new risks

Concerns about energy security, along with high oil prices, are driving the oil and gas industry into ever more sensitive and risk-laden environments. These include deep and ice-bound waters, tar sands, conflict zones and indigenous peoples’ lands. In the wake of high-profile tragedies such as the April 2010 Gulf of Mexico spill — and more frequent lower-profile cases of pollution and conflict, such as in the Niger Delta — pressure is intensifying for the industry to demonstrate its ability to deliver good environmental and social performance.

At the same time, with increased outsourcing and host-government efforts to capture more benefits from production, the oil industry operating model is shifting towards ever more complex chains of contractors and subcontractors. Despite its perceived efficiencies, this

model often makes it difficult for operating companies to manage social and environmental risks effectively and to promote sustainable development in the regions where they operate.

Ensuring good social and environmental performance is a complicated matter for any industrial sector. Success relies on a combination of technical skill, effective risk management, the right mix of regulation and government support, an alert and informed civil society, the ability of companies to listen and be responsive, and collaboration between industry players. Some or all of these factors exist in regions in which some oil and gas projects are located, while in others (especially in new oil-producing regions) they may be compromised or immature.

1.1.2 Multiple interests and responsibilities

Operating companies are not alone in wanting to ensure positive outcomes, or in being subject to stakeholders’ expectations of good performance. There are many social and environmental issues for which governments have or should have primary responsibility, such as upholding human rights or setting emissions limits. In practice, however, stakeholders may not always make this distinction and may have high expectations of the ability of companies to address multiple challenges effectively.

Moreover, the risks of poor social and environmental performance mean it is in the interests of business to work with other stakeholders to ensure positive outcomes. The challenges faced by companies in regions as diverse as the Niger Delta and the Russian Far East vary tremendously, but all have significant consequences for business success. And the impact of catastrophic headline-grabbing events such as the Exxon Valdez or Deepwater Horizon underlines the fact that major challenges are not restricted to regions of weak governance.

1.1.3 Multiple business functions

Effective management of contractor performance relates to a range of business functions (see Figure 1). Internal corporate synergy and organisational effectiveness are therefore essential. A variety of departments, including project management, procurement, local content, health, safety and the environment (HSE) and external affairs, must operate in harmony and seek to align their objectives, policies and initiatives.

It requires a concerted effort on behalf of executive and mid-level managers to address issues in a consistent way and to ensure that standards and codes of conduct are implemented across the range of business functions and throughout the contracting chain.

1.1.4 Cultural shift required

Over recent decades, against the backdrop of pressure from international non-governmental organisations (NGOs), investors, governments and lenders, the oil and gas industry has been making efforts to improve environmental and social performance and adopt international standards of good practice. It is becoming

evident, however, that legal contracts, corporate codes of conduct, standards and policies alone do not ensure good practice throughout the contracting chain. As detailed in Part 2, this is because of the considerable difficulties in implementing changes in attitudes and behaviours far beyond the capabilities of any legal contract.

Moreover, the industry needs to commit to take shared responsibility, across the industry and in collaboration with external stakeholders. This involves building greater trust and communication, and overcoming what has been referred to as a ‘culture of complacency’.¹ This refers to an over-reliance on tick-box compliance with standards and procedures that undermines the ability of industry workers and regulators to remain alert to risks and respond effectively to unexpected challenges.

This cultural shift is necessary industry-wide, across stakeholder groups and throughout contracting chains. It not only applies to the external-affairs and HSE departments of companies, but needs to be embedded throughout industry operations.

Figure 1: Corporate objectives in contractor management



1.2 The trends

Several factors have emerged over recent years that now put contracting chains at the centre of attention. These include the following:

- **Challenging operating environments**
- **Complex contracting chains**
- **Spread of international good-practice standards**
- **Local content requirements in investment agreements**

1.2.1 Challenging operating environments

Oil and gas has always been a highly technical business. Now, driven by technological advances and increasing concerns over energy security, as well as fluctuating but sufficiently high oil and gas prices, the industry continues to expand into ever more sensitive and difficult operating environments, including:

- technically challenging natural environments (e.g. deep water, tar sands, extreme cold)
- areas on or close to lands and waters traditionally used for local livelihood activities
- undisturbed areas or fragile ecosystems

Public concern regarding the industry's environmental and social performance is perennially high, and especially sensitive in the aftermath of major incidents. Risks are exacerbated in middle- and low-income countries, where operating companies might encounter:

- weak or poorly enforced regulatory regimes
- local procurement requirements in investment agreements with the host government, where local contractors may not have sufficient capacity or experience to manage social and environmental impacts effectively
- lack of capacity in civil society to hold the government and industry to account

Furthermore, the oil industry in many developing countries is dominated by national oil companies (NOCs), who retain control of a large majority of hydrocarbon resources globally, and may enter joint ventures with IOCs and major contractors.²

The examples in Box 1, below, represent cases where effective contracting chain management might be compromised by extreme challenges relating to the natural environment (e.g. isolation and difficult or unexplored terrain); poor governance of resource extraction; or cross-cultural communication (including 'first contact' with local communities).

Box 1: The oil and gas industry moves into new and sensitive environments

With high oil prices and concerns about energy security, oil and gas exploration and production is increasingly taking place in difficult environmental and social terrain. Deepwater oil extraction is expanding, with reserves located at a depth of 600 feet accounting for 42-56 per cent of all discoveries between 2006 and 2009.³ Most deepwater oil finds have been in the 'golden triangle' of the Gulf of Mexico (12 oilfields below 400 metres) and off the shores of Brazil (15) and West Africa (10).⁴

Oil sands are mostly located in Alberta, Canada, and currently account for 1 per cent of global oil production (this is expected to rise to 4 per cent by 2035).⁵ Oil sands development requires larger energy

inputs, with higher greenhouse gas emissions, than conventional oil (estimates range from 10-25 per cent to as much as 300 per cent greater).⁶ Eni is proposing controversial oil sands exploitation in the conflict-prone Congo Basin, around 50-70 per cent of which would occur in primary forest or other biodiverse areas.⁷

The potential for social conflict can also be high. For example, oil and gas concessions currently cover nearly half of Peru's Amazonian rainforest (up from 7 per cent in 2003), overlapping with over half of Peru's titled indigenous land.⁸ In 2009 clashes at Bagua led to the death of at least 23 police officers and 10 protestors. Further oil extraction is proposed in regions inhabited by isolated indigenous peoples, potentially increasing their risk of disease and social conflict.⁹

Table 1: Examples of activities in the contracting chain

Example activities	Environmental and social aspects	Time horizon
Seismic surveys Testing geology for presence of hydrocarbons	<ul style="list-style-type: none"> Habitat or wildlife disturbance from use of explosives 	1-6 months
Road building Clearing habitat and creating access for vehicles and people to exploration sites	<ul style="list-style-type: none"> Disturbance of habitat, wildlife, traditional activities Access roads providing increased opportunities for damaging activities such as deforestation and poaching, but also enhanced opportunities for livelihood and leisure activities 	6 months to 2 years
Pipeline construction River crossings, over-land/ under-sea pipelines	<ul style="list-style-type: none"> Community inconvenience (e.g. noise, dust) Threats to wildlife breeding grounds, marine life, domestic animals; disturbance of agricultural and indigenous peoples' land 	2-5 years
Construction of processing facilities Large-scale construction on land/shorelines	<ul style="list-style-type: none"> Employment/business opportunities, labour standards, living standards Land acquisition, resettlement, socio-economic displacement Threats to cultural heritage 	2-5 years
Materials supply e.g. pipe, cement, steel	<ul style="list-style-type: none"> Environmental impacts of quarrying/other sourcing Pollution issues associated with factory production Employment/business opportunities Labour standards, living standards 	2-4 years for construction
Manufacture of goods e.g. equipment, clothing	<ul style="list-style-type: none"> Employment/business opportunities Labour standards, living standards Materials sourcing Pollution issues associated with factory production 	2-4 years for construction; ongoing for operations
Support services e.g. catering, laundry, logistics, transportation	<ul style="list-style-type: none"> Employment/business opportunities Labour standards, living standards Opportunities from local sourcing of foodstuffs Food quality and other service standards 	

1.2.2 Complex contracting chains

Recent evolution of the oil and gas industry has been shaped by industry drives towards greater efficiency through increased outsourcing and by the efforts of host-country governments to capture more benefits from oil and gas production, notably through inclusion of 'local content' targets in investment agreements (discussed in Section 1.2.4).

As a result, the industry operating model is shifting towards increasingly complex, long and diffuse chains of contractors, subcontractors and suppliers. The International Association of Oil and Gas Producers (OGP) asserts that contractors currently carry out more than 75 per cent of work-hours in the industry.¹⁰

Different IOCs vary in terms of how reliant they are on contracting chains. The phenomenon of contracting chains is universal, but some players outsource much more than others, or more in some regions than others.

In this document, we focus on contracting chains related to the construction phase of major projects. This includes some high-risk activities (see Table 1). Contractors tend to suffer more fatalities than operating companies and frequently find themselves on the front line of relations with local communities.

Industry contractors range from large multinational oil and gas field services companies with a wide range of competencies, down to small, independent local firms offering one or two key services. These service

Table 2: Selected major service companies — size and main activities

Company	Main activities	Size
AMEC	Engineering, construction, project management, consulting	US\$2.5 billion revenue 23,000 employees
Halliburton	Drilling, pipelines, project management	US\$14.5 billion (2009) 50,000 employees
Maersk	Oil tankers, drilling	US\$48.5 billion (2009) 115,000 employees
Parsons Brinckerhoff	Mainly onshore pipelines	US\$2.1 billion 13,000 employees
Schlumberger	Drilling, cementing	US\$22.7 billion 105,000 employees
Transocean	Rig-based construction services	US\$11.6 billion Over 21,000 employees
Baker Hughes	Reservoir development, drilling	US\$9.7 billion (2009) 34,400 employees

providers are hired to deliver goods and services throughout the exploration, construction, operations and decommissioning phases of hydrocarbon projects.

Major service companies such as Transocean, Halliburton, Schlumberger, Parsons Brinckerhoff, AMEC and others (see Table 2) manage significant volumes of local contracting on behalf of operating company clients, through formal procurement processes.

This contracting model allows operating companies to focus on their core competencies, avoiding the need to maintain many costly specialist services in-house when they may only be required periodically. It allows major service companies to specialise and offer the same services to a range of oil company clients worldwide. It provides development opportunities for local businesses, with positive local outcomes such as employment and tax revenue.

Companies tend to avoid local procurement of high-risk services unless highly skilled service companies are available. But even where highly qualified and experienced companies are involved, the complexity of contracting chains poses a challenge for environmental and social performance management and oversight. When less experienced contractors and subcontractors are unfamiliar with international standards, or lack the incentive to implement them, the operating company is likely to face additional challenges. Moreover, the large

volume of contracting within the industry means that risk management in the contracting chain substantially affects the industry's environmental and social performance as a whole.

Complex contracting chains raise a number of questions:

- Who is responsible for ensuring that contractors and subcontractors are properly prepared to address all risks, however unlikely?
- What actions must an operating company take to check that its contractors and subcontractors can meet their contractual requirements and that they work to international good-practice standards?
- How can high standards for environmental and social performance be maintained, even when speed and low cost of delivery are priorities?

Box 2 on the April 2010 Gulf of Mexico disaster, illustrates just how complex these management questions can be in practice, and how the challenges can unfold with uncontrolled consequences.

Box 2: Deepwater Horizon: a case study in complexity¹¹

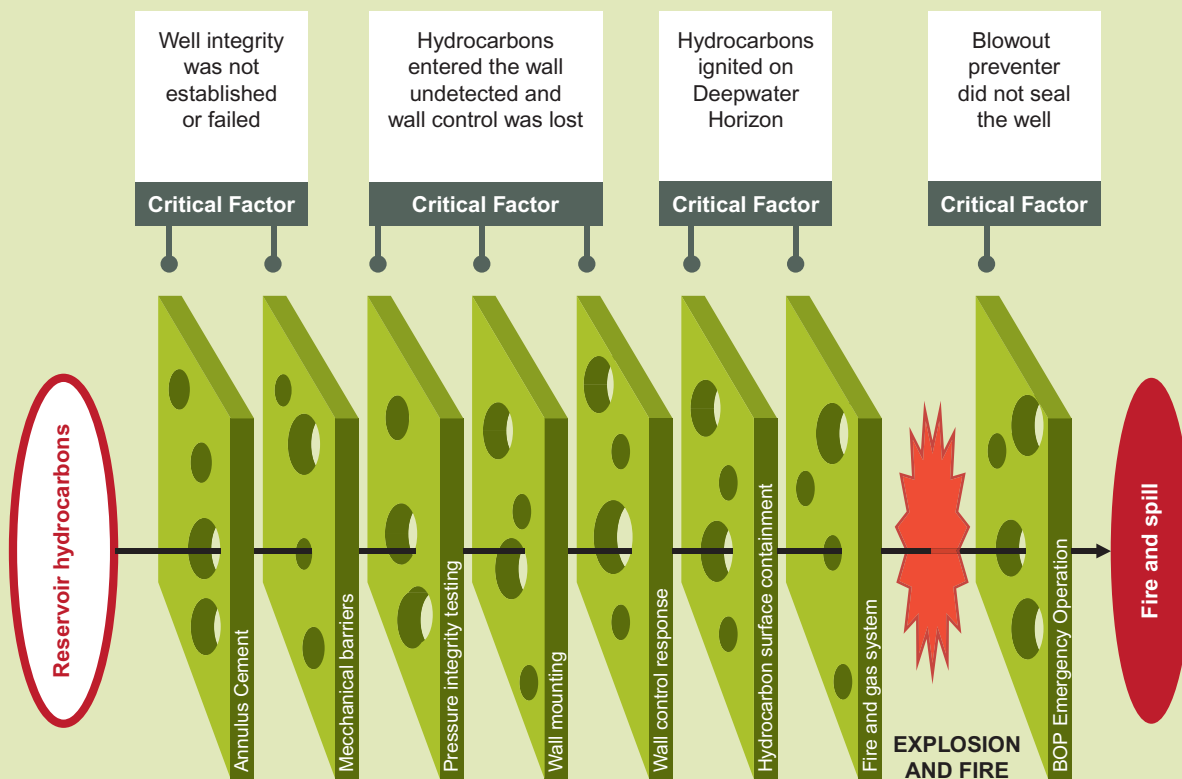
On 20 April 2010 the Deepwater Horizon rig exploded in the Gulf of Mexico. BP had hired the rig to drill its Macondo well in 1,500 metres of water, 66 kilometres from the shores of Louisiana. The rig was owned and operated by Transocean and had performed well internationally since 2001 when it was built by Hyundai Heavy Industries. Of the 126 workers on board, 11 lost their lives, 9 of whom were Transocean employees. The oil spill (4.9 million barrels) continued until 15 July, when the well was temporarily capped before being sealed on 19 September.

Initially the US government named BP as the responsible party, holding it accountable for clean-up and damage. In fact, a wide range of companies were involved as co-owners, contractors and suppliers, including Transocean, Anadarko, MOEX,

Halliburton and Cameron International. BP's bill has totalled over US\$8 billion to date, not including funds set aside for potential future damages.

Investigations have been conducted by BP, Transocean, the US Coast Guard and Bureau of Ocean Energy, and the US president's national commission.¹² The US Minerals Management Service (MMS; now known as the Bureau of Ocean Energy or BOE) was criticised for inadequate inspections prior to the disaster and poor documentation of it. They were also considered responsible for a flawed well plan, along with BP, Anadarko and Mitsui.

In November 2010, BP released its report, including analysis of events leading up to the accident, with 25 recommendations to prevent a similar accident in future. The investigation concluded that no single factor had caused the tragedy, but there had been a sequence of failures involving a number of different parties (see diagram below).



Source: BP. 2010. Deepwater Horizon Accident Investigation Report. p.181

The recommendations from the BP report cover two broad areas:

1. Drilling and well operations and Operating Management System implementation.

Actions include updating and clarifying technical guidance documents and standards for operations and reporting; developing training programmes for contractors; enhancing in-house expertise in blowout prevention; recommending that industry associations develop good-practice standards; and strengthening of audit processes.

2. Contractor and service provider oversight and assurance.

Actions include review and strengthening of oversight, monitoring and control standards and functions; sharpening up management systems and procedures; and review and strengthening of contractor requirements and contractor verification processes.

Despite the existence of good-practice standards, high levels of awareness and experience and a rig that had performed well internationally, there were many areas of operations and oversight that were flawed. This underscores the importance of paying greater attention to management of contracting chains, even in regions of the world where one might expect good levels of management and oversight from all parties. Even though the disaster was a singular event among the tens of thousands of wells safely drilled in the Gulf of Mexico, the impacts have been profound for the entire industry.

'We have said from the beginning that the explosion on the Deepwater Horizon was a shared responsibility among many entities. This report makes that conclusion even clearer ...'

Bob Dudley, Chief Executive Officer, BP

In his official statement on 9 November 2010, William K. Reilly, the co-chairman of the US National Commission charged with investigating the Macondo well incident, referred to a 'culture of

complacency' permeating BP and its lead contractors Halliburton and Transocean that, in his view, lay at the root of the tragedy:

'Whatever else we learned and saw yesterday is emphatically not a culture of safety on that rig. I referred to a culture of complacency and speaking for myself, all these companies we heard from displayed it. And to me the fact that each company is responsible for one or more egregiously bad decisions, we're closing in on the answer to the question I posed at the outset of yesterday's hearing, whether the Macondo disaster was a unique event, the result of special challenges and circumstances, or indicates something larger, a systemic problem in the oil and gas industry.'

William K. Reilly

Reilly refers to an unacceptable level of poor decision-making, including badly run tests, the premature removal of safety barriers, the ignoring of warning signs, and the failure — at all levels, including senior executives — to take risks seriously. Reference was made to 'financial pressures and time limits', which, it was argued, appeared to have had a major impact on individuals' responses.¹³

The US president's national commission report of January 2011 states: "The record shows that without effective government oversight, the offshore oil and gas industry will not adequately reduce the risk of accidents, nor prepare effectively to respond in emergencies. However, government oversight, alone, cannot reduce those risks to the full extent possible. Government oversight must be accompanied by the oil and gas industry's internal reinvention: sweeping reforms that accomplish no less than a fundamental transformation of its safety culture."¹⁴

1.2.3 Spread of international good practice standards

There is an increasing emphasis on the need to maintain high environmental and social performance standards in the oil and gas industry. Pressure from NGO campaigns, ethical investors and governments increases with every high-profile disaster, and with every local incident that has an impact on livelihoods and ecosystems. Standards have also been evolving in response to a growing awareness of the importance of managing contracting chains responsibly. The oil and gas industry can benefit from the experiences of other sectors where chain-wide responsibility has been increasingly promoted. Box 3 offers a glimpse into the kinds of activity being pursued in other sectors.

Most IOCs have facilities certified to international standards of the International Organization of Standardization (ISO) and the Occupational Health and Safety Advisory Services (OHSAS). Primarily these

include ISO 9000 (quality), ISO/OHSAS 18001 (health and safety) and ISO 14001 (environmental management), and many have established equivalent internal performance standards. Companies are drawing up codes of conduct and environmental policies, and are engaging in sustainability reporting. Several IOCs have signed the Voluntary Principles on Security and Human Rights and have become members of initiatives such as the United Nations (UN) Global Compact, which includes a set of good-practice principles, and the Global Reporting Initiative (GRI) for sustainability reporting.

In their quest to ensure projects comply with international standards throughout the contracting chain, companies are increasingly requiring that these standards be part of tender processes. Other drivers for major contractors include sustainability reporting, rankings and membership in industry associations.

Throughout the chain, there may be varying levels of

Box 3: Supply-chain initiatives in other sectors

Electronics. The Electronic Industry Citizenship Coalition (EICC) was established in 2004 by key electronics companies. By 2009 the EICC included 42 electronics companies. The EICC uses a code of conduct with 38 principles covering five areas (labour, health and safety, environment, management systems and ethics). The code of conduct is subject to ongoing revision based on suggestions from member companies and external stakeholders. There is a system of professional auditing using unified tools and methodologies. The EICC maintains ongoing dialogue with NGOs, who believe the initiative has had a positive effect on environmental impacts and discrimination, with less progress on collective bargaining, job security and workers' awareness of their rights.¹⁴

Forest products. There are several major initiatives on forest-product certification, notably the Forest Stewardship Council (FSC) and the Programme for the Endorsement of Forest Certification Schemes (PEFC). These initiatives have demonstrated the difficulty of achieving the dual goals of improving standards in a supply chain and including more local-level enterprises. Local community organisations often find certification processes expensive, and they may not be well placed to reap the benefits.

On the other hand, certification has encouraged the transfer of new management techniques and technological innovations. Companies have been able to break into new markets and win concessions. Positive impacts also include market transparency, efficiency and an enhanced 'licence to operate', which make companies more attractive to potential investors.¹⁵

Agriculture. There are many different supply-chain initiatives in the agricultural sector. The Fairtrade Foundation and the Rainforest Alliance both use a set of performance standards to improve agricultural practices. The Fairtrade Foundation offers a guaranteed minimum price for a commodity and an additional 'social premium' to be invested in a project by the recipient community, and ensures high environmental and sustainability standards during production. The Rainforest Alliance works with farmers to improve their practices, thereby encouraging them to be more environmentally sustainable, efficient and productive. They are currently adapting their standard to include smallholders and unorganised farmers. There is a tension between enforcing high standards and increasing the cooperation of poorer groups who may find the requirements too costly. The Fairtrade Labelling Organization (FLO) has looked into the possibility of making the standards more flexible for smallholder producers.¹⁶

Box 4: Evolving standards: focus on international financial institutions

A key driver for the uptake of global environmental and performance standards in the oil and gas sector are the conditions placed on project finance. Lenders and investors require adherence to performance standards so as to reduce risk in their investments, and employ exhaustive due-diligence exercises.

In 2006 the International Finance Corporation (IFC) approved its revised Performance Standards (PS) on social and environmental sustainability. These define the roles and responsibilities of IFC's clients and the conditions for IFC support. They include environmental and social management systems (PS1) and labour standards (PS2), among others. IFC standards are taken as a benchmark for the oil and gas industry, although other interna-

tional financial institutions (IFIs), notably the European Bank for Reconstruction and Development (EBRD) and have more stringent performance standards, particularly in relation to social issues. The IFC standards have also been adopted by the Equator Principle Financial Institutions, a group of about 90 major financial institutions representing over 90 per cent of global project finance activities.¹⁹

The IFC website has considerable information and guidance on supply-chain management.²⁰ They require clients to assess the performance of 'third parties' and provide training where necessary. Third parties include the 'principal contractor', but not other contractors in the chain. This reflects current attitudes in the industry that focus on the relationship between operating company and lead contractor, while effective management of the rest of the contracting chain is given less attention.

awareness of ISO standards. Major international contractors, such as Schlumberger and AMEC, tend to hold certifications to international standards.¹⁸ NOCs and joint ventures are increasingly adopting voluntary standards and requiring this of their service providers. For example, TNK-BP and its service providers are certified to ISO 14001. Kazakhstan's national company KazMunaiGaz likewise has established a parallel set of standards, with some of its daughter enterprises formally certified with ISO 14001 and OHSAS 18001.¹⁹ In general, quality, health and safety take priority, while environmental and social issues management remains of secondary concern.

Further along the chain, however, it becomes increasingly difficult to find companies that are certified to international standards, particularly in the sphere of environmental and social issues management. Local service providers may lack the skills required for the best environmental and social performance. This may be due to lack of investment or lack of sufficient engagement with the sector to identify the value of acquiring these skills.

So how are standards promoted throughout the contracting chain?

Companies have systems for transferring environmental and social standards to their contractors, including contracts, bridging documents (to align standards and expectations), project-specific HSE and social manage-

ment plans, monitoring and reporting requirements and audits. These processes and procedures are discussed further in Part 2.

The industry is developing mechanisms to address environmental and social performance throughout the contracting chain. For example, Statoil uses a voluntary supplier declaration scheme to encourage first-tier contractors to adopt international good-practice standards. Contractors sign the declaration, committing to recognising HSE and social standards. Statoil has signed up to the Voluntary Principles on Security and Human Rights, adherence to which is included in all of their security contracts, with compliance training provided. Some of Statoil's other contractors, such as Halliburton and Maersk, are now starting to take on board the Voluntary Principles themselves. Further mechanisms are being introduced to procurement processes, including pre-screening on human rights. The procurement agency Achilles has also been working on a social standard, which is still under development.²²

There is increasing awareness about the importance of reporting by all members of the contracting chain. The International Petroleum Industry Environmental Conservation Association (IPIECA), along with OGP and the American Petroleum Institute (API), have issued recommendations on the inclusion of reporting in the contracting chain as part of their newly-revised Industry Voluntary Guidance on Sustainability Reporting.²³ The GRI is also pilot-testing an oil and gas sector

supplement to its reporting guidelines and is creating a supply-chain reporting protocol for universal use, including within the oil and gas sector.²⁴

1.2.4 Local content requirements in investment agreements

Governments of oil- and gas-bearing regions, especially in middle- and low-income countries, are increasingly including local content targets in the investment agreements that they negotiate with oil and gas companies, and increasingly enshrining such requirements in law. Local content targets are ratios for the employ-

ment of local people and the procurement of local goods and services.

Local content provisions are employed by governments to capture more of the value of hydrocarbon development in-country. Ultimately, these efforts should help to support the long-term development of the sector locally so that future oil and gas projects can bring the desired sustainable benefits to the local economy.

The ability of a company to meet local procurement targets depends on the nature of the work to be

Box 5: Local content development in Kazakhstan: the role of the government²⁵

Promotion of local content in the oil and gas sector is a major policy priority for the government of Kazakhstan. New legislation is in place and the target for procurement from Kazakhstan suppliers is 50 per cent by 2012; for services, the target is up to 90 per cent. In April 2010, 34 oil and gas industry contracts were terminated due to noncompliance with local content requirements.

Legislation requires that production sharing agreements include at least 50 per cent to be held by the NOC KazMunaiGaz, and requires companies to submit their local procurement plans to the government for review. The use of single-source tenders is limited, and foreign companies must offer a 20-per cent cost reduction over Kazakhstan companies to win a bid. The legislation also calls for provision of equal conditions and remuneration for Kazakhstan personnel, including for subcontracted work.

Electronic procurement has been introduced to enhance transparency. A public tender is required for supply to state-controlled companies of certain goods and services. Contracts also stipulate fines for failure to meet local content requirements.

The government's Concept on Further Development of Local Content (2009) proposes improvement of legislation in support of domestic companies; fixed requirements for local content in contracts; tariffs and other incentives; and transitioning to international standards and requirements, including management systems. The plan's success will depend largely on clear and consistent economic and legislative mechanisms for implementation. The Action Plan to 2012 includes:

Stage I (2009-2010): defining major prospective categories for goods and services, as well as minimal local content requirements for subsurface users, and developing appropriate legislative provisions

Stage II (2010-2011): availability of state subsidies or credit schemes to promote prospective domestic producers of good and services. Technology transfer, science support and acquisition of new skills feature prominently here.

Stage III (2010-onward): state support for domestic entrepreneurs' access to international markets. A government working group, in collaboration with operators and service companies, will target human-resource training capacities and coordination of the skills base for the industry.

The Ministry of Oil and Gas and the Ministry of Industry and New Technologies have attempted to formalise the definition of local content and have created a comprehensive registry of local companies providing specialised services in different regions.

A National Agency for the Development of Local Content has been set up, with the two ministries as primary shareholders. Its role includes managing and updating the registry, facilitating the implementation of local content policy and ensuring that procurement practices are transparent.

Observers express concern about the pace of these changes in the light of limited capacity among local suppliers and workers, which requires longer-term investment. There are still concerns around lack of transparency and access to the tendering process, lack of reporting from the government and business, and the lack of transparency around financing for capacity-building schemes and small and medium enterprise (SME) development.

undertaken and the availability of enough people with the right skills and talents to do the job. Specialised contractors are increasing in number in some oil-producing countries, with rising demand from large-scale projects, partly in response to local content targets.

Where specialised contractors do not yet exist, operators are expected to meet local content targets in other ways — for example, by focusing on the local catering or clothing-manufacturing industries, by investing in training and capacity-building of local enterprises (see Section 2), or by helping to register local branches of international service companies (an approach that has been quite controversial, as it is seen as an effort to bypass the rules).

Some companies comment that they feel forced into local content obligations by governments. Other companies understand that pursuing local procurement objectives can deliver a range of strategic and business benefits, such as reducing transportation or labour costs, or enhancing relations with the host government and building a ‘social licence to operate’ within host societies. Observers note the need for more dialogue between companies and government agencies around the mutual benefits of optimising local content.

It should be emphasised that building local capacities to meet local content targets is not the sole responsibility of the industry. Government has a key role to play. In the case of the Sakhalin-2 project, for example, a joint steering committee was set up between the

Sakhalin regional government and the project operator, Sakhalin Energy, with some participation from major contractors. This body identified, discussed and approved the social investment projects that could most effectively contribute to sustainable development in the region. Box 5 describes the efforts made by the government of Kazakhstan to promote development of local capacity to meet local content targets.

Expectations of high levels of local content from the outset frequently lead to disappointment. Often an initial ‘boom’ of high employment — for example, in pipeline construction — results in a subsequent ‘bust’ once the construction phase is over. Governments and local businesses need to be more strategic about the kinds of capacities that they focus on developing over the long term. In some cases, a better option may be to bring in an experienced workforce for the short construction period, while cultivating skills in areas that are more likely to be required in the longer term (e.g. manufacturing, business management and catering).²⁶

Several experts with whom we consulted emphasised that governments and other stakeholders should seek to *optimise* rather than *maximise* local content.²⁷ That is to say, local contracting should provide the greatest possible long-term benefits to society in the context of local skills and capacities. This may not necessarily result in the maximum possible local spend in the short term. Highly technical and complex skilled work cannot be carried out by an inexperienced local workforce, whereas less skilled work might lend itself well to



ANATOLY JUSTINENKOV/ISTOCKPHOTO.COM

greater local involvement, including logistics, transportation, catering, laundry, office work, environmental and social surveys and long-term monitoring, and middle-management functions, moving towards upper management over time.

IIED's interest in contracting chain management was initially spurred by the challenges of managing environmental and social risks in the context of increased local content requirements in developing and emerging economies.²⁸ The case of Deepwater Horizon, however, along with a subsequent near miss on a Shell/Transocean rig in the North Sea,²⁹ have underscored the fact that serious challenges are not restricted to less developed parts of the world with weak governance.

1.3 The changing climate of responsibility

There have been a few notable efforts to make concrete a shared framework for managing responsibilities and impacts beyond areas of direct company control. For example, a 2002 IPIECA/OGP report on management of social issues recognises the role contractors play in delivering social performance on the ground.³⁰

More recently, OGP, in collaboration with the International Marine Contractors Association and

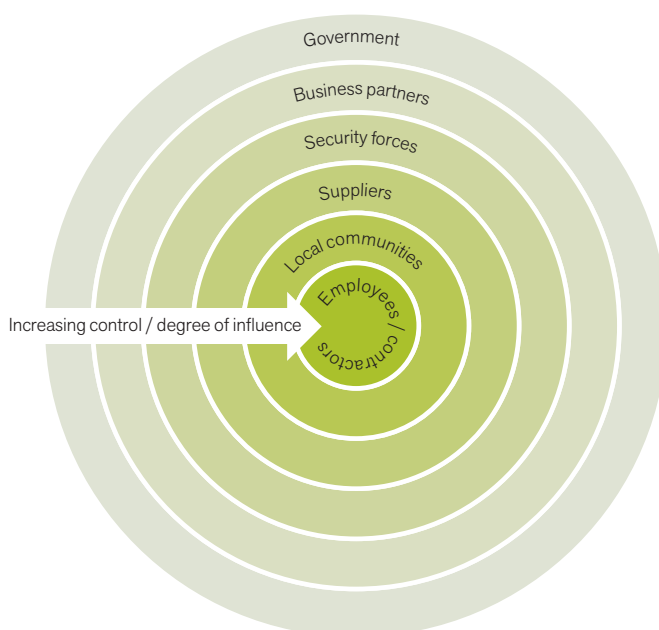
International Association of Geophysical Contractors, issued a set of technical guidelines to ensure health, safety and environmental performance is factored into the contracting process.³¹ These guidelines attempt to codify a range of relevant procedures that can be followed throughout the project lifecycle, and therefore reflect a growing understanding of this critical relationship in delivering good performance.

The UN Global Compact has been involved in introducing the concept of a company's 'sphere of influence' as a way to help companies understand the scope of their responsibility in addressing human rights issues, and may be useful in understanding other issues as well. The idea is that a company's influence over a situation – and therefore its direct responsibility for outcomes – diminishes further from the locus of control. Figure 2 shows how one company, BHP Billiton, has illustrated this concept using concentric circles.

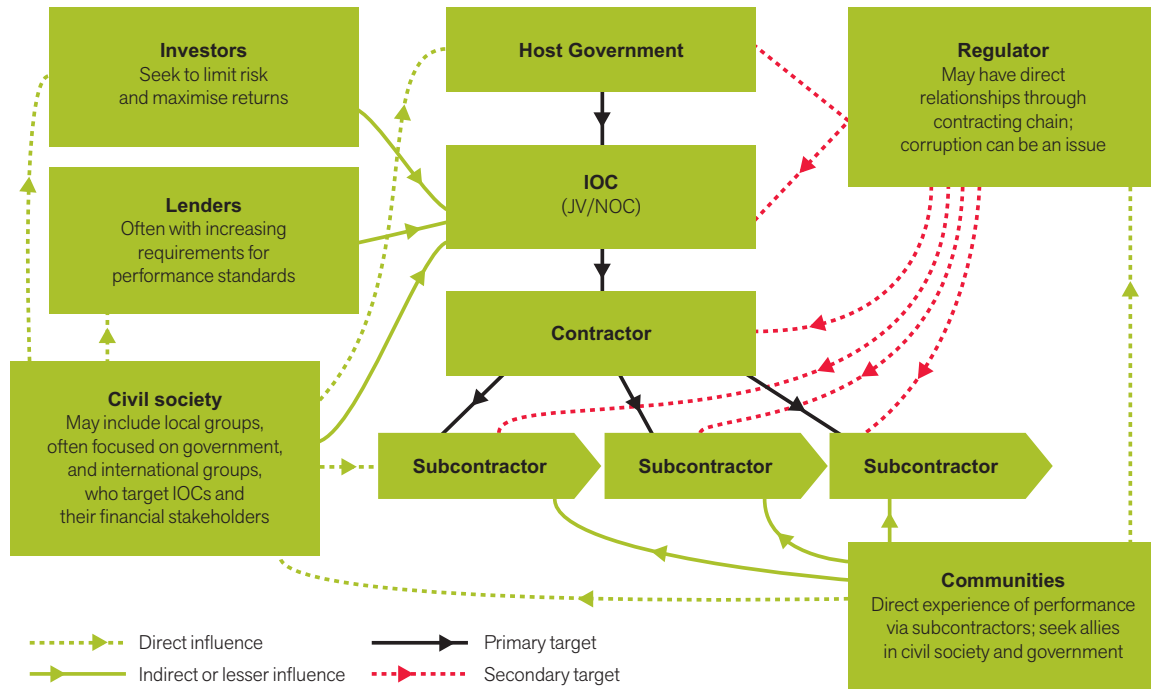
Although each project is distinct, different participants tend to play certain roles in controlling and influencing one another towards desired outcomes, directly or indirectly, as illustrated in Figure 3.

As Figure 3 illustrates, projects are subject to direct and indirect lines of control and influence both top-down and bottom-up, with IOCs seen as primary targets for influence. Notwithstanding the roles of

Figure 2: BHP Billiton's human rights 'sphere of influence' management model



Source: <http://sustainability.bhpbilliton.com/2006/community/ourApproach/humanRights.asp>

Figure 3: Influence, control and pressure among stakeholders

government and civil society, the exact nature of a contractual arrangement between companies — and the associated financial rewards — will depend on the nature of the goods or services being sought and the capabilities and risk appetite of the contractor.

Usually, contracts focus on legal transfer of authority for certain activities and outcomes, while formal responsibility for results is maintained by the operating company. But the responsibility landscape has shifted significantly in recent decades and now encompasses domains beyond the realm of legal responsibility. These are not equally recognised or accounted for in relationships between companies in the contracting chain. Table 3 (overleaf) identifies three realms of responsibility and the risks of failure in each.

The area of *legal responsibility* (legal compliance), illustrated in Table 3, is well understood and characterised by specific criteria and a binding system of consequences if criteria are not met. Nonetheless, in regions of poor governance and weak regulatory enforcement, it is possible to evade legal responsibility. Furthermore, where contracts provide an inadequate balance of incentives and penalties it is possible for contractors to fail to meet their full range of contractual requirements by being forced to prioritise some aspects (e.g. time and cost of delivery) over others (e.g. environmental protection) (see Section 2.2.3).

A second area is that of *responsibility to stakeholders*, encompassing the expectations of a company's stakeholders for the environmental and social outcomes of a project, which may extend over and above compliance with the law. For example, a company may be legally liable to pay up to an agreed limit to cover the cost of cleaning up an oil spill, but public and government expectations may result in them paying well over that amount. A company's actions in this area may be influenced by a legal requirement to meet local content targets, but it may also be a strategic decision to enhance government relations and the company's social licence to operate.

A third domain, which we term *managerial responsibility*, is less well understood as a distinct area of responsibility. Yet this is often the key element that ensures companies in the contracting chain are able to meet expectations and contractual requirements. It includes the management actions (capacity-building, monitoring, communication and oversight) required to ensure that contractual obligations and stakeholder expectations are met. These rely on the proactive commitment of the contract holder. Decisions to invest more or less effort, money and time in meeting managerial responsibilities tend to be voluntary, although they are frequently essential in order to meet legal requirements — and they may be referenced in formal contracts.

Table 3: Three areas of responsibility³²

Environmental and social responsibilities		Risks of failure
<p>Legal responsibility Specified, formally binding and compliance-based; enforced by government regulators and contract holders</p>	<ul style="list-style-type: none"> • Legal compliance • Conformity to international standards included in investment agreements and contracts • Meeting local content targets • Carrying out mandatory public consultation and social investment • Implementing adequate emergency-response procedures 	<ul style="list-style-type: none"> • Legal sanctions, fines and penalties • Contractual disputes • Court cases and associated costs and delays
<p>Responsibility to stakeholders Responsiveness to the expectations of stakeholders for good performance beyond legal and contractual compliance</p>	<ul style="list-style-type: none"> • Meeting good-practice standards not included in national legislation or contracts • Transparency • Ensuring meaningful and responsive engagement with stakeholders • Respect for and protection of the local environment and livelihoods over and above legal obligations • Development of beneficial and equitable social programmes for local communities on a voluntary basis 	<ul style="list-style-type: none"> • Reputational damage • Loss of social licence to operate • Loss of future investment opportunities
<p>Managerial responsibility Efforts applied by contract holders to maintain good environmental and social performance throughout the contracting chain</p>	<ul style="list-style-type: none"> • A culture of shared risk and responsibility • Effective communication throughout the chain • Training in technical and managerial skills and cultural awareness • Technology transfer • Effective oversight and monitoring 	<ul style="list-style-type: none"> • Loss of control over project outcomes and impacts • Inability to meet legal responsibilities and responsibilities to stakeholders

This report argues that the domain of managerial responsibility can sometimes be taken for granted in contracting chains of the oil and gas sector. This compromises companies’ ability to meet both legal and stakeholder responsibilities. It also presents various unnecessary challenges for companies in ensuring good environmental and social outcomes.

1.4 Moving forward together

It must be recognised that the circumstances we have described in this section – as well as the proposed responses – are complicated. Making progress is not without risk or downside, as it may sometimes increase operating costs, add delays and require considerable managerial attention. But at the same time, the expectations of governments, companies in the value chain and society are legitimate, and the business case for companies to meet those expectations is substantial, compelling and growing.

Furthermore, we do not assert or imply that companies are solely responsible for addressing the challenges

that we highlight in this paper. The term ‘shared responsibility’ in the title underlines our view that governments and civil society, as well as the various companies that make up the contracting chain, also have important roles to play in ensuring positive environmental and social outcomes. While focusing primarily on actions for oil and gas operating companies and major service contractors, we emphasise the importance of government oversight, investment and support, and civil society’s capacity to hold business and government to account.

This exploration is based on the premise that it is in the interest of all stakeholders to develop a competent local oil and gas service industry that can manage environmental and social issues effectively. The recommendations and actions contained in this report are aimed at helping to deliver this. It is our intention to stimulate discussion, debate and experimentation around the challenges and actions to address them, which will better enable all companies to carry out their roles effectively and to create the best possible social and environmental outcomes.

2

PART 2

Understanding the challenges

Many of the challenges of ensuring good social and environmental performance throughout the contracting chain are multifaceted, long-standing, even intractable. Our research demonstrates that signing up to international good-practice standards and developing corporate policies and management systems alone is not sufficient to ensure good environmental and social performance. It depends on those standards, policies and management systems being effectively implemented and embedded in everyday practice across the whole range of business functions and throughout the contracting chain. And it requires meaningful collaboration between industry players other stakeholders.

We have identified three broad sets of factors that hamper effective chain-wide performance:

1. **Lack of a sense of shared responsibility throughout the contracting chain and across stakeholder groups.** Responsibilities are typically fragmented across a project. There is a need for shared ownership of activities and outcomes overall, rather than just the individual tasks taken on by each partner.
2. **Inadequate implementation of systems and procedures to enforce standards and incentivise good performance.** It is not enough simply to adopt standards and policies on paper; they have to be implemented and enforced.
3. **Cultural and contextual challenges in widely differing regions of the world.** Companies must come prepared to address the many contextual factors in a new country, including the perception that international best practices do not always apply.

Key challenges are identified and described in this section under these three headings, and we offer a

number of recommended actions for overcoming the challenges in Part 3: Taking Action.

2.1 Lack of a sense of shared responsibility

Despite the complexity and importance of contracting chains, these chains tend to function as collections of individual interests rather than as coherent and coordinated professional teams. This is perhaps the most important challenge, from which the others flow. Given the distribution of responsibilities across a typical project, there is a strong need for shared ownership of a project and its outcomes overall, rather than just the individual tasks and jobs taken on by each partner.

William K. Reilly, the co-chair of the US National Commission set up to investigate the Deepwater Horizon tragedy (see Box 2), referred to a ‘culture of complacency’ in the oil and gas industry, in which poor decisions are made and risks ignored despite the presence of excellent risk management systems on paper. Observers also point to a lack of coordinated efforts to ensure and promote responsible practice internally (between different business functions); among members of the contracting chain; and between stakeholders, including industry, local enterprise associations, government agencies, IFIs, independent experts, communities and civil society organisations.

2.1.1 Links are weak between IOCs and subcontractors

IOCs engage closely with their lead contractors, but engage much less with subcontractors further down the chain. Yet all members of the chain are expected to understand and implement international standards and codes of conduct that IOCs have publicly committed to following in all their operations. Because of the often diffuse and decentralised way in which contracting

chains operate, it can be difficult for all parties to share the same view of social and environmental performance expected from them, and from the project overall.

2.1.2 A ‘tick-box’ mentality undermines implementation of standards

Major oil and gas companies are increasingly signing up to corporate responsibility initiatives, adopting international good-practice standards, and developing world-class policies, procedures and management systems. All this effort is undermined, however, when a ‘tick-box’ mentality takes over. This means the main focus is on having standards, policies and procedures on paper, and there is less focus on the complicated

‘The United Kingdom Health and Safety Executive formally defines the safety culture of an organization as “the product of individual and group values, attitudes, and perceptions, competencies, and patterns of behavior that determine the commitment to, and the style and proficiency of, an organisation’s health and safety management.” A more popular description is that safety culture means doing the right thing even when no one is watching.’

US presidential commission report, p.218

(<http://www.oilspillcommission.gov/final-report>)

steps required to implement them effectively. Internally within a single company, it is difficult to ensure that everybody has bought into the need for new ways of thinking and operating, and to change behaviour. It is even more difficult to change culture and behaviour outside the company, among contractors and subcontractors, who have their own ways of working.

Where standards and procedures exist on paper and effective implementation is assumed, the result is a false sense of security, not only for members of the contracting chain, but also for other stakeholders (such as government regulators and even civil society organisations). Individuals do not challenge accepted conclusions and are poorly prepared to respond when systems and procedures fail. An example is when a risk assessment is undertaken and the likelihood of a catastrophic event happening is described as ‘very slight’, and then steps required to prepare for its eventuality are not followed through.

Critical analysis of good-practice standards frequently

focuses more on the wording of the standards and procedures themselves and less on the implementation methods and their effectiveness on the ground. This is an area where further independent research would be helpful.

2.1.3 Contractors and subcontractors are less visible than operators

Contractors and subcontractors are less visible and therefore less directly accountable to key stakeholders in an oil and gas project. In some cases this leads contractors to believe that they do not need to engage directly with stakeholders, as this is the responsibility of the IOCs. Conversely, IOCs sometimes prefer to shift the attention to their major service contractors, arguing that the contract between the IOC and the lead service contractors should guarantee a certain level of performance from the rest of the chain.

It is often the more visible ‘branded’ IOC – rather than NOC partners or service contractors and subcontractors – that is held responsible in reports from problem regions of the world, such as in the case of Shell in the Niger Delta or the Russian Far East. Campaigning NGOs sometimes prefer to name the IOCs as having the lead responsibility, as they are seen to be the most amenable to modifying their behaviour in response to external pressure. Similarly, where IFIs are responsive to NGO concerns they may also become the conduit for those concerns. Despite this, it is the subcontractors who tend to have more direct contact with local communities and be responsible for direct environmental impacts.

2.1.4 Companies and governments lack mutual understanding

Proponents of corporate social responsibility frequently highlight the need to better align the sustainable development goals of government and industry. Where industry and government are seen to be engaging closely, this has both negative and positive outcomes. It might take the form of aggressive lobbying of government to promote oil industry interests and the interchange of high-powered roles in industry and government (seen in OECD and developing countries alike). The government may explicitly promote the interests of the NOC, directly or indirectly.

Relations between governments and companies may become adversarial where they are based primarily on negotiations rather than a common search for solutions. IOCs and foreign NOCs frequently find it difficult to build a constructive dialogue with national government representatives on issues such as environmental regulation and local content. In Kazakhstan, for example, observers

have noted that companies often feel forced into delivering unrealistic local content targets, whereas more meaningful dialogue might result in a better understanding of the mutual benefits of strategically optimising local content in international oil and gas projects.

There are considerable sustainable development benefits of closer industry-government engagement. The experiences of Norway and Alaska are frequently taken as a model for emerging oil-producing countries. Outcomes include the Norwegian and Alaskan development funds, Alaska's Native Corporations and the involvement of indigenous people in decision making and benefit sharing.³³

2.1.5 Advance planning is often inadequate

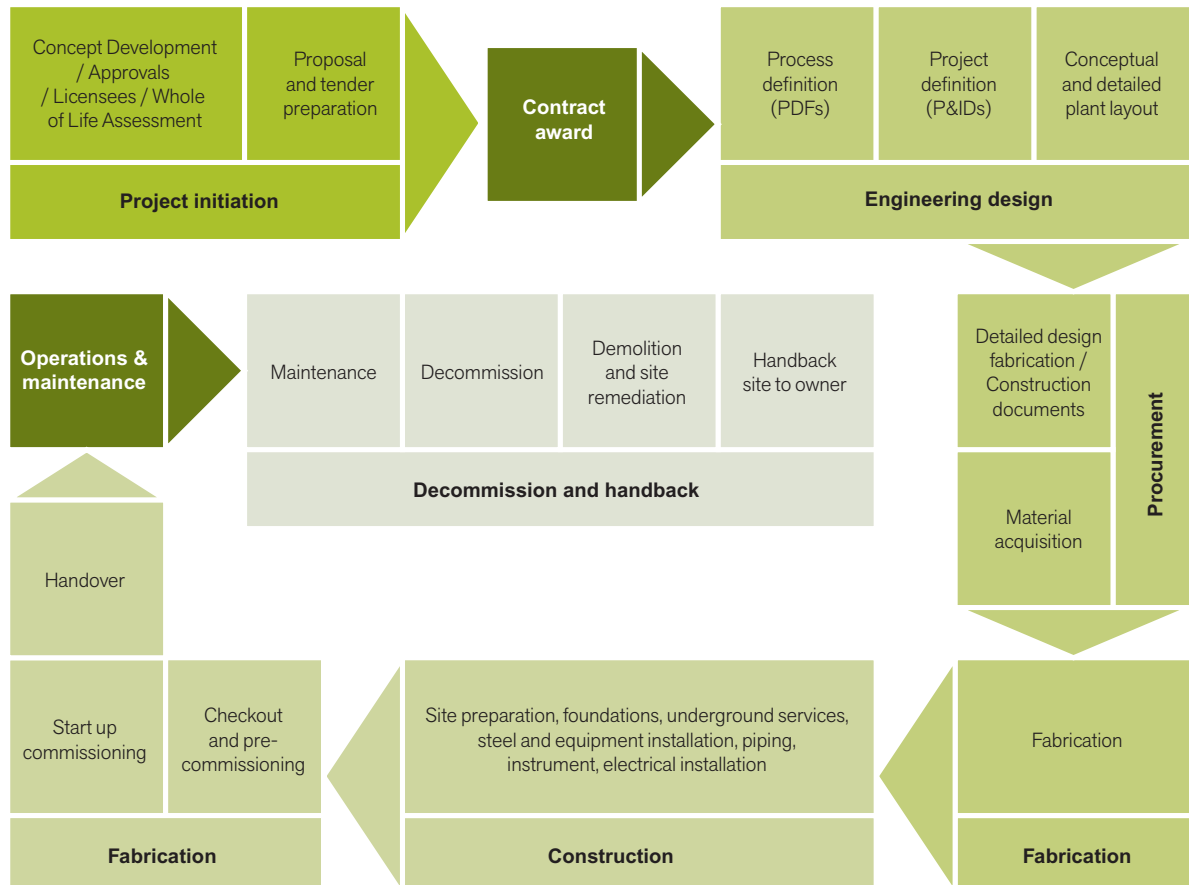
All too often the project cycle does not allow for advance planning and engagement. Key issues are not discussed at the time of the initial negotiations between governments and operators around investment agreements. For example, local content targets may be agreed, but ways of achieving these targets are not discussed. In

general there is insufficient advance understanding of where local capacities are lacking. This limits opportunities for up-front investment in capacity-building for local enterprises and services such as oil spill response teams.

In general this points to a lack of government leadership, which is especially important where multiple companies are working in one region. Observers, however, also note a lack of collaboration on advance planning between industry and government, and across the industry. Within the industry itself, local content, social or other requirements are often tacked on, once the overall contours of the project are set, and it is exceedingly difficult for large contractors, especially, to reset their plans once contracts have been signed and work begun.

The project cycle runs from complex front-end engineering design, detailed design, construction, installation and commissioning to long-term operations and asset support. (Figure 4 is a generic representation.)

Figure 4: Project cycle



Source: <http://www.clough.com.au/oil-and-gas/upstream-oil-a-gas-industry-menu-191/project-life-cycle-industry-menu-51.html>

2.2 Inadequate implementation of systems and procedures

Although certain standards are becoming more important as explicit elements of the contracting process, adequate attention is seldom given to ensuring they are put into practice. It is not enough simply to adopt standards and develop policies on paper. They have to be implemented and enforced — and there must be sufficient capacity to do both. Experts within the industry as well as concerned observers recognise that not enough attention is paid to the issue of implementation and enforcement and forward planning remains a low priority.

Operating companies and major contractors are aware of the issue but in practice fail to anticipate it properly. This relates not only to social standards, which are still poorly understood in the industry as a whole, but also to HSE standards, which are better understood and have been more widely adopted. Our research — including interviews with contractors on the ground — shows that at times, the transfer of key standards, codes of conduct and other procedures is limited to appending the relevant documents to the standard contract.

The contractor management process for an oil and gas project typically consists of the following main elements:

- contract language and contractual requirements
- bridging documents to align standards and expectations
- project-specific HSE and social management plans
- monitoring and reporting requirements
- validations/inspections/audits by the company of contractor operations
- end-of-project report

We argue that without sufficient training and awareness raising, a suite of documents is frequently inadequate to address the complexities of social and environmental requirements.

2.2.1 Commitments are subject to negotiation between IOCs and partners

The majority of IOCs have developed management systems to address the environmental and social

impacts of their operations, including compliance with national legislation, and usually these systems apply when the company is a majority shareholder or joint venture partner. They tend to commit to working with partners and contractors to deliver these standards, at least to a large extent.

But with increasing requirements for IOCs to partner with host-government NOCs — and with other NOCs, such as the China National Offshore Oil Corporation (CNOOC), increasingly operating internationally — IOCs sometimes find themselves in a minority position. In such situations, their commitments to implement certain standards are subject to negotiation between the partners and may be compromised in practice.

2.2.2 Procurement processes pay insufficient attention to standards

In prequalification/capability assessment and tender-selection processes, operating companies and engineering, procurement and construction (EPC) contractors tend to give preference to contractors who are certified to international standards, particularly ISO 9001.

But although there is frequently a corporate-level commitment to adopting major international social and environmental performance standards, industry observers suggest that procurement processes still treat HSE and social standards as low priority. As already noted, specific tools for ensuring that standards are incorporated into procurement processes (e.g. pre-screening on human rights) are only starting to be introduced or are in the early stage of development. Companies seeking to meet local content requirements sometimes take on subcontractors with the required technical expertise, but without demonstrated expertise in HSE and social standards (e.g. ISO 14001 certification), with a view to developing these management skills on the job. This can work only if training and supervision are adequate and timely. (Some industry experts appear to be shocked at any suggestion of lowering standards to allow local enterprises greater access.) There may also be issues around internal coordination. Corporate responsibility teams may get standards adopted at a high level, but procurement teams are not provided the necessary support and training to ensure that their procedures adequately incorporate the additional requirements.

2.2.3 Contracts fail to incentivise good environmental and social performance

A key issue highlighted in the course of our research is the language of the contracts negotiated between the

operating company and lead contractor, and with subcontractors along the chain. These contracts are important tools for establishing agreed sets of activities and obligations, setting standards, and establishing incentives and penalties for good or bad performance. Contracts generally require compliance with national law and regulations (including environmental regulations and labour law). But enforcement of the law is highly variable in some parts of the world, which may put a greater burden on the contract holder to ensure good performance.

The way that a contract is designed and negotiated determines the relative priority a contractor or subcontractor assigns to cost, speed of delivery, quality, and environmental and social performance. Box 6 summarises some of the key elements of an EPC contract. These elements also apply to other contracts throughout the chain.

A key issue is the balance of incentives and penalties in a contract. Contracts tend to incentivise keeping to cost and schedule (e.g. 80 per cent of incentives and penalties might relate to meeting deadlines within budget, whereas 5 per cent relate to correct environmental procedures). Moreover, where budgets allocated to environmental and social protection are not ring-fenced, they may be used for other purposes argued to be more urgent. Fixed-sum contracts can pose a particular challenge where no additional funds are provided to meet any additional commitments that arise after the contract has been signed – for instance, following impact assessments.

Contract holders are limited in the sanctions that they can invoke, particularly if they have tight construction deadlines to meet. They can apply financial penalties and withhold payment; they can address their concerns to the contractor's parent company or shareholders. Contract termination may not be desirable in terms of the potential costs and delay involved in a court action and the replacement costs in an industry already stretched for workforce during the construction phase.

2.2.4 Procedures for harmonising standards are confusing and complex

Different parts of the contracting chain are likely to work to different environmental and social standards (and it is worth noting that IOCs do not necessarily have higher standards than their contractors in every case). It is essential to harmonise standards and approaches at an early stage of the project. IOCs employ bridging documents to fill the gap between their corporate policies and those of their

first-tier contractors. This involves experts from the IOC looking at the contractor's HSE and social policy, management systems and procedures to make sure that they meet expectations. Where there are gaps they are addressed. Relevant documents are appended to the EPC contract, including the project environmental impact assessment (EIA) and impact mitigation commitments; HSE standards; and the code of conduct (including anti-corruption commitments). The contractor will pass on these requirements and commitments to the subcontractors as they see fit.

Project finance adds a further layer of commitments where lenders require an international-style environmental, social and health impact assessment (ESHIA) on top of the standard legal EIA requirements. For example, the BTC pipeline ESHIA consisted of 11,000 pages and over 3000 commitments; there were over 5000 commitments in the Sakhalin-2 project ESHIA. The timing of involvement of international financial institutions (IFIs) can also be problematic if new commitments are overlaid on a project after it has been approved, after contracts have been signed and/or after construction has begun.

Documents are sometimes available only in English, which may be a barrier to understanding for some contractors and subcontractors. In any case, the documents can be so dense and lengthy that assistance with interpretation is essential, yet frequently overlooked.

2.2.5 Enforcement of standards is difficult across dispersed contracting chains

At project level, the operating company is responsible for monitoring and oversight of the work of its first-tier contractors, who in turn supervise and monitor the subcontractors. Contractors and subcontractors are required to submit regular reports on their performance. On a construction site, the site manager makes sure that reporting requirements are met, but cannot personally observe all behaviour and outcomes.

Operators may arrange regular (e.g. monthly) and spontaneous site visits that include subcontractors, but the practical logistics of these may be difficult to arrange for distant locations. IOCs tend to have procedures for confidential internal reporting of unsafe, illegal or unethical conditions or practices. These include confidential company hotlines and policies of non-retaliation towards whistleblowers built into company codes of conduct.³⁵

IOCs admit that they cannot control everything that happens, particularly in remote sites. Each partner

along the contracting chain is likely to miss some instances of standards not being upheld, procedures not being followed or warning signs being ignored. Despite IOCs' drug and alcohol testing, policies of 'no hunting, fishing and gathering', and codes of conduct with anti-corruption clauses, drug and alcohol abuse, poaching and corruption still exist.

Many different agencies, including government agencies and IFIs, have roles to play in enforcing legal regulations and international performance standards. Civil society organisations also provide oversight and challenge complacency. Yet there tends to be a lack of coordination between different entities. Some contractors and subcontractors describe what they see as too much supervision and monitoring, making it difficult for them to carry out their work without interference. Company staff also report resistance from contractors and subcontractors during auditing and monitoring visits.

Overall, the picture is one of good intentions and multiple monitoring, supervision and audit arrangements, but one that at times suffers from insufficient overall coordination between stakeholders and throughout the chain, and an inability to implement procedures and systems effectively to enforce good-practice

standards universally. There also seems to be a lack of understanding that a policy on paper is a feeble weapon against entrenched cultural practices.

2.2.6 Public engagement and reporting remains limited

Most operating companies have stakeholder-engagement strategies and organise public meetings to fulfil their legal obligations, IFIs' requirements and corporate policies. Contractors and subcontractors, in contrast, rarely take part in formal stakeholder engagement. Operators may make commitments at public meetings — for example, on levels of local hiring — yet contractors and subcontractors may not meet these commitments if there are insufficient incentives in their contracts or lack of local capacity, or if they are unaware of the commitment or of local sentiment on the issue.

Similarly, contractors have fewer reporting obligations. The project operator will normally be obliged to report to the host government with regular performance statistics, including information on issues such as accidents, ecological indicators and waste management. They also report to their shareholders and to the public (via annual reports and sustainability reports). Some operating companies include their contractors' performance in

Box 6: The EPC contract

The EPC contract is the main project contract that legally binds the operator and the lead contractor (the EPC contractor). It includes a scope of work, outlining the technical specifications and detail of the activities to be undertaken or services to be provided. These objectives are frequently linked to incentives in the contract, mostly in the form of penalties and fines.

The basic priorities in an EPC contract are **time, cost and quality**.³⁴ Other features include:

- **A single point of responsibility.** The EPC contractor is responsible for all design, engineering, procurement, construction, commissioning and testing.
- **A fixed contract price.** Risk of cost overruns and the benefit of any cost savings are shifted to the contractor's account.
- **A fixed completion date.** Damages are payable if this date is not met.
- **Performance guarantees.** These are measured in terms of output, efficiency and reliability. Damages are payable if the contractor fails to meet the performance guarantees.
- **Caps on liability.** Liability is capped at a percentage of the contract price (frequently 100 per cent). Damages might be capped at 20 per cent of the contract price.
- **Performance specification.** This details the performance criteria that the contractor must meet, but the contractor is left to determine *how* they are met. Thus, almost all the construction risk is passed to the contractor.
- **Control.** In return for a guaranteed price and completion date, the operator cedes most of the day-to-day control over the construction. They have limited ability to intervene when problems occur during construction. The more they interfere, the greater the likelihood of the contractor claiming additional time and costs.



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their own corporate statistics. In general, lead contractors are obliged to report only to the operating company on their own performance, and they tend not to report on the performance of their contractors. This tends to reduce accountability across the contracting chain.³⁶

2.3 Cultural and contextual challenges

Citizens of oil-producing countries that experience heightened oil-related pollution or conflict often feel that oil companies do not consistently uphold global environmental and social standards. Accurately or not, they perceive companies as failing to bring their good-practice experience to these countries. This can underscore the importance of culture and socio-political context in ensuring good environmental and social performance.

Where Western companies are working in non-Western contexts, they frequently need to take into account the inherent tensions and trade-offs between the internal corporate environment and the state of governance and accountability in the host countries. There are many contextual factors, the most obvious being levels of transparency and corruption in national government and society as a whole, levels of democratic participation and the ability of civil society to hold government

and industry to account, and the capacities of the workforce involved in the project (be it predominantly local or imported workers).

2.3.1 Underdeveloped contractor markets pose risks as well as opportunities

In regions with underdeveloped markets for oil and gas services, these may be dominated by one or two leading companies. Performance, whether on quality, social or environmental standards, may suffer through lack of competition. There may also be political pressure from governments for operators to work with favoured suppliers. This can create or exacerbate significant challenges with respect to bribery and corruption (see section 2.3.2).

In some cases governments exert strong pressure to support the development of contractor markets so as to increase opportunities for maximising local content in oil and gas projects. Operators and major contractors may find it hard to justify delaying development of a project — perhaps for a year — while potential contractors are trained. Few project managers are given the best incentives to build time for training contractors into project schedules, particularly when this training is not ‘on the job’, but relates to development of the local market.

2.3.2 Corruption and patronage hamper effective contractor management

In December 2010 Nigeria's anti-corruption agency dropped bribery charges against former US Vice President Dick Cheney and oil services company Halliburton after the company agreed to pay fines totalling up to US\$250 million in a case dating back to the mid-1990s. This case, like that of Baker Hughes in Kazakhstan (where a US\$4 million bribe was paid for a US\$219 million contract), hit the headlines during the WikiLeaks revelations of late 2010.

The above are high-profile cases of alleged corruption on a massive scale. Much more common, but much more mundane, are the transactions that take place lower down the contracting chain. Doing business at any level in many oil-producing nations is impossible without instances of patronage, cronyism and corruption in all tiers of the contracting chain. This presents management challenges throughout a project's life cycle and can limit the effectiveness of a host government's efforts to capture more of the value of hydrocarbon development within the country.

In some cases corruption cannot be remedied by companies alone or at all, for example where corrupt government officials block or dissolve effective legislation. Transactions carried out in the lower tiers of the contracting chain may remain 'invisible', despite their potential to create operational and reputational risks higher up the chain. These might include small-scale bribery for overlooking violations of environmental regulations, or bribes paid for foreign work permits. Such bribes may happen without the knowledge of other players in the contracting chain. At that level, they may be an example of culturally accepted behaviour.³⁷

Leading companies often have a code of conduct that explicitly states their 'zero tolerance' of bribery and corruption. In Western headquarters, company experts may state with confidence that their code of conduct prevents corrupt practices throughout their operations.

On the ground, however, many company staff feel that they lack the power to address corruption throughout contracting chains. Lack of resources for audits may be just one problem. Promoting zero tolerance among local staff is unlikely to remove underlying issues. These may relate to local expectations and established practice, along with the pressure of performance targets that can be met more easily if a bribe is paid. Furthermore, where companies are forced to work in joint venture partnerships with NOCs in host countries, it is very difficult to alter the culture and practices of those NOCs.

2.3.3 Limited understanding of local culture and practice increases risks

Changing behaviour is as much a matter of cultural change as it is a management or regulatory issue. There have been positive examples of changing behaviour in the oil and gas industry. On Sakhalin Island in Russia, these include efforts to encourage workers to use protective gear such as hard hats on worksites, and promotion of road safety (encouraging the wearing of seatbelts and discouraging drink-driving). Road-safety campaigns have also been extended to the wider community.

Uptake of international standards and business culture may, however, be influenced at the individual and corporate level by the attitude that 'we don't want outsiders to tell us what to do'. This extends to the project sites, where local workers may refuse to wear hard hats and safety clothing because they have never done so before for similar work.

In some cases in outlying areas, community issues — especially minor ones — are addressed directly between local oil workers and local residents. In places where the oil workers are long-serving, these relations have developed effectively.³⁸ Where the workers are new to the area, they may be unfamiliar with local cultural norms — or they may be perceived as unwanted interlopers taking local jobs. This may undermine their ability to resolve issues at the local level, and it may increase the risk of local-level conflict.

3

PART 3

Taking action

Creating resilient, responsive and high-performing relationships throughout the contracting chain is a long-term process that requires commitment from all parties to achieve the right results. In this section we outline a set of actions that have been identified as good practice.

But more than the individual actions, a critical change must take place in the relationships between and among various stakeholders. This includes relations between operators and contractors or subcontractors along the contracting chain, but also relations with other stakeholders, notably government. We are advocating not just a more explicit treatment of environmental and social issues in contracting relationships, but a significant shift in attitudes between the parties as to what outcomes are in the best interests of all involved, and how they will work together to ensure those outcomes.

Some experts with whom we consulted on this report rightly noted that these actions may represent significant additional costs to the companies involved. Some commented that this may not be desirable to many companies; others appreciated the value of investing in these actions up front to reduce the cost of addressing major issues at a later date.

We do not offer guidance on how to prioritise different options if such decisions have to be made. We do recommend, however, that the bottom line be good environmental and social performance; in light of this, companies and governments in the more challenging oil-producing regions should work together to optimise rather than maximise local content, and all actors should ensure performance considerations and outcomes remain top priorities.



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Action 1: Collaborate on early-stage planning and assessments

Assessment and planning need to take place in the early stages of the project cycle — where possible, during the approvals and contract-negotiation phase, and at least during the stage of front-end engineering design (FEED). They may also take place in the early stages of strategic planning for business development when a company is seeking to develop new business in a region, before any projects have been agreed.

The responsibilities table (Table 3) provides the framework for Action 1. It is in these early stages that legislative requirements and stakeholder expectations are established and management objectives are set. In order to foster shared responsibility for good environmental and social performance, it is important that operators work in collaboration with government and first-tier contractors to the greatest extent possible.

Meaningful engagement with government is necessary to develop appropriate local content strategies, emergency response plans, etc., and to understand and potentially improve the overall environment that enables responsible business practice. Understanding the expectations and drivers of the NOC is also essential. It is useful to collaborate with government agencies that are anticipating increased industrial activity in a region or developing strategies in response to legislative changes.

An example is the local enterprise capacities study carried out jointly by the Norwegian and Nigerian governments (see Box 7). If several operations are located in close proximity, operators could collaborate as a way to share the costs and benefits of joint assessments. Engagement should not be limited to the government and the operator, as the contracting community may be better placed to assess local capacities, understand development requirements and ultimately deploy local services — either directly or through subcontracts.

At the earliest stages, it is important to foster a culture of teamwork and shared responsibility between the operator and the first-tier contractor. Joint assessments and engagement with government agencies may be a way to do this. Opportunities to cultivate this relationship are limited before the operator has identified its first-tier contractor, but there may be opportunities to engage major contractors collectively, especially where tenders for several projects are on offer.

Key activities:

- Define the **legal requirements** as they relate to the work to be carried out throughout the contracting chain. These should be passed to the contracting community through an open and transparent tendering process that takes into account the need for high standards of environmental and social performance (see Action 3).
- Complete an **environmental and social risk assessment** focusing on the contracting chain, identifying any potential capacity gaps, and an action plan to address these risks and gaps (including training and management procedures). **Environmental and social impact assessments (ESIAs)** should be carried out as early as possible; additional requirements (e.g. from lenders) should be predicted well in advance, preferably (in preliminary form) before EPC contracts are signed.³⁹
- Identify **stakeholder expectations and perceptions** and ensure that these are considered fully in the process of making commitments and developing policies and procedures. Where expectations cannot be met or perceptions are unrealistic or mistaken, they should be managed through awareness raising and direct engagement. **Stakeholder engagement** is an ongoing process throughout the lifetime of the project and should include contractors and subcontractors as early as possible. Commitments made to stakeholders (e.g. regarding local hiring) should be ‘owned’ by those responsible for meeting the commitments.
- Complete an **analysis of workforce and local-enterprise capacity** (including environmental and social performance) and of overall long-term socio-economic impacts and opportunities associated with the project.⁴⁰ Develop a **policy and action plan to optimise local content** with a strategy for increasing education and building capacity in local markets to meet international environmental and social performance standards for the industry. This should present a broadly coherent view on making the most of local talent while minimising risks.
- Clarify the **environmental and social standards, procedures and methods** that will be used to manage and evaluate project performance. Operators and contractors should collaborate on this, in consultation with government experts, to ensure consistency across business functions and throughout the contracting chain.

Box 7: Statoil: Enhancing fabrication capabilities in the Nigerian oil and gas industry⁴¹

In 2000, a detailed study was commissioned jointly by the governments of Norway and Nigeria to assess the enabling environment for private-sector development in the Nigerian upstream petroleum industry and to recommend ways of increasing and improving the capabilities of Nigerian supply and service companies. The result was a report, *Enhancement of Local Content in the Upstream Oil and Gas industry in Nigeria*, which has subsequently been used for work related to development of local content legislation in Nigeria. The report identified the fabrication industry (manufacture and assembly of project components) as having the highest potential for increasing Nigerian content, taking into account the potential for increasing employment and locally manufactured equipment.

Based on this detailed contextual analysis, the project Enhancing Fabrication Capabilities in the Nigerian Oil & Gas Industry was created with the

aim of increasing the competence and capabilities of small and medium-sized fabricators in Nigeria, enabling them to better compete for work in the country's oil and gas industry. The project is managed by the IFC and is funded on a 50/50 basis by Nigeria and Norway.

The execution phase of the project ran from 2008 to 2010. In this phase, seven small and medium-sized Nigerian fabricators were assessed in detail against international quality-management standards to identify potential gaps. The project subsequently aims to work with these seven companies over two years to help close these gaps through training and capacity-building. The project has also established the Fabrication Training Centre (FTC), located at the Industrial Skills Training Centre in Lagos and officially opened in October 2009. The training centre includes classrooms and welding workshops has been used for the technical courses run by the project. Work is ongoing to establish sustainable governance and participation, ensuring that the FTC has a long-term future after completion of the project.

Action 2: Invest in capacity building in underdeveloped local markets

In regions where the economic and business climate is immature, the oil and gas sector may suffer through lack of access to sufficiently qualified subcontractors. The process of overall economic, enterprise and skills development resides with government and local authorities, especially where multiple companies are present in a region. Nonetheless, it is in the interest of companies to support cross-industry collaboration on understanding local needs and investing in capacity-building, together with governments. Civil society can help to increase awareness and advocate on where resources might best be applied.

Ideally, capacity-building ought to start in advance of any specific project decisions. This may be possible if a company is interested in a particular region and has a number of potential investment opportunities. For example, Statoil's supplier-development programme in northwestern Russia started up several years before they negotiated a share of the Shtokman project.⁴² Where it is not feasible to plan in advance, these activities should start as early as possible in the project cycle. In any event, the time horizon should be as long-term as possible; there is a limit to the depth of capacity-building that can feed into a two- or four-year construction project, and all too often this means the longer term is not addressed.

Capacity-building serves the interests of both companies and wider society – the former by enabling local content targets to be met in regions of low historical capacity, and the latter by stimulating robust and varied local markets, and enhancing opportunities for employment and enterprise development. Companies that take a long view of building up local contractor markets and workforces, including assessment of local capacities and discussion with local government about priorities, may enjoy the strong support of local

communities and governments, and the best results. This may also help them secure future projects.

More and more companies are using social investment funds to support education, training and capacity building (see Boxes 8 and 9). Strategic investment in building local capacity to provide services to the industry is a prime opportunity for companies to deliver local development opportunities that can directly benefit their business. Increasingly, this is viewed as more valuable than one-off investments such as building clinics or schools, which may have only a short-term political benefit, especially in cases where there are no nurses or teachers, or where there is no further investment and buildings fall into disuse.

Key activities:

- **Engage with government agencies and experts** to ascertain local capacity needs (see Action 1).
- **Support educational programmes in higher education establishments** in subjects relevant to the oil and gas industry.
- **Fund programmes to build capacity** of the local workforce and businesses, including training in international environmental and social standards, in collaboration with local government and/or educational establishments.
- **Encourage joint public-private initiatives** in this area. Frequently public funds are available for local SME development, including such activities as Environmental Management Systems (EMS) certification, which allows for cost-sharing.
- Engage with and **support existing associations of contractors and suppliers** to the oil and gas industry to build enterprise and workforce capacities.

Box 8: BP Azerbaijan's Enterprise Centre

BP set up its Enterprise Centre in 2002 on behalf of its project partners in Azerbaijan (Chevron, Statoil, ExxonMobil and the State Oil Company of Azerbaijan Republic or SOCAR). The aim is to help small and medium enterprises (SMEs) to enhance their business capacities and improve their opportunities to win contracts with major oil and gas projects. The US\$15 million Supplier Finance Facility was launched in 2007 in collaboration with the IFC and the Micro Finance Bank of Azerbaijan to provide transparent sources of finance for local businesses, allowing them to use their contracts with BP as part-collateral for loans.

A three-year Enterprise Development and Training Programme was launched in 2007 to assist local enterprises in building the necessary skills and knowledge to reach international standards to compete for supply-chain contracts. Initial advice is provided free of charge, but local companies are expected to invest in training and consulting as required. Such companies are more likely – but are not guaranteed – to win a contract with a major oil project in the future. Since the programme's inception, more than 150 local SMEs have undergone assessments. In 2008, 14 local SMEs signed long-term contracts with BP Azerbaijan totalling more than US\$50 million.⁴³

Box 9: Statoil: Building the capacity of educational institutions in northwest Russia

Statoil has invested in developing the capacity of local education institutions in northwest Russia, a region that is likely to become an increasingly important operating area for the company in coming decades.

At Pomor State University, Statoil has contributed financially and in the form of technical assistance to the development of a Bachelor of Business Administration (BBA) degree focusing on petroleum management. The programme has been developed in close collaboration with the Norwegian University of Science and Technology, and it also receives funding from the Norwegian Ministry of Foreign

Affairs. Emphasis has been placed on building skills and capacity within Pomor University itself to ensure that in five years the university will be able to run and manage the BBA without any further external assistance. The first two groups of BBA students have recently graduated.

Statoil also helped to initiate a technology-transfer programme between the Arkhangelsk State Technical University (ASTU) and the University of Stavanger, aimed at expanding the technical courses offered at the ASTU to include advanced drilling technology, offshore technology and seabed and underwater technology. New curricula were designed and offered for the first time in autumn 2007. The programme has also led to further bilateral agreements and projects between the two universities in these areas.⁴⁴

Action 3: Encourage uptake of standards through procurement processes

Part 1 and Part 2 highlighted several areas of concern in relation to procurement processes. The first is the need to prioritise health and safety, environmental and social standards in procurement processes, alongside requirements for other standards (such as ISO 9001 on quality). Second, there is a need to promote opportunities for smaller local contractors to gain access. Often, local contractors can benefit considerably when the procurement process is simply made friendlier to small and newly established businesses, and when environmental and social expectations are clear from the beginning. Third, procurement processes need to be designed as much as possible to resist corruption and patronage practices that are endemic in many local societies.

Key activities:

- **Include health, safety, environmental and social stipulations in pre-qualification processes and tender requirements.** Where SME suppliers are

unable to meet these requirements immediately, arrangements should be made to ensure training is provided before the start of and during the course of the contracted work.

- **Increase the transparency and accessibility** of tender processes by increasing the information flow – for example, by publishing information on websites and community notice-boards, by engaging with small-enterprise associations or by hosting supplier workshops.
- **Introduce electronic procurement (e-procurement) systems** that reduce the risk of corruption and patronage by keeping bureaucracy and gate-keeping to a minimum. Such systems preserve the anonymity of bidders, which helps ensure contractors are hired on the basis of merit.
- **Resist pressure from local authorities to hire or support specific enterprises.** It may help to bring third parties into discussions with authorities to increase transparency around such discussions.

Box 10: ExxonMobil's e-procurement initiative in Chad⁴⁵

ExxonMobil's operations in Chad have included the development and implementation of a comprehensive system for procurement, especially geared towards the needs of SMEs. It hinges on an e-procurement system designed to remove human contact at certain points in the process, thus avoiding corruption and enhancing consistency and transparency of information and procedures. The system includes:

- **SME mapping** to identify local SMEs and ensure the greatest possible degree of outreach, so that more companies are aware of tender opportunities

- **SME rating system** of one to three stars, used to assess ability and competency
- **Public workshops**, open to all comers, used to communicate uniformly and transparently to the contractor market about tender opportunities and ExxonMobil's requirements
- **Access to IT** to enable interested companies to prepare and submit bids
- **Training and skills enhancement** to allow SMEs to build their capacity to use the e-procurement system effectively
- **Access to finance**, in partnership with financial institutions, to build SMEs' ability to deliver contracts.

Box 11: Sakhalin Energy's Vendor Development Programme, Russia⁴⁶

Sakhalin Energy's Vendor Development Programme is aimed at preparing potential vendors to apply for tenders in the oil and gas industry. The programme is open to experienced oil and gas industry contractors and to enterprises that have no prior experience in the oil and gas sector. Participants in the programme receive a password that allows them to access materials via the Sakhalin Energy website.

Training courses cover HSE, quality management and tendering skills. Benefits include:

- learning about international companies' requirements for their contractors in environmental protection and safety, and quality of goods and services provided
- access to information about Sakhalin Energy's tendering process, training in preparing bids and participating in tenders, and advice on the most common mistakes in preparing bids
- opportunities for companies to demonstrate their capabilities.

Certificates are provided to companies on completion of the training course. Sakhalin Energy emphasises on its website that completion of the training does not guarantee successful bidding for any of their tenders. Sakhalin Energy also offers online access (password not required) to information about current and upcoming tenders for provision of services, equipment and materials; a list of successful bidders for major contracts that have been awarded; and news updates about local enterprises that have won contracts with the Sakhalin-2 project.

Action 4: Ensure that contracts incentivise good practice

As noted in Part 2, the way that a contract is designed and negotiated determines the relative priority assigned to cost, speed of delivery, quality, and environmental and social performance. We have also cautioned against an over-reliance on standards and procedures on paper, and we have emphasised the importance of good management practices, relationships and alertness. One of the experts we consulted commented that the search for the perfect contract is a bit like the search for the Holy Grail, and really it's all about relationships and building trust.

Be that as it may, we believe that there are certain areas where contracts can be designed to incentivise good environmental and social performance. Current contractual design tends to disincentivise this.

Key activities:

- Recognise that the areas of a contract carrying the biggest incentives and penalties will be prioritised over others. Therefore, **find a balance between incentives for cost and schedule, and those for responsible practice**, to make sure that cost and schedule are not prioritised over other considerations.
 - **Ring-fence budget lines for environmental and social protection**, or be prepared to allocate additional funds when the need arises.
 - **Allow contractors to review technical specifications** and suggest amendments to their terms of reference in advance of signing contracts; incorporate a mechanism for capturing feedback and lessons learned post-signing.
 - In addition to including **environmental and social standards for the project in all EPC contracts**,
- prioritise development of bridging documents. Comparison of standards to align approaches and agree common standards and means of assessing performance is essential during negotiations between the operator and a first-tier contractor.
- Work with first-tier contractors to **include corporate environmental and social standards in all subcontracts** and to create mechanisms to support understanding and implementation.
 - **Provide support and training to help contractors understand and apply commitments** to good environmental and social performance and risk mitigation. Seek, where feasible, to **complete preliminary environmental, social and health impact assessments before signing contracts** with first-tier contractors. Where IFIs (or other standard-setters) are expected to be involved, their involvement should be pre-empted by preparing for a full ESHIA and other likely requirements. Where this is not possible, the risks ought to be assessed and mitigated. Contractors should be informed in advance of signing contracts about possible further requirements, with provision for additional budget to allocate to later requirements.
 - **Extend transparency and anti-corruption requirements to contractors** (and require that they are extended to subcontractors); provide appropriate **training and awareness-raising for employees** in all departments and at all levels of the contracting chain.
 - It may also be useful to provide **training and awareness-raising for local officials** and others who may be engaged in small-scale ethics transgressions lower down the chain. Understanding these people and their constraints may offer insights into ways of addressing corruption at this level.

Action 5: Build capacities and trust on the job

Contractors can benefit from on-the-job training whatever their level of skills and capacities — and whatever the local context. For example, training might relate to the set of skills outlined in the BP assessment of the Deepwater Horizon disaster (see Box 2 in Part 1), or to building the skills of inexperienced local contractors to improve social risk management (see Box 12 below). Other key areas include emergency response training, particularly oil spill response, and road safety.

Where the capacity of local contractors is low, companies tend to follow one of two preferred paths. Some focus on capacity-building of local contractor markets as a whole, with a view to building up the available pool of local contractors (see Action 2). Others have a preference for longer-term contracts with local contractors, combined with capacity-building on the job.⁴⁷ Regardless, the overall aim of on-the-job capacity-building is to enhance the ability of contractors to meet and exceed requirements — for robust, quality service, and for environmental and social performance.

Key activities:

- **Set aside sufficient budget** for contractor capacity-building on the job and develop a **long-term management plan** to ensure social and environmental skills and knowledge are up to date.
- Provide **training** to contractors to aid understanding of the full technical specifications and environmental and social standards appended to their contracts; assist contractors in developing their own **environmental and social management plans**.
- Assist contractors in planning and carrying out appropriate **training and awareness-raising for subcontractors**.
- **Ensure reporting, communication and feedback mechanisms are effective and consistent** throughout the contracting chain, between operating companies, first-tier contractors and subcontractors.
- Consider, where possible, **longer-term contractual relations for local subcontractors** with the aim of building contractors' capacities, mutual understanding and trust over time.
- Develop **cultural awareness** among contractors and subcontractors, particularly those from outside the region, to facilitate their engagement with local communities. At the same time, operating-company staff from outside the region can also learn from local contractors with greater local understanding and knowledge.

Box 12: Sakhalin Energy: management of social issues in the contracting chain⁴⁸

This box summarises actions taken in 11 key areas by Sakhalin Energy's Social Assessment Group to manage social impacts over the lifetime of the Sakhalin-2 project. The construction phase involved 10 first-tier contractors and more than 100 subcontractors, with up to 25,000 workers at the peak of construction activities. Some contractors had multinational personnel, and some consisted of Russian nationals only.

1. Contracts

During the tender process, the results of social, environmental and health impact assessment were considered in the EPC contracts. At a later stage, when the project's Health, Safety, Environment and Social Action Plan (HSESAP) was developed (as a requirement of the project lenders), its provisions became compulsory requirements for contractors.

Initial bid release. Bidders were required to include a preliminary Social Performance Management Plan (SPMP) as part of the tender bid (including plans for community engagement, grievance resolution, impact mitigation and standards).

Evaluation of bid offer. Bidders were required to respond to socio-economic questions; preliminary SPMP was analysed.

Contract award. Social-performance terms and conditions were included in final bid discussions.

Post-award. Contractors were assisted in preparing final SPMP; contractor plans were reviewed; a plan for compliance with Sakhalin Energy requirements was devised; assistance in improving the plan was given; the plan was approved; workshops and training were offered.

Ongoing interactions and monitoring. Social Assessment Group specialists interacted with contractors during construction; contractors' community liaison officers (CLOs) were assisted in community interaction; SPMP implementation was monitored.

The first-tier contractors whose work related to construction of facilities or pipelines with significant potential social impacts were required to

prepare more detailed Socio-Economic Management Plans as part of their tender submission. First-tier contractors incorporated the plans into their contracts and cascaded the relevant commitments to their subcontractors. Some plans were revised based on lessons learned or additional and altered commitments.

2. Code of conduct

During induction, all contractor staff were trained on the code of conduct, including business principles such as confidentiality of information, acceptance of and reporting of gifts, and other general principles of business conduct; the policy against hunting, fishing and gathering of natural resources; contractor camp management and workers' housing; interaction with local communities; grievance procedure; public behaviour; waste management; and other requirements. Key provisions of the code of conduct were discussed with communities. Awareness campaigns included leaflets, posters and meetings, and significantly contributed to compliance. Awareness and compliance, including cascading of the policy to staff and subcontractors, have been monitored by the Social Assessment Group and CLOs.

3. CLOs

Sakhalin Energy requires contractors to have their own CLOs or to nominate a social focal point to be responsible for addressing community matters. Responsibilities include building and maintaining good community relationships, monitoring social issues, liaising with Sakhalin Energy's CLOs, social reporting, assistance to communities, participating in contractors' social projects, and regular open hours and public meetings organised by Sakhalin Energy. In the construction phase, the onshore pipeline contractors had six CLOs (including two for the subcontractors), with social focal points nominated for the three major construction sites. Sakhalin Energy provided training to CLOs, facilitated access to information, conducted internal and external monitoring, and maintained records on consultation, social monitoring and grievance resolution.

4. Grievance resolution

Grievance resolution involves Sakhalin Energy CLOs and Social Assessment Group, and contractors' CLOs and social focal points. The Social Assessment Group monitors the status of grievances on a monthly basis and ensures that

managers are made aware of issues not resolved within the stipulated 45 working days; the group also watches for repeated grievances that may require special efforts to address an underlying issue. The grievance mechanism has received recognition from UN representatives testing the Ruggie Principles and an award from the Shell Group.

5. Russian content and employment

The Sakhalin-2 project Production Sharing Agreement (PSA) commits Sakhalin Energy to making its best effort to use at least 70 per cent Russian labour, materials, equipment and contractors over the life of the project. Contractors have reported regularly on the Russian content of employment, goods and services, and overall progress has been reported in the corporate annual report. Contractors were required to provide accurate information about job opportunities in advance to local communities. Regular meetings have been held with local employment centres. Beyond the commitments made in the PSA, Sakhalin Energy has encouraged procurement from locally owned and operated businesses.

One of the challenges has been to keep local expectations realistic. At every public meeting conducted by the company in Sakhalin communities, contractors have explained the standards and competencies required of people working on the project. Sakhalin Energy's CLOs have regularly visited local community employment centres to elicit local perceptions of contractors' efforts to recruit and hire local and Russian workers, and to make sure the information provided was sufficient for planning within the local labour market. Contractors are required to support training and educational programmes and initiatives in communities (e.g. career fairs). Contractors have maintained employment records that identify the communities employees came from and have reported on recruitment measures taken in communities.

6. Resettlement

The project's Resettlement Action Plan describes the policy framework and procedures to address land acquisition and resettlement (based on World Bank policy). It contains compensation and mitigation measures for people and enterprises affected by the project. Contractors were required to include in their socio-economic plans the steps to be taken if they planned to acquire property or land, describing how they would adopt the principles and

procedures of the project's Resettlement Action Plan, coordinate their intent to acquire land or property with Sakhalin Energy, assess potential socio-economic impacts using a methodology similar to that used by Sakhalin Energy, conduct community consultations and provide results to Sakhalin Energy for review and approval prior to acquisition, and take measures to reduce identified adverse impacts to acceptable levels.

Key areas 7-11

Other aspects of social issues management throughout the contracting chain include **camp management** (living standards, behaviour, and leisure and services); **archaeology and cultural heritage** (meeting international standards to mitigate impacts); **indigenous peoples** (engagement and communication plans, socio-economic plans, grievance resolution and impact mitigation, based on World Bank policy); and **social investment spending** (contractors were required to set up their own social investment projects, based on Sakhalin Energy criteria).

12. Monitoring and reporting

The monitoring and reporting process consists of a multi-level interface between the company and contractors. CLOs make weekly reports to Sakhalin Energy; the contractor makes monthly reports to Sakhalin Energy using the Social Compliance Monitoring Handbook (see below); the contractor's CLOs have daily contact with Sakhalin Energy CLOs and monthly debriefing meetings in Sakhalin Energy's head office. Sakhalin Energy carries out biannual field monitoring of contractor performance (primarily via polling of communities and contractor workers, direct observations and document reviews).

The Social Compliance Monitoring Handbook forms the basis for the monitoring process. It includes checklists, questionnaires and reporting data sheets. Completed questionnaires and checklists are delivered to the Social Assessment Group monthly and undergo quantitative and qualitative analysis. Training and refresher sessions on how to use the handbook have been held regularly for contractors and subcontractors; the sessions also give them an opportunity to provide feedback on the process. CLOs have the principal responsibility for observing the work of contractors and describing their activities in reporting forms.

Action 6: Ensure excellent communication and oversight throughout the chain

In addition to having contracts, policies and procedures, and building the capacity of contractors and subcontractors to implement these effectively, attention should be paid to the quality of relationships between the operating company and the other members of the contracting chain.

Constructive relationships are built by ensuring good communication, mutual trust and shared understanding of goals and objectives. Reporting and oversight mechanisms should be clear, consistent and not onerous; they should be coordinated with any third-party reporting and oversight mechanisms.

Key activities:

- Establish **open lines of communication** between operators, contractors and subcontractors, with an explicit agreement that **performance expectations are a shared aspiration**.
- Establish **feedback loops and other learning mechanisms** so contractors can continuously improve and learn from each other.
- Ensure **sufficient on-site supervision**, coordinating efforts with government, lenders and others to avoid overload or confusion for supervisory staff or contractors.
- Require first-tier contractors to **include subcontractors' health, safety, environmental and social performance indicators in the company's own results** when reporting internally.
- Ensure that confidential internal **whistle-blowing mechanisms (e.g. hotlines) extend to contractors and subcontractors**, and feed into **response mechanisms** for improved practice.
- Provide **CLOs** (usually hired by operators) with sufficient **authority to work with contractors and subcontractors**. Contractors and subcontractors should be encouraged to engage with the CLOs of operating companies, and where appropriate should employ their own CLOs.

Action 7: Build trust and accountability with external stakeholders

NGOs and community groups are calling for greater transparency about contractors and subcontractors, and greater clarity about chains of responsibility relating to a project. As noted in Part 1, there is increasing interest (including from GRI and IPIECA) in public reporting that includes contractors and subcontractors. It is important to enable public scrutiny of and confidence in performance along the chain and to build public understanding of the realities and challenges of managing complex contracting relationships.

Contractors and subcontractors should be encouraged to take part in stakeholder-engagement initiatives as much as possible. Key approaches to stakeholder accountability include public meetings, educational campaigns, tracking and reporting of formal statistics, and company-led grievance procedures. Third-party oversight⁴⁹ includes monitoring panels, citizens' oversight bodies (see Box 13), direct NGO monitoring of project activities (see Box 14), and use of social media tools, such as Niger Delta Watch, an online monitoring tool that allows people to report and locate environmental and social issues (not only those related to the oil and gas industry).⁵⁰

There are various ways for companies to support third-party oversight by civil society groups. Direct funding can be controversial and is often refused by NGOs and community groups. There are some examples, however, such as the Alaska initiative described in Box 13 below, where companies in a single region have contributed to a central fund that is governed in such a way as to be clearly independent from company influence.

Whether NGOs are independently funded or not, operating companies should be prepared to meet with them, engage in meaningful dialogue and provide introduction and access to contractors and subcontractors as appropriate. Contractors and subcontractors should also be encouraged to build their skills in open public engagement and engage directly with local NGOs and community groups.

Key activities:

- Encourage more **public reporting of performance** by all members of the contracting chain, using a systematic reporting framework such as the GRI Guidelines or IPIECA guidance. Operators should include contractors' health, safety, environmental and social performance indicators in the company's own results when reporting to the public, government and shareholders.
- The **lines of responsibility** between members of the contracting chain should be made clear in public documents. Ideally this should cover both the management systems and processes for ensuring good performance throughout the contracting chain, as well as the actual performance attained.
- Contractors and subcontractors should be encouraged to **engage with the CLOs** of operating companies and, where appropriate, hire their own. CLOs should be provided with adequate information and tools on social and environmental performance to meet stakeholders' needs and anticipate risks. **Grievance mechanisms and CLO activities** should provide opportunities for communities to address issues related to contractors and subcontractors effectively. This should include a system of third-party recourse, for example if a contractor or subcontractor is not paying its workers or is discriminating among them, or if local communities are affected by negligent work.
- Encourage more **direct engagement** of contractors and subcontractors with communities and civil society organisations, including public consultation.
- Provide **training in community relations and stakeholder engagement** for contractors and subcontractors, especially if they are unfamiliar with local culture and issues.
- Consider **citizens' oversight groups** as providers of effective third-party oversight, but provide arms-length funding and appropriate governance mechanisms to avoid compromising their objectivity and legitimacy. Such arrangements may also require support for necessary training, and will need time to build the necessary trust between the local groups and the operating company.

Box 13: The Prince William Sound Regional Citizens' Advisory Council⁵¹

The Prince William Sound Regional Citizens' Advisory Council (PWSRCAC) was mandated in the United States Oil Pollution Act of 1990. It is an independent nonprofit corporation that aims to promote partnership and cooperation among local citizens, industry and government, to build trust and to provide citizen oversight of environmental compliance by the Alyeska Pipeline marine terminal in Valdez, Alaska, and the oil tankers that use it. PWSRCAC is accountable to its 19 member organisations, which include representatives from communities, aquaculture, commercial fishing, environmental, Alaska native, recreation and tourism groups.

In February 1990, PWSRCAC and Alyeska Pipeline Service Company signed a contract that ensures the independence of PWSRCAC from Alyeska, access to Alyeska facilities, guaranteed annual funding, and assurance that the contract will last as long as oil flows through the trans-Alaska pipeline. Under the terms of its contract with Alyeska, PWSRCAC reviews, monitors and comments on various aspects of the company's operations, including oil spill prevention and response plans, environmental protection capabilities, actual and potential environmental impacts of terminal and tanker operations, and raising public awareness about these matters. The council was initially funded at US\$2 million a year. The funding is renegotiated every three years; current Alyeska funding is approximately US\$2.8 million a year.

Box 14: Sakhalin Environment Watch: independent NGO oversight

Sakhalin Environment Watch⁵² has been working with international partners since the mid-1990s to monitor and hold to account the Sakhalin oil and gas projects (in addition to work on forest protection). Its strategies include extensive documentation of the impacts of project activities such as dredging and pipeline construction on local wildlife, traditional land-use areas and local infrastructure. Sakhalin Environment Watch has published photographs from monitoring expeditions on its

website, and some of its evidence has been used in court cases relating to environmental damage. The group has also collaborated on joint campaigns with local indigenous peoples' organisations. It has engaged directly with the Sakhalin-2 project lenders and potential lenders (notably the EBRD) and has provided information on environmental and social issues to the media both nationally and internationally. Sakhalin Environment Watch does not take funding from oil companies; it is funded by international NGO partners and foundations. The organisation does, however, engage directly in dialogue with oil companies where possible.

4

PART 4
Conclusion

As described in this report, a great many challenges arise from the difficulty of establishing coordination and shared ownership of oil and gas projects. The complexity and diversity of the contracting chain has encouraged this state of affairs, and it has also increased social and environmental risks inherent in projects. Good social and environmental performance in practice relies on the actions of all stakeholders together, regardless of the good intentions and practices of any individual. Therefore, a fundamental recognition of these challenges and commitment to improvement over time and across the industry must underpin all of the initiatives and actions intended to improve performance.

Beyond the specific actions recommended above, success will depend on a significantly improved commitment to collaboration and shared responsibility across the industry. It is too early to make any definitive pronouncements about how this will be brought about. We propose the start of a new dialogue within the industry, based on the following essential elements:

- **A culture of teamwork and shared ownership:** IOCs, governments, NOCs, lead contractors and subcontractors will need to develop tools and attitudes that support a joint approach to project success.
- **Less reliance on paper exercises, more on culture and communication:** In the execution of projects, partners must support one another in identifying and resolving problems and challenges, not avoiding them or deferring them to others.
- **Emphasis on long-term time horizon and outcomes, regardless of the timeline of individual activities:** Contractors and subcontractors should be encouraged to see how their roles contribute to the overall performance of the project and broader sustainable development goals.
- **Agreement to improved industry-wide practices to increase capacities and participation among local firms:** These may include common procurement practices, a code of conduct or industry commitment, common audit mechanisms and other tools.
- **Commitment from all companies in the chain to engage meaningfully with external stakeholders at all levels,** ensuring that issues and concerns are addressed appropriately and adequately.

Throughout this project, we have been convinced that the oil and gas sector has the potential to deliver significantly improved environmental and social outcomes through its contracting chain relationships. We are also struck by the scale of potential consequences — by what the industry, environment and society have to lose if this potential is not fulfilled.

We remain committed to supporting and encouraging the good practices and changes in attitudes that can help underpin the success of these endeavours.

Endnotes

- 1 Phrase used by William K. Reilly, the chair of the US Presidential Commission reviewing the Deepwater Horizon disaster (see Box 2).
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- 12 <http://www.oilspillcommission.gov/final-report>
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- 50 Niger Delta Watch website. See: www.nigerdeltawatch.org
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High oil prices and concerns about energy security are driving expansion of the oil and gas industry into ever more sensitive environments with greater technological, political and social risks. While brands such as BP, Shell and ExxonMobil are well known, some 75 per cent of oil and gas industry activities are typically contracted out to specialist service providers and their subcontractors. These contracting chain relationships can be difficult to manage, and often carry social and environmental performance challenges. The fallout from the April 2010 Gulf of Mexico disaster shone a spotlight on some of these difficulties in contracting relationships. Risks are heightened in less developed countries where corruption may be endemic and governance weak. Effective management of contracting chains — from early assessments to communication and oversight — is critical to ensure good social and environmental performance. This report draws on three years of research and interviews within the oil and gas sector to highlight an array of critical challenges facing oil and gas companies involved in complex supply chains, and to identify urgent and longer-term actions for progress.

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