

THE SOVEREIGN WEALTH FUND FOR LEBANON: SHORTFALLS OF THE CURRENT APPROACH AND RECOMMENDATIONS FOR THE WAY FORWARD



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CONTEXT

The Budget and Finance parliamentary committee has announced the finalization of a draft law on the establishment of a Sovereign Wealth Fund (SWF) for oil and gas following a seven-month long discussion in Parliament.

This discussion, held behind closed doors, confuses – intentionally or not – two types of “sovereign funds”. The first fund refers to the 2010 law under which net proceeds collected or received by the government from petroleum activities or petroleum rights are to be placed in a sovereign fund. The second fund relates to the bank and gap resolution frameworks and the establishment of a “deposit recovery fund” with operating rules that remain unclear until the moment.

This note solely pertains to the discussion regarding the establishment of a SWF intended to manage potential proceeds from the oil and gas sector. However, considering the aforementioned confusion, **it is already evident that such a separation is impossible until fundamental questions regarding debt restructuring, the central bank and banking sector restructuring are resolved.**

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DO WE NEED A SWF TODAY?

The law organizing the oil and gas offshore sector (2010) states that proceeds from oil and gas shall be allocated to a SWF. The purpose of that provision¹ was essentially to avoid any political and clientelist capture of this future wealth. It explicitly stipulates the establishment of a Sovereign Wealth Fund leaving the “statute regulating the Fund, the rules for its specific management the principles of investment and use of proceeds to be regulated by a specific law.” While the objective related to preventing corruption is valid, changing economic conditions since 2010 require reopening the debate on the relevance of a SWF, pending clarity on future proceeds once a commercial discovery is made.

Petroleum revenues are typically volatile, driven primarily by prices, and are, generally speaking, temporary. These features imply that policy makers need to critically think about which petroleum revenues may have to be smoothed over time, and what proportion might be more optimal to save for future consumption in light of broader macroeconomic conditions.

Managing expectations is key when it comes to planning for a prospective petroleum sector in Lebanon. We have no confirmation to date as to the presence of a reservoir and the commercial quantities that could be developed. The second licensing round closing was, once again, postponed to October 2023, indicating clear lack of appetite from oil companies. Revenue estimates remain highly speculative and could be negligible. According to a 2020 estimate made by OpenOil for Kulluna Irada and The Lebanese Oil and Gas Initiative-LOGI, “Following the most positive scenario, if Lebanon discovers and develops a large oil and gas field similar in size to Israel’s Leviathan Field (16 TCF), and were able to develop all its reserves, then in the model’s base scenario Lebanon’s share of revenue would be in a range of \$6.1billion, expressed in today’s money (Assuming \$6 per MBTU through life of project in real terms).”² By comparison, the Karish field size, which is closer to the so-called Cana field, is much smaller: 1.4 TCF.

Fiscal and macroeconomic conditions are key considerations when assessing the utility of a SWF. Additionally, establishing an SWF should be accompanied by prudent investment and governance practices to ensure the fund’s effectiveness and long-term sustainability. The second objective is subject to the first; there is no point in discussing the governance structure of an institution if its very purpose is not determined yet.

¹ The Offshore Petroleum Resources Law (OPRL) (Law no. 132/2010) stipulates in its Article 3: Principles for the Management of Petroleum that the net proceeds collected or received by Government arising out of petroleum activities or petroleum rights shall be placed in a sovereign fund. The statute regulating the Fund, the rules for its specific management, the principles of investment and use of proceeds shall be regulated by a specific law, based on clear and transparent principles for investment and use of proceeds that shall keep the capital and part of the proceeds in an investment fund for future generations, leaving part to be spent according to standards that will guarantee the rights of the State and avoid serious, short and long term negative economic consequences.

Law

² https://logi-lebanon.org/uploaded/2020/8/79EH0XT4_FinancialRecommendations-V.2%20Digital.pdf

Lebanon’s energy plan might call for a proportion of any commercial gas discovery to be earmarked for domestic energy production, which implies uncertainty concerning remaining for other types of budgetary support. If used domestically, switching the electricity generation from imported fuel oil to a mix of domestically produced natural gas power plants and renewable energy would have the potential to make efficiency gains in the Lebanese economy as a whole, and to improve significantly public finances long-term.

Based on best practices, SWFs are not established prior to any commercial discovery. According to the timeline mentioned in the agreement between Total and Israel, production is not expected before the third to seven year after a commercial discovery. In the best base scenario, future oil and gas proceeds are not expected to materialize before 2027, on the condition that a commercial discovery happens this year and there are no delays in field development. **In the absence of macro-stability and of any vision on future needs it is, by design, impossible to decide on the allocation of oil and gas proceeds, which is precisely the purpose of a SWF.**

WHY THE RUSH?

It is important to note that there is absolutely no urgency in creating a sovereign fund. In fact, quite the opposite, as evidenced by international experience in this regard. The comparative table below shows that major petroleum producing countries had a lag between the date of the first petroleum discovery and the date at which a SWF was established. On average, it took them around 33.5 years to establish a SWF after making their first commercial discovery.

Lebanon has not yet made a commercial discovery. To date, Lebanon does not have any proven petroleum resources. The exploration well that was drilled in Block 4 in 2020 confirmed the presence of a hydrocarbon system, but no reservoirs were identified. In parallel, exploration activities are expected to start in Block 9 in the fourth quarter of 2023. Following exploration activities, several months are needed to assess the results of the drilling. As per laws and regulations, the exploration phase lasts 3 to 6 years followed by, 1 to 2 years for development and up to 30 years for production.

WHEN DID OTHER PETROLEUM PRODUCING COUNTRIES ESTABLISH THEIR SWF?

| Country | Date of commercial discovery | Date of SWF establishment | Time lag |
|-----------|------------------------------|---------------------------|----------|
| Norway | 1969 | 1990 | 21 years |
| UAE | 1958 | 2006 | 48 years |
| China | 1958 | 2007 | 49 years |
| Israel | 1955 | 2014 | 59 years |
| Russia | 1960 | 2008 | 48 years |
| Kuwait | 1938 | 1953 | 15 years |
| Singapore | 1961 | 1981 | 20 years |
| Cyprus | 2011 | 2019 | 8 years |
| KSA | 1938 | 1971 | 33 years |

*Research by Olga Jbeili - ANND

Lebanon cannot afford to finance a new public entity before balancing and stabilizing its public finances. It must not make the mistake of putting the cart before the horse and creating a new institution without a budget to fund it, especially considering that it will not be operating for several years.

The discussion on SWF is today a diversion from other urgent priorities. Discussing a SWF is part of the authorities' kick-the-can-down-the road strategy. Debating the SWF is reinforcing the myth that oil and gas resources can be a lifeline. MPs, government and the public at large should be discussing and mobilized around the only appropriate discussion and top priority on how to get the country out of its unprecedented crisis.

KEY PREREQUISITES TO ANY DISCUSSION ON A SWF ARE STILL UNMET

The current process is flawed, and stakes in this vital sector are too high to turn the blind eye. Establishing a SWF is not a guarantee in itself against corruption. If ill-designed and ill-managed, SWFs can still become channels for corruption and patronage diverting billions of dollars away from social service and infrastructure spending. According to international evidence, designing a SWF in a rushed way is a manifestation of a pre-source curse trend.

Instead, the establishment of the SWF should abide by the following process:

- Wait for a commercial discovery and assess its potential. Revenue estimates remain highly speculative and could be negligible.
- Ensure that a macro-fiscal strategy is developed to put Lebanon's economy on a stable track.
- Complete an overall strategy for the oil and gas sector interrelated with a strategy for the energy sector. One of the potential policy decisions might be to exclusively earmark future gas extraction for domestic energy production.
- If a fund is to be set up, define its type according to the macro and sector strategies chosen abiding by the Santiago Principles which consists of 24 generally accepted principles and practices to establish and run a SWF
- Establish capable institutions to implement rules and regulations.

THE PROPOSED DRAFT LAW FAILS TO ABIDE BY SEVERAL OF THE SANTIAGO PRINCIPLES

The Santiago Principles³ consist of 24 Generally Accepted Principles and Practices (GAPP) voluntarily endorsed by the International Forum of Sovereign Wealth Funds' members that evolve around three main pillars:

1. Legal framework, objectives and coordination with macroeconomic policies.
2. Institutional framework and governance structure.
3. Investment and risk management framework.

The proposed draft law does not address the following Santiago Principles:

- SWF principles not coordinated nor consistent with overall macroeconomic policies.
- SWF principles do not tackle operations and activities in host countries.
- SWF principles are not clear about the fund's governance framework and objectives, nor addresses how the fund's management is operationally independent from the owner and should be publicly disclosed.
- SWF should not seek or take advantage of privileged information or inappropriate influence by the broader government in competing with private entities.
- SWFs principles not addressed with respect to viewing shareholder ownership rights as a fundamental element of their equity investments' value, nor provisions related to the SWF public disclosure of its general approach to voting securities of listed entities.
- No provision related to SWFs viewing shareholder ownership rights as a fundamental element of their equity investments' value and that the SWF should publicly disclose its general approach to voting securities of listed entities.
- No provision related to regular review of the implementation of the GAPP.

³ https://www.ifswf.org/sites/default/files/santiagoprinciples_0_0.pdf

THE CURRENT DRAFT LAW FAILS TO ADDRESS THE GENERALLY ACCEPTED SANTIAGO PRINCIPLES AND PRACTICES

Generally Accepted Santiago Principles and Practices

3. Where the SWF's activities have direct domestic macroeconomic implications, those activities should be closely coordinated with the domestic, fiscal and monetary authorities, so as to ensure **consistency with the overall macroeconomic policies**.

15. **SWF operations and activities in host countries** should be conducted in compliance with all applicable regulatory and disclosure requirements of the countries in which they operate.

16. The **governance framework and objectives**, as well as the manner in which **the SWF's management is operationally independent from the owner, should be publicly disclosed**.

20. The **SWF should not seek or take advantage of privileged information or inappropriate influence** by the broader government in competing with private entities.

21. **SWFs view shareholder ownership rights as a fundamental element of their equity investments' value**. If an SWF chooses to exercise its ownership rights, it should do so in a manner that is consistent with its investment policy and protects the financial value of its investments. **The SWF should publicly disclose its general approach to voting securities of listed entities**, including the key factors guiding its exercise of ownership rights.

24. A process of **regular review of the implementation of the GAPP should be engaged** in by or on behalf of the SWF.

*Research by Olga Jbeili - ANND

CONCLUSION

Given the uncertainty with regards to the oil and gas sector and macro-economic conditions, it is impossible for Lebanon to draft a law pertinent to the use of oil and gas proceeds, starting from the opportunity to design a SWF to the type of fund needed eventually.

Some of the areas that are challenging to assess at this stage without having any information on a prospective commercial discovery specifying recoverable quantities and their associated monetary values, include:

- The need for a fund. This is dependent on commercial discoveries, their magnitude, and the needs of the economy.
- Type of fund and its objectives: stabilization, future generation, reserve investment, pension reserve – including the ratios to invest or save and the potential ratio of revenues to invest in foreign assets.
- The governance structure: definition of the role between the owner and the manager of the fund and clarifying the role of different institutions including the Ministry of Finance and the Central Bank.
- The fund's role in macroeconomic management and fiscal rules determining withdrawals, proportions allocated for debt servicing and savings.
- Investment rules: lack of investment rules or prohibitions on specific types of assets purchases (real estate, below-investment grade shares etc.), absence of details on management fees, oversight of external managers or selection of external managers. A domestic investment target leaves the prospective fund to channel money to companies with which there could be a conflict of interest.
- External oversight and transparency: No requirement to make a full independent external audit publicly available.

As stated by Andrew Bauer for the Natural Resource Governance Institute (NRGI): “authorities in countries with high debt payments, small resource revenues relative to their economies, uncertain revenue flows and acute development needs may wish to think twice before creating a “premature fund.” Establishing a new institution or opening a new account in a low-capacity or poor governance environment are not themselves steps that will improve the management of natural resource wealth. **A more important priority might be to ensure that the budget is well managed and that government resources are spent to improve development outcomes.** If a SWF is warranted or a political reality—since funds are useful in some circumstances and the establishment of a fund is often used by politicians a symbolic gesture of “responsible government”—good governance crucially depends on enacting the right fiscal rules, investment rules and appropriate transparency and oversight”.

A fund cannot be established without a proper democratic debate. This approach has led many countries to fail. Unless there is broad consensus on the use of resource revenues and informed civil society and oversight bodies to put pressure on governments to follow their own rules, even the best rules will usually not be followed.

APPENDIX

OVERVIEW OF SWFS⁴

1. WHAT IS A SOVEREIGN WEALTH FUND

Many countries use extra-budgetary funds to manage their natural resource revenues⁵. In fact, all but a handful of large oil producers have established a natural resource- financed special fund. Together, these funds manage trillions of dollars in resource revenues annually.

In some cases, these funds are merely accounts within the state treasury, created for political purposes to demonstrate a commitment to financing a certain expenditure item (e.g. education) or for accounting purposes. In other cases, they are institutions that are subject to different rules than the rest of the government's financial transactions. They may even have their own staff and legal standing.

Sovereign wealth funds (SWFs) are but one type of extra-budgetary fund. The International Forum on Sovereign Wealth Funds defines them as government-owned entities, established for a macroeconomic purpose, which do not have liabilities and invest at least partly in foreign assets⁶.

2. WHAT IS THE PURPOSE OF A SOVEREIGN WEALTH FUND

There are several legitimate reasons why a government might establish an extra- budgetary fund:

First, traditional budgets are set on an annual basis, whereas funds can serve as multi-year funds. Parliament must approve the fund's budget and spending must be channeled through normal budget processes, however the fund retains any unspent funds at the end of the year.

Second, funds can be used to earmark revenues for a specific purpose. For example, the oil-and land sales-financed Texas Permanent University Fund in the U.S. earmarks interest earned to the public university system in the state. Similarly, Alabama's (U.S.) Forever Wild Trust Fund, financed by between 3-5 percent of the state's oil and gas revenues, allocates money to environmental protection.

⁴ Lebanese Sovereign Wealth Fund Proposal – LOGI – Andrew Bauer – December 2017

⁵ Extra-budgetary funds are defined by the IMF as “general government transactions, often with separate banking and institutional arrangements, which are not included in the annual state (national) budget law and the budgets of subnational levels of government.”

⁶ <http://www.ifswf.org/>

Third, funds can protect a specific stock of fiscal revenues from political interference. Most government pension funds are established as extra-budgetary entities in order to safeguard this pool from appropriation for other purposes. This enhances senior citizens' confidence that they will receive their full pension benefits many years in the future.

Fourth, the budget process sometimes does not function well, especially in low-capacity environments. Extra-budgetary funds can be subject to more stringent transparency, oversight and governance standards than the budget, and be allocated more qualified staff, in order to create islands of good governance inside the government. While this may be true in theory, real world examples of these "islands of good governance" are rare.

Finally, it is to be noted that for each case of a well-run extra-budgetary fund, there is a case where the fund is a problematic source of corruption and patronage. As commonly as they are established to address a justified economic or political need, governments create extra-budgetary funds to avoid public scrutiny or finance pet projects. As the Overseas Development Institute writes, "transactions outside the budget are unlikely to be subject to the same kind of financial discipline as are budget operations (for example, state-owned enterprises may have their own financial regulations and appoint their own auditors), partly because they are financially independent and partly because they are not explicitly compared with other public expenditures. This may result in an increased level of fraud, irregularity, or the use of such funds for unauthorized purposes. In addition, the use of extra-budgetary funds means the reported level of government expenditure may be understated. It also is more difficult to compare the finances of two governments if they have different levels of extra-budgetary funds."⁷

⁷ ODI (2010) Guide to Transparency of Public Finances: Looking Beyond the Core Budget. Online: <https://www.internationalbudget.org/wp-content/uploads/Looking-Beyond-the-Budget.pdf>

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