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SustainAbility



Towards good practice in the oil & gas contracting chain

Discussion paper for 3rd December 2007 workshop

This document is designed as a discussion paper to prompt dialogue at the workshop on the 3rd December, 2007. We are also sending it to those that took part in our research or have indicated an interest in the topic, to give them an opportunity to comment, if they are unable to attend the workshop. The workshop will be conducted under Chatham House rules (i.e. comments will be unattributable); unless the contributor indicates explicit approval to be quoted.

Please read the document prior to the workshop to enable you to consider the issues in advance and input your thinking into the discussion. We would like participants to discuss and prioritise these areas during the workshop, adding any key areas that we may not have highlighted. The following is a summary of the key topics for discussion, which are expanded on in this document.

1. Investment agreement conditions
2. Role of regulation
3. Influence of local content requirements
4. Scope of corporate policy implementation
5. Harmonisation of standards
6. Risk management for investors
7. Role of National Oil Companies
8. Selection of Contractors
9. Contractual Measures and Project Specification
10. Responsibility and Accountability
11. Monitoring and Enforcement
12. Reporting
13. Corruption
14. Training and communication
15. Enterprise development

In considering these issues we would also like you to observe:

- A. Which are the most important aspects for delivering improved environmental and social performance
- B. Which are generic issues and which are specific to certain situations?
- C. Are there other aspects of the contracting chain and its context we have not covered?
- D. Are there specific examples or case studies you could offer?

The discussion paper that follows contains some more specific questions which relate to the above topics to prompt your thoughts.

If you wish to send comments (before 31st December 2007) or have any questions please contact

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1. Introduction

The upstream oil and gas sector typically outsources many non-core activities. This leaves a primary core function of operators essentially as project management with up to 90% of work contracted out. For example BP spends about \$35 billion a year on suppliers which represents 80% of the company's total spend; and interfaces with over 100,000 suppliers globally across its upstream and downstream businesses. This includes office supplies, catering, retail divisions, as well as exploration and production, and refining and marketing. Shell reports that it spent \$10 billion on goods and services from locally owned companies in low and medium countries in 2006.

As well as international oil and gas industry providers, local contractors and suppliers from the countries or localities where projects are situated have increasing opportunities to work on international projects. Opportunities are provided by clauses in foreign investment agreements that require a percentage of 'local content' in the overall project development. The environmental and social performance of international and local contractors and subcontractors is therefore critical to the overall successful delivery of a project.

Opportunities for developing local potential through procurement of goods and services are currently under-developed. However, in order to benefit from these opportunities local contractors and suppliers need to have a good knowledge and experience of international good practice, not only in the technical sphere, but also in the sphere of environmental and social performance, including health and safety. Where clear requirements for environmental and social capabilities are made, there is potential competitive advantage for those able to demonstrate their ability to comply through a more responsible approach.

The management of environmental and social issues along the oil and gas supply chain has been recognised as a key issue for the industry. In Russia, this has been demonstrated by the Sakhalin II project, where management of the environmental performance of contractors and sub-contractors has been highlighted as a key factor in problems associated with pipeline construction work across Sakhalin's rivers.

According to the performance reports of multinationals, contractors (and subcontractors) suffer more injuries and fatalities than the operating companies themselves. Contractors are often exposed to more dangerous activities. However, other factors such as not having effective management systems in place also play a role. Many incidents may be due to issues of behavioural culture, such as wearing safety clothing, using seat-belts or driving under the influence of alcohol or drugs. These figures also raise concerns about the performance of contractors in the sphere of environmental protection and social performance, which are currently not reported on to the same extent. This is particularly important given their role in the front-line of project activities, with a direct impact on the environment and direct engagement with local communities.

At times sensitivity or confidentiality of information may have hindered our ability to gain a full picture of the oil sector contracting process. Several representatives of industry expressed great interest in our research findings but were unwilling to provide us with an interview. We understand the sensitivity of this area, reflecting unresolved issues of responsibility, the role of governments, and the general state of good practice in regions around the world. We would like to thank those in the industry who did make time available and were transparent about their processes, and to invite further comment and participation from others as well.

We welcome any further input from the all sections of industry and other stakeholders on how we can work together to systematically improve the performance of the sector along the supply chain. If there is a specific company or project you feel has been misrepresented, please contact us.

2. Research methodology

This research funded by WWF-UK was conducted by the International Institute for Environment and Development (IIED), and SustainAbility, with assistance from WWF Russia; a Kazakhstani research partner; and Engineers Against Poverty.

WWF-UK brings experience of engaging with some of the largest petroleum projects seen in recent years, including the Baku-Tbilisi-Ceyhan pipeline and the Sakhalin II project. WWF has experience of hydrocarbon developments around the world, and the range of issues that arise in relation to the environment and local communities. The role of the supply chain has emerged as a critical link in a number of the projects we have dealt with.

SustainAbility interviewed experts within industry and consultants with close connection to company headquarters and/or to company's procurement processes. They were knowledgeable of their organisation's or clients' procurement policies and procedures, and so were able to give a bird's eye view on how the processes were intended to operate. In some cases, they were also able to reflect, at a macro level, on the successes and failures of some initiatives. These different perspectives were illuminated in hour-long, semi-structured interviews.

IIED conducted a regional survey in Kazakhstan and Russia, in partnership with WWF-Russia and a Kazakhstani researcher. The team surveyed a range of stakeholders based in Russia, Kazakhstan, Europe and the US about their key concerns and observations about environmental and social issues in the oil and gas sector in general, and management of oil and gas supply chains in particular. The majority of the research was conducted in-country, drawing also on the prior experience of the IIED researchers and their partners in these countries. The consultation took the form of semi-structured interviews based on a set of questions; informal discussions; email correspondence and questionnaires sent electronically.

The context of any operation will also be important in determining the outcome for local communities and the environment. For this reason we chose to take the regional focus on the Former Soviet Union (Russia and Kazakhstan) in addition to the overview of industry-wide good practice. Some of the insights from this research will be generic to the industry and/or transferable to different regions. Others will be specific to similar countries in transition.

Participants are invited to comment on our methodology and the transferability of our approach to other oil and gas bearing regions of the world.

3. The oil and gas supply chain

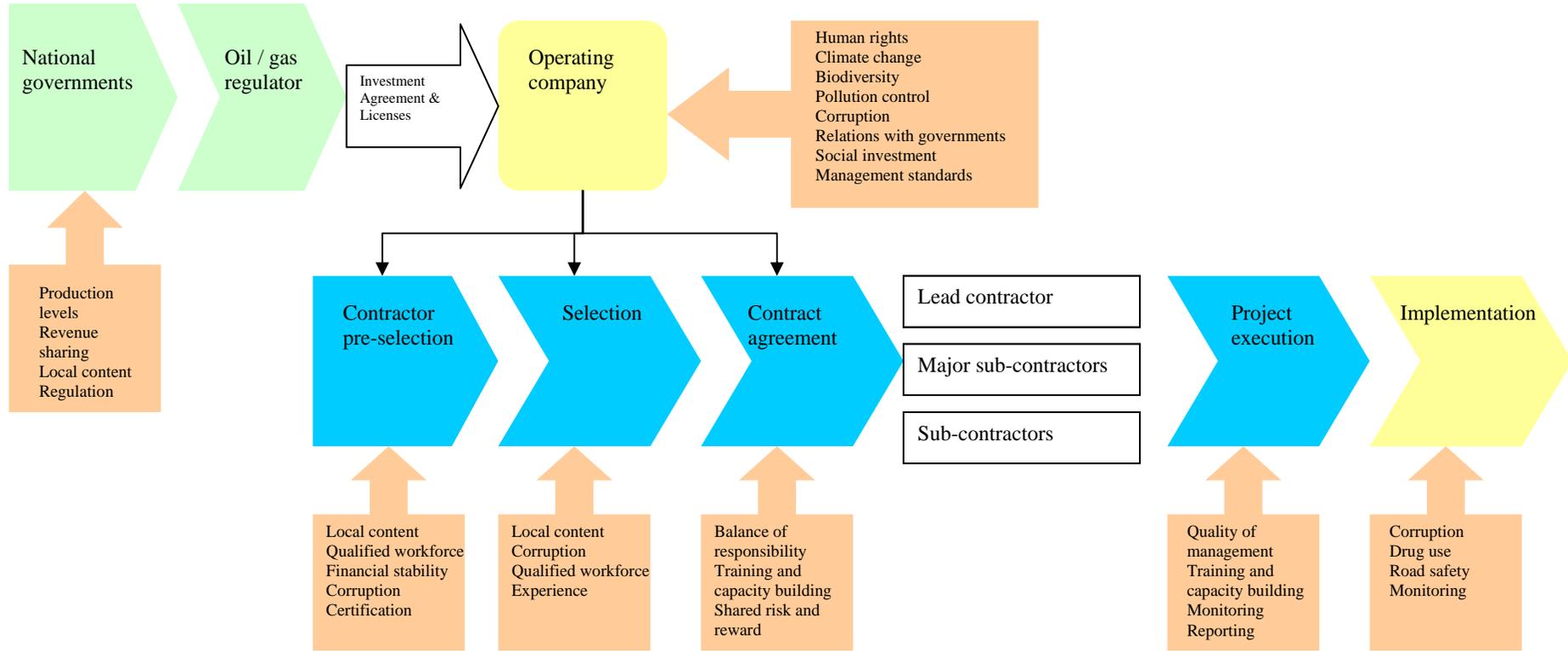
Major infrastructure projects, such as those required in the oil and gas sector, require a series of transactions and interactions. The multiple relationships between the government entities, oil companies, their shareholders, lead contractors, sub-contractors, and finance institutions influence the way a project is implemented. These include regulatory requirements, corporate responsibility commitments, development objectives, and the standards required by finance institutions, notably the International Finance Corporation (IFC) Performance Standards. Civil society groups can also exert an influence.

The ‘supply chain approach’ allows for analysis of the big picture (i.e. the whole chain of performance and responsibility associated with an area of oil and gas industry activity). This allows us to identify and focus on critical areas related to governance of the chain, and identify key points at which intervention may improve performance. We propose that this approach could be applied to supply chain-related issues in the development of investment agreements, risk assessments, procurement processes, environmental and social management systems, and civil society engagement processes. (See diagram on following page.)

We would like participants to comment on the usefulness of the supply chain approach for addressing environmental and social issues related to oil and gas development.

A representation of the wider framework, issues and relationships surrounding contracting in the petroleum sector

What is missing from this diagram? What shouldn't be in there?



4. The regulatory environment

4.1 Foreign investment agreements

The basic foundations for the governance of major oil and gas projects lie with a variety of kinds of ‘investment agreements’ negotiated between investors and host states, along with applicable national legislation. These investment agreements typically address issues such as the applicable regulatory regime, environmental standards and liabilities. They may contain nationalisation targets or provisions requiring preference to be given to national citizens in defined circumstances. And they also frequently contain local content requirements and targets (see below).

Investment agreements for significant projects incorporate a mixture of national legislation and oil industry good practice standards. Investment agreements may therefore effectively make contractually binding the environmental and health and safety management system adopted by the oil and gas operators – for example one major production sharing agreement requires that petroleum operations be conducted “*in strict compliance with all applicable EHS laws of the [host state], principles and procedures in the internal EHS management system.*” The terms of supply chain contracts are also in part determined by the obligations of consortium partners within the investment agreements under which they operate.

Investment agreements do not define the entirety of the supply chain management systems, nor the norms that are found within contracts. But they provide a baseline for contracting relationships. Investment agreements may contain explicit requirements relating to subcontractors, e.g. “*Contractor shall require each of its subcontractors to comply with the terms of this agreement in each contract with each subcontractor...*”

The terms of contracts between operators, contractors and subcontractors are not publicly available, and in many countries, the terms of investment agreements between investors and host governments are considered confidential in their entirety. Some include provisions expressly prohibiting disclosure of the terms of individual agreements.

Q1. How do the terms of investment agreements influence the environmental and social performance of contractors?

Q2. What is considered a) desirable, b) good practice in terms of investment agreement provisions affecting the terms of contractors’ relationships with operators?

4.2 Regulation

National regulations generally include the tax regime, use of subsurface resources, licences and permits, environmental regulations, procurement requirements, labour standards and social protection.

Experience shows that environmental regulation is only as effective as its monitoring and enforcement. According to our respondents, in more mature oil fields, such as the North Sea, the industry feels that regulation has driven up a minimum standard of performance, and that responsible operators are going beyond this to minimise incidents, and be ahead on regulatory risk. Despite lacking a systematic approach to managing subcontractors, most western operators feel this is not a major issue in established well-regulated operations.

However there is significant regional variation across the world. In Kazakhstan, environmental legislation has been significantly modified through the introduction of the new Environmental Code in January 2007. This Environmental Code still needs to further develop implementation, compliance and enforcement mechanisms. While there are many prescriptive and aspirational messages around better standards, lower emission targets and better environmental management, the methodology and specific targets remain to be developed.

In Russia, most respondents agreed that while the Russian legal framework governing environmental management of industrial activities is quite good, specified mechanisms for implementation and enforcement are lacking. Furthermore, recent amendments mean that the legislative base itself has become weakened. However there has been increasing attention to environmental compliance by the regulatory authorities. Observers argue that environmental issues are being used as a negotiating tool for Russian state companies to gain access to international projects (as for example in the case of the Sakhalin II project). A similar trend is being observed in Kazakhstan, notably in relation to the Kashagan project.

Q3. How significant is the influence of national regulation on performance?

Q4. Can a lack of effective regulation be compensated through voluntary approaches?

Q5. Could participants suggest effective ways of enhancing the regulatory environment?

4.3 National requirements for 'local content'

Foreign investment agreements may stipulate that a project is to incorporate a certain amount of 'local content'. For example the Sakhalin II PSA requires that 70% of materials and labour are of Russian origin, provided they can meet equivalent prices and quality to foreign alternatives. Although the financial value is less than 70%, the sheer scale of the project means that Sakhalin Energy has procured over \$10 billion in Russian contracts (out of a total of over \$20 billion).

In both Russia and Kazakhstan no clear distinction is made between 'local' companies (i.e. based in a local province where the project is located) and 'local' (i.e. national Kazakhstani or Russian) companies. Operators are by and large free to develop their own definitions, making it quite difficult to measure and monitor. Respondents noted that Western companies sometimes set up 'local' companies for the purposes of a project. Such companies and Western contractors who establish a project office in Russia are counted as 'Russian content'.

According to respondents, some companies feel that national requirements for local content (e.g. Nigeria's 70% requirement) are unrealistic given the current capacity available from local companies in those countries. Operators are therefore left with a choice of making a promise they cannot keep, or negotiating with the government to build up the level of local content towards meeting the 70% target. Operators also distinguish between the types of activity they may seek to use local content for during the different phases of exploration, development and production. There are more generic functions such as construction or catering, which may be easier to start with, but also specialist technical functions relating to seismic surveys or drilling require expertise, which cannot be developed overnight.

Q6. Are local content requirements having an increasing influence on the way that projects are developed (i.e. the choice of contractors)?

Q7. Does the lack of an internationally agreed definition of 'local content' pose a problem?

5. Corporate approaches

5.1 Voluntary corporate standards and management systems

The majority of large international oil companies have developed their own internal management systems (including policies, responsibilities, processes and procedures) to address the environmental and social impacts of their operations. Most of the policies that govern these management systems explicitly define compliance with local legislation as a minimum performance standard. Some also make commitments to maintaining consistent standards across their international operations. These internal management systems typically draw on international standards and frameworks. Certification to ISO standards on quality or environmental management are also an indicator or requirement used by some.

An important development in this area is the release of the new International Finance Corporation (IFC) Performance Standards on Social & Environmental Sustainability. These standards have also been adopted by the Equator Principle Financial Institutions, a group of more than 40 major international financial institutions that collectively represent around 80 percent of global project financing. The IFC standards require assessment of “third party performance” which includes the “principal contractor” and which requires the client to “collaborate with the third party to achieve the outcomes consistent with the Performance Standards”. Performance Standard 1 (Social and Environmental Assessment and Management Systems) requires project clients consider the “role and capacity of third parties” when analysing and addressing social and environmental risks and impacts.

The timing of the involvement of financial institutions has exposed a number of problems. Another layer of standards can be overlaid on a project after it has been approved and often after construction has started. The earlier such partners become involved, the easier it is to incorporate their input (see section ‘Contracts’ below).

In their policy statements, multinational companies usually require their standards to be used where they are a joint venture partner or majority shareholder, and state that they will work with their partners and contractors to deliver the same standards. The scope of strict application and direct control is therefore limited, with multinationals holding minority stakes in many projects and an increasing nationalisation of assets. In practice therefore not all activities will be subject to the strictest application of the corporate approach, especially during phases such as construction, where the ratio of operating company employees to contractors is at its lowest. Monitoring, enforcement and reporting will also be less likely to be directly supervised by the operator, the further along the contracting chain the activity takes place.

Corporate standards evolve over time and are influenced by interactions between different industry actors and peers. For example, the practice of starting projects by bringing together top representatives of all parties to define the important and sensitive environmental issues of the project appears to be gaining ground. Industry representatives noted that good practice standards were often seen by the corporate headquarters as common sense. Yet, this “common sense” cannot be passed down the supply chain and needs to be documented and articulated in a company policy so that it can be applied uniformly. Both the company’s past experience and what is accepted in the industry as good practice influences company standards. There are different perceptions at the corporate head offices of key issues amongst contractors, compared to those actually managing and working on the projects.

Major international contractors observed that each project tends to bring with it a new set of standards. One of the first processes during negotiations between the operator and a major contractor is a comparison of standards, to align the approaches, and agree a common standard.

In Russia, respondents noted that the regional branches of national companies and joint ventures may work to different standards, depending on the project, the nature of relations between Russian and international partners, the experience of personnel, and the region where they are working. This affects key aspects of the work, including relations with local and indigenous communities, and management of relations with contractors and subcontractors.

Major international contractors who work in Russia and Kazakhstan are generally certified with all the required international standards. Our research also revealed an increasing awareness among major Russian contractors, such as Stroytransgaz, and industry associations (e.g. the Murmansk Association of Contractors and Suppliers to the Oil and Gas Industry) about the need to become certified. Russian companies tend to have a strong focus on quality certification, whereas environmental standards are prioritised less, reflecting priorities within the industry as a whole. However, smaller companies tend not to be certified, due to the expense of certification.

Q8. What proportion of a multinational's activities is strictly covered by its corporate policies and systems? Does this need to change to address issues along the supply chain?

Q9. Is there a need for greater harmonisation of standards or clearer expectations from operators?

Q10. How can corporate managers and financial institutions most effectively address the environmental and social performance of contractors and subcontractors as a risk?

5.2 National oil companies

Our research revealed that Russian and Kazakhstani operating companies, particularly those with strong foreign influence, are striving towards improving their voluntary company standards. International standards, notably ISO 9001, ISO 14001 and ISO/OHSAS 18001, are gradually becoming accepted and integrated into practice. Respondents noted that private companies (e.g. Lukoil in Russia) were more likely to have environmental management systems and follow international standards, due to influence from joint venture partners e.g. in the case of TNK-BP and Narynmarneftegaz (Lukoil and Conoco-Phillips), and financial institutions. However, state-owned companies such as Gazprom are increasingly looking to develop their own environmental standards and management systems as they compete in international markets. 'Gazpromcert' is Gazprom's equivalent to the ISO family.

National governments may insist on the involvement of a national oil/gas company in major projects as a means of ensuring domestic participation, for example Gazprom's recent take-over of the Sakhalin II project and their control over the Shtokman project, and Rosneft's participation in the Sakhalin II and V projects. In Kazakhstan, the 2004 PSA Law required for the first time that all new production sharing agreements include at least a fifty percent stake to be held by the national oil company KazMunaiGas (KMG)—with KMG's participation effectively funded by the other partners. Also the companies developing the offshore deposits were required to expand "local content" to the projects in terms of both services and products.

KMG is not only a significant player in the oil and gas sector in its own right, but also a significant client for local and national suppliers. For a number of Kazakhstani companies, their principal exposure to international standards comes through contracting relationships with various parts of the KMG family. In this sense, efforts to stimulate good practice improvements within the supply chain of this major national oil company can help to ready Kazakhstani suppliers for wider international contracts. Furthermore, KMG is increasingly positioning itself as at the very least a major regional oil company, gradually expanding its networks and acquisitions, and likely to play an increasing role in Kazakhstan and beyond.

It is also worth being aware of the experience and knowledge that national companies and national/local personnel bring to joint ventures and project partnerships, including specific technical expertise and understanding of physical environments, business culture, the political environment, the legal framework and local communities.

Q11. What role can national oil companies play in delivering improved standards in the supply chain?

Q12. How do the approaches of national oil companies and Western operators differ and what challenges does this create?

Q13. What can Western operators learn from the experience of national companies?

6. Contractor Strategy

The above discussion and diagram sets out that there is clearly a broader framework and context in which any contracting will take place and operators therefore need to incorporate these issues in a contractor strategy. The multi-stage process outlined below is generally employed to select and engage an appropriate contractor.

6.1 Contractor Selection

The selection process varies depending on the nature of the work, however not all the companies that were interviewed for this research were able to provide a clear standard framework for procurement that was systematically applied to all major contracts. There is considerable variation in how procurement is approached in different countries.

The nature of the markets also influences selection. Respondents observed that the Russian major contractor market is under-developed and characterised by a tendency towards monopolism and a lack of transparency. Relations between state officials and these companies may influence this market. The monopolists also hamper opportunities for others to develop. Major international contractors provide some competition for the major Russian contractors. Respondents noted that there tends to be more competition in the local (subcontractor) markets, but a major factor is the relationship of the smaller companies to local and regional administrations.

Key phases include the following:

1) Pre-qualification/screening:

This ranges from “we’ve worked with them in the past” and “weeding out the worst performers” to rigorous analysis of HSE records, programmes, manuals, organisational charts, insurance, staffing levels of HSE departments, and training certificates.

- “Black lists” are illegal in the US because of anti-trust regulations, but in Kazakhstan it was found that some local contractors had been effectively black-listed by an international operator. However, according to respondents, the “weeding out” process in place in many companies reflects this practice and has the same net effect. Local administrations themselves can effectively employ a “weeding out” process themselves, offering only a limited number of local companies as possible contractors/subcontractors on major projects.
- In more developed markets, centralised contractor databases like Achilles are available. Achilles covers the majority of contractors in the North Sea; the company is currently working on extending its coverage to other petroleum regions, including the Barents Sea and Kazakhstan.

2) Invitation to tender:

The documentation included in the invitation to tender can range from a short description of the project, to extensive “coordination procedures” with clear expectations and responsibilities of contractors. At best, this step will include clear expectations of contractor HSE policies, systems, programs and performance, and clear and simple metrics to be reported periodically.

3) Evaluation:

This step should include a review of the financial abilities to fulfil requirements, with submissions required to include comprehensive plans. In

theory, this acts as a way to see if the contractor's standards are in line with those of the operator. Ideally, the operator will request the contractor to develop appropriate plans to ensure full understanding on both sides, and in order to provide the contractor with the opportunity to demonstrate adequate capability and capacity. A commitment may also be sought from the contractor to reach the standards within a defined timeframe, or to undergo training. This may form a probationary period of the contract.

Q14. Are there other key elements of the contractor selection process (including 'good practice' elements)?

Q15. What role do databases such as Achilles play in this due diligence process? Do they adequately cover environmental and social aspects? Will they be as effective in emerging markets?

Q16. What decisions are already made or predetermined prior to this selection process?

Q17. How can the issues associated with contractor/subcontractor markets be addressed? (e.g. monopolism, lack of competition, favouritism)

6.2 Differentiating factors

Respondents noted that the pre-selection process is a crucial factor in encouraging improved performance. It can be seen in some cases that health and safety (and increasingly environmental) credentials are a differentiating factor and therefore a competitive advantage. We believe this is also a critical time to table other social and environmental expectations. The selection phase is crucial, as once a contract is agreed it is only terminated in extreme circumstances.

In Russia, TNK-BP and Naryanmarneftegaz reported that they include HSE standards in their pre-qualification requirements but other companies reported that such requirements are a very minor part of the pre-tender process, partly because most companies would find it impossible to meet such requirements (largely due to the expense of doing so). Several companies noted that if a contractor is certified (with ISO 9001, 14001; ISO/OHSAS 18001) then they are given preference, but they also emphasized that they do not exclude uncertified contractors and subcontractors. Generally the focus is on the preparedness of the workforce, technology, experience and industrial performance, with a minor focus on environmental performance.

It has also been suggested that some local contractors may be selected based on their ability to "fast-track" the permitting process. This is apparent in the planning phases, where effective contractors are able to get permits from governmental bodies without having to spend months in an uncertain negotiation process with authorities. Similarly, Exxon has stated that working with state oil company Rosneft has expedited the Russian permitting process for Sakhalin I, due to Rosneft's familiarity with the system. Operators must ensure however that it is this greater understanding of the systems that delivers, rather than any bypassing of regulations or methods that would constitute breaches of business principles.

Q18. How good an indicator of suitability is certification to ISO standards or equivalent?

Q19. In what circumstances does HSE performance becoming a competitive advantage?

Q20. What are the main benefits and risks of using local contractors and subcontractors?

6.3 Contracts

The contract is the legal instrument by which legal responsibility is passed to the lead contractor, and, according to our respondents, these generally also include a clause that requires that lead contractors pass on this responsibility to their own contractors and subcontractors. However from a regulatory or stakeholder perspective, it is the operator of the project that has ultimate responsibility, and a moral duty to deliver. Whilst penalties and costs may be passed down the supply chain, reputational damage appears to be higher at the top of the chain. We therefore propose that contracts should not be viewed as a tool to ‘outsource’ responsibility, but as a positive tool for managing and improving performance.

An Engineering-Procurement-Construction (EPC) contract legally binds the operator and the EPC contractor, with a scope of work outlining the specifications and detail of the activities to be undertaken or services to be provided. These objectives are regularly linked to incentives in the contract, mostly in the form of penalty and fines. The balance of these incentives is critical; if 80% of incentives relate to meeting deadlines and 5% relate to correct environmental procedures, then the former will be prioritised.

One key problem identified by respondents from all stakeholder groups was that contracts frequently contain the wrong balance of incentives and penalties to ensure adequate attention to good social and environment performance. If there are insufficient or unbalanced incentives in the contract, environmental breaches may be ignored to meet deadlines, unless there is awareness that regulatory enforcement is likely to result in further delays whilst the problems are rectified. Respondents generally noted that the main priority for contractors (and subcontractors) is to be “*on time and on budget*”. Health and safety requirements usually have a fairly high priority. However, environmental and social standards generally have a lower priority, unless there is a major issue.

The project specifications contain the detailed technical requirements and expectations. It is these more specific conditions which are likely to dictate the techniques and standards used, and ultimately determine the outcomes for the environment and communities. It is essential that contractors and operators have good mutual understanding and agreement on these issues. In Russia the project specifications are developed by scientific research institutes (the so-called ‘design institutes’). Contractor respondents observed that the design institutes have good scientific experience and knowledge, but may lack some of the necessary practical industrial experience. As a result, some of the technical requirements may not be appropriate in the context of the actual work. Contractors suggested that it would be useful to have a mechanism whereby early problems in project implementation could feed into amendments to the project specifications. Some respondents also suggested that operators sometimes do not provide the contractors with the full project specifications in order to reduce project costs.

The translation of detailed mitigation measures outlined in an Environmental Impact Assessment (EIA) or integrated Environmental Social and Health Impact Assessment (ESHIA) into contractual requirements was highlighted as a key issue by respondents. This may pose even more of a challenge if a project uses project finance, as the lenders may require additional assessments and measures, which may be negotiated after some of the contracts have already been agreed with contractors. In the case of the Sakhalin II project, contracts with onshore pipeline contractors were renegotiated to include more specific environmental protection requirements to try and improve river crossing performance as the original requirements were not interpreted in a way that met the operator’s expectations, and

there were discrepancies between international practice and Russian methods (e.g. whether to dry cut or wet cut a river when constructing a pipeline across it). Similarly, social requirements introduced on the recommendation of lenders were rolled out after construction had already begun.

Matching budgets with requirements was highlighted as a key issue by operators and contractors. TNK-BP highlights the importance of ring-fencing budgets for environmental and social issues. In some cases contractors and subcontractors may use money allocated for environmental protection to meet other requirements of the contract. Contractors themselves noted that they are sometimes not provided with enough money to complete the environmental and social requirements of their contract. Most major operators indicated that they actually do verify that budgets are allocated for environmental and social aspects of the projects.

Contract termination can and does happen in the industry, and sends out a warning signal to other contractors. Terminating a contract is a potential sanction, but not a desirable course of action, in terms of going through the potential costs and delay of a court action and the replacement costs in an industry already stretched for workforce, during the construction of a project. Shell reports that it cancelled 271 contracts in the last 5 years due to incompatibility with its Business Principles. It is not clear what proportion of contracts this might be, or the exact nature of the issue, however it does at least demonstrate that there are times when the behaviour of a contractor becomes unacceptable.

Q21. What role does the contract play in transferring responsibility and in managing and improving contractors' environmental and social performance?

Q22. How significant are the project specifications to successful project delivery?

Q23. Is it feasible to include contractors in earlier design stages and reviews? What kinds of feedback mechanism are suitable?

Q24. To what extent are incentives/penalties included for environmental and social performance and how do they compare to time and cost penalties?

Q25. How effective is the practice of ring-fencing budgets for environmental and social protection measures?

6.4 Supervision, Monitoring and Enforcement

With regard to active monitoring and auditing of contractors and staff working on sites, there was no agreement between respondents on the required/optimal frequency and process of such monitoring, or even which aspect of the work they cover. Respondents noted that the easiest thing to monitor is “speed of delivery” while other factors are “assumed to be under control”, with attention only paid if a major problem is identified.

Respondents reported a range of supervision and monitoring approaches, including on-site supervisors; regular audits; inspection visits; third-party monitoring; and community monitoring/consultation. However, these methods have varied levels of success, with particular challenges in outlying regions. Drug and alcohol tests are frequent, for example. Some operators claim to have comprehensive drug and alcohol testing programmes, yet anecdotal reports from oil regions suggest that abuse is widespread, and it would be difficult to have a clean supply chain. Similarly, despite policies such as ‘No hunting, fishing and gathering’ in outlying project sites in Russia, reports of poaching by project workers are common.

Some contractors/subcontractors reported ‘too much’ supervision and monitoring, and a lack of co-ordination between efforts by operators, lenders, contractors and

government agencies. Industry representatives also reported resistance from contractors and subcontractors during auditing and monitoring visits. There is some resentment towards ‘Western experts’ in this context as in others.

We were told by some major operators that they monitored “all projects, everywhere in the world” in the upstream construction phases. Other commentators see this as unrealistic in practice. An insider working for a major operator confessed that its audit teams were not appropriately staffed. Even if the publicly disclosed aim is to audit major contracts every year, in reality this is done every three years or so. Contractors told us that they are putting in place active monitoring of their 3rd level contractors. In the past, we were told, it has been “assumed” that contractors were taking the appropriate actions and did not need further monitoring.

Another smaller operator relied on its cooperative (the local industry association) to conduct regular audits and make appropriate recommendations when necessary. This smaller operator would resort to conducting its own audits (through a 3rd party firm) only when it suspects important problems or breach of procedures. Following low levels of compliance with its river crossings strategy, Sakhalin Energy resorted to hiring a separate firm of independent monitors, which involved significant expenditure, in order to try and improve performance and demonstrate this to potential funders of the project. Compliance improved in some areas, but the root causes of some problems remained.

With regard to the IFC Performance Standards, this raises further questions as to whether funding institutions have sufficient capacity to monitor the supply chain of projects they are funding. Banks can also require stricter monitoring from the operator when agreeing loans, and provide mechanisms for the reporting of non-compliance by affected communities and interested parties.

Community monitoring is increasingly seen as important and relevant. Respondents highlighted the fact that the most important point of engagement with local populations, especially in the construction phases of a project, is established by locally based contractors and subcontractors. However, it is generally the operating company whose image and reputation are at stake in cases of poor relations or poor environmental performance. While operating companies may take responsibility for organising public hearings with the communities, locally-based contractors and subcontractors rarely take part.

Most major oil and gas projects have public engagement strategies and a network of ‘community liaison officers’ or CLOs. Where CLOs are respected representatives of local communities they can be very successful. However, there is some local resentment where CLOs are hired from outside local communities due primarily to their knowledge of the English language, and these experts lack local knowledge or fail to earn the respect of the local communities they work with. A public Grievance Procedure can be an effective way to formalise channels of communication, but sometimes these channels are inconvenient or unfamiliar to local residents, particularly to those who live in outlying areas (e.g. without access to a telephone).

The operators for the Sakhalin-1 and Sakhalin II projects organised joint consultation with local reindeer herders, including regular meetings on the reindeer pastures. These proved effective at facilitating communication with the construction contractors working in the local area, and for example enabled construction schedules to be modified to suit reindeer migration. In the Nenets Autonomous Region, reindeer herders and the oil companies have established communication channels whereby

the herders' concerns are regularly communicated to the contractors and the operating companies, and addressed at the appropriate level.

Civil society organisations provide an important scrutinising and monitoring role. NGOs tend to focus their attention on international operating companies and financial institutions, but are increasingly seeking to focus on trying to engage constructively with national companies, major contractors and locally-based subcontractors.

Q26. What methods for monitoring and enforcement are most effective, and/or considered to be industry good practice?

Q27. Should third party monitoring become a standard practice?

Q28. What are the most effective methods of engaging communities in project monitoring?

Q29. How can contractors and subcontractors be encouraged to engage more directly with civil society? How important is it that they do this?

6.5 Reporting

Reporting of non-financial (social, environmental, governance or other) performance has a range of benefits and is indeed approaching standard practice among the largest companies worldwide. A reporting program might be entirely internal (to aid understanding and management of issues, strengths and weaknesses); have a limited external audience, such as investors (who may require such information as part of their due diligence); or be fully transparent externally (to inform and influence a range of audiences, meet accountability expectations and build trust). “Non-financial” reporting is one of the most effective ways for companies unfamiliar with the ‘sustainability’ space to test their readiness and build internal processes.

Operators report against major environmental and social indicators in their annual financial or sustainability reports, such as lost time injury rates, environmental fines, and emissions. Some health and safety metrics include contractors as well as employees. Environmental key performance indicators (KPIs) for the supply chain are still evolving, and social indicators are still very much at an exploratory phase. GRI is spearheading an effort to encourage reporting across supply chains, among a range of sectors globally. The results of this exercise may be of interest in terms of identifying some easy wins that can add value to contractors on the ground.

Our research suggests that inclusion of indicators relating to contractors' performance in operators' own performance reporting may provide a core pillar of 'responsible contractor management'. In Russia for example, TNK-BP and Naryanmarneftegaz do include their contractors' performance with their own.

Internal reporting is important, yet reporting on non-compliance or accidents can have a negative counter-effect of under-reporting. There can be immense pressures to hide incidents if the foreman's bonus is based on “no one gets hurt” target. No-one wants to be the individual responsible for spoiling the figures. This negative effect of self-reporting is dealt through the company's culture and with proper management attitude. What is crucial is to “encourage a learning atmosphere” in the company, so that other divisions can learn from mistakes. However many organisations struggle to transfer lessons across to other projects.

Q30. What scope of reporting of contractors' performance is appropriate and feasible?

Q31. Can there be too much reporting? Does it ever hinder project performance?

Focus on Russia case study: *TNK-BP Supply chain management*

The fundamental principle of supply chain management for TNK-BP is that of a ‘unified workforce’ that includes the contractors. Any incident of violating HSE regulations is addressed in the same way, whether it is a worker from the contractor or the company. Key areas of focus include the following

- **Reporting:** contractors are included in TNK-BP’s reporting indicators for HSE
- **Investigation:** incidents are investigated in the same way for company and contractors
- **Training:** there are standard approaches to training for company and contractors
- **Transfer of corporate standards:** to the contractors through inclusion in the contracts

In the contracts TNK-BP includes a clause that the contractors are responsible for the performance of their contractors. TNK-BP tries to influence their contractors so that they also influence their own contractors. However, they acknowledge that this is difficult the further you go along the chain. According to TNK-BP, the major international contractors all understand the situation and the standards pass through them to their contractors. The Russian major contractors need more time for this to become regular practice, but there is some progress. The approach relates to all levels of the contracting process:

- **Prequalification:** HSE is included in the prequalification requirements
- **Tender:** HSE and ecological security requirements are included in the tender process
- **Audit/control during implementation:** TNK-BP carries out regular audits of its contractors. This process started in 2006.

TNK-BP has included it as one of their four main priority areas of their business. They have identified the following key focus areas for contractor relations:

- a) **Harmonising approaches:** Harmonising the approaches of a company and its contractors depends on long-term, robust relationships (contractors of 3+ years). These are essential if a company wants to increase the competitiveness of the contractors it works with. TNK-BP seeks to promote enthusiasm among its contractors for good performance. Contractors also need to be aware of the threat of losing their contract if they do not perform to the required standards.
- b) **Motivation:** A carrot and stick approach is required. Russian culture tends to favour punishment over encouragement, but TNK-BP tries to do both. They include penalties and incentives in their contracts. Penalties are incurred if a contractor violates environmental law and HSE regulations. Responsibility is allocated at a personal level. The company also offers bonuses for good HSE performance and good environmental protection actions.
- c) **Supervision:** TNK-BP has outsourced construction, infrastructure development, drilling and recultivation. They are currently developing an (outsourced) supervisory function to manage this work. Supervision is especially needed in complex projects with more than one contractor as this provides leadership and authority. TNK-BP now has supervisory functions for drilling and construction. They are working on supervisory function for recultivation.
- d) **Budget security:** TNK-BP seeks to ensure that the budget lines for environmental protection and labour standards are protected by the contractors and the money is not spent on other aspects of project work.

TNK-BP also has a focus on *assurance*. They check corporate standards and legal compliance. They have a relatively small assurance team (50 people) monitoring changes within staff and contractors. Audits of contractors only started in 2006, so as yet it is difficult to comment on the dynamic.

Source: Interview with HSE manager, TNK-BP, Moscow, May 2007

We would welcome more submissions of best practice in supply chain management

7. Corruption

At a conference on CSR in Moscow, a BP manager explained the company's approach to fighting corruption. BP's Code of Conduct for employees makes clear that bribery and corruption are unacceptable. BP staff undergo checks from their line managers to make sure that they understand the code. Staff report where a bribe has been offered; these reports go all the way up to the Board of Directors. However, there are limits to the effectiveness of a code of conduct, and companies are aware of this, not least because it only applies to the operating company employees.

Corruption is a systemic problem in many resource-rich countries. Eradicating it is a central challenge in building the 'enabling environment' for national companies to enter and maintain a position in oil and gas supply chains. In Kazakhstan for example, informal indications were that at the 'lower' less visible end of the supply chain, it is common practice for local contractors to pay their way into the supply chain in a variety of ways.

Bribes and facilitation payments skew the smooth functioning of markets. And they have a number of adverse consequences from a social and environmental performance perspective. For example, corruption and bribes payable in the acquisition of scarce work permits for foreign workers can mean that those international workers who do come are less qualified than the international norm.

For the major operators, transactions carried out in the 'lower' parts of the chain may remain invisible to all intents and purposes, despite their potential to create reputational risks higher up the chain. Lack of resources for auditing supply chains may be one problem. But we encountered a sense among Russian and Kazak staff working within the major operators that their power to change the way in which things are currently done is limited.

Understanding on appropriate responses to the problems of bribery and corruption needs to become more sophisticated. Management responses that simply remind workers of contractors' 'zero tolerance' for bribery and corruption are unlikely to remove underlying issues – which may be as much to do with the pressure of performance targets that are much more easily met if workers succumb to bribes or corrupt payments. Work also needs to be done in order to address the expectations of local officials if corruption and bribery are considered to be accepted practice in certain circumstances.

Q32. *To what extent is corruption a major barrier to delivering environmental and social standards?*

Q33. *Are there different perceptions of the issue along the supply chain?*

8. Communication and capacity building

8.1 Training and awareness

While most respondents emphasised that the contract is the main tool for establishing and clarifying responsibilities, one interviewee working for one of the major operator and involved in the review of these contracts warned against putting too much emphasis on this aspect of the process. "Contracts," he said, "are important but up to a point. Relationships (between the operator and contractors) are much more important." This is supported by our on-the-ground research in Russia and Kazakhstan.

Relationships between the operator and contractors are established and managed in various ways:

- Communication of corporate standards/awareness raising [through seminars, leaflets, posters, campaigns]
- On-the-job capacity building of contractors through training courses and seminars; assistance with development of management plans, etc. Internal communication and feedback mechanisms [this also relates to monitoring and reporting]

Companies noted that an effective way to build contractors' capacity and mutual understanding is through a long-term working relationship. TNK-BP expressed a preference for long-term contracts and working with contractors over efforts to build the pool of available contractors through industry associations, as practiced by Norwegian companies in northwest Russia, for example (see below).

Respondents highlighted the importance of lesson-learning, internal communication and consistent approaches to key environmental and social issues. Operating companies and contractors (as well as other stakeholders) appear to be keen to learn lessons from the experience of the Sakhalin II project, for example. However, respondents from all stakeholder groups commented that companies are missing opportunities for learning within their vast corporate networks. This relates to the transfer of staff between regions of the world (every 3-4 years), leading to a lack of consistency and locally-grounded knowledge and expertise, and missed opportunities for using the global experience of staff based in corporate headquarters.

Respondents noted frequent resentment at requirements for English language among staff working on international projects; issues related to the use of language on-site (e.g. which language is used for safety drill in multi-lingual contexts); and cultural and linguistic barriers between ex-pat and local staff (in local headquarters offices as well as on construction sites).

Respondents noted that Western 'experts' frequently lack an understanding of the local context. They may try to apply their experience of other countries, which may not be applicable to the specific local context they find themselves in. Or they may make (sometimes major) decisions without a proper knowledge of the legal requirements or common practices in the country they are working in. This may lead to poor decision-making (with sometimes major cost implications) or to the alienation of local stakeholders. The situation is exacerbated when the local counterparts of these Western experts have been selected on the strength of their knowledge of the English language rather than their technical expertise or 'local knowledge'. Misunderstandings may also arise out of inadequate translation of discussions or documents, especially where this relates to interpretation of legal requirements and regulations.

Q34. What skills is the industry building – technical; environmental; stakeholder engagement?

Q35. Do project managers incorporate extra time or reduced expectations during a training phase?

Q36. To what extent do linguistic and cultural factors influence the effectiveness of project decision-making, the working environment and the development of community relations?

8.2 Local employment and enterprise development

There are a number of examples of ‘external’ training being undertaken by both operators and major contractors, to build up a pool of available contractors and subcontractors in local regions. Often this has occurred where there are regulatory/contractual drivers and the region has very limited existing expertise. The company may also be making a strategic investment in the region and is anticipating operating there for some time. On a project basis however, it is harder to justify delaying the development for a year whilst potential contractors are trained. Few project managers are willing to build in time for training contractors in the project schedule.

Norwegian companies are currently working in the Murmansk region to build capacity amongst local contractors. This has stemmed from a desire to be involved in the large projects in the Russian Barents Sea, such as Shtokman. INTSOK (a Norwegian industry association) and StatoilHydro are working with Murmanshelf (the Murmansk Association of Contractors and Suppliers to the Oil and Gas Industry) to raise awareness about international standards.

Respondents noted that altering behaviour is as much a matter of cultural change as it is a management/regulatory issue. They cited positive examples of changing behaviour such as road safety campaigns (encouraging the wearing of seatbelts and no drink-driving) and efforts to encourage workers to use protective gear on the worksites. (However, respondents from Western companies also noted that Russian workers sometimes have the attitude that they don’t need to wear hard hats and safety clothing.) Sometimes awareness raising campaigns (particularly in relation to road safety) are extended to the wider community, rather than just employees.

The research indicated that the majority of training relates to quality, health and safety, rather than engaging with local communities or reducing environmental impact. This reflects the overall concern that social and environmental issues still lag behind health and safety as being an accepted priority throughout the contracting chain.

Oil and gas companies are increasingly seeking to focus their social investment efforts on building local enterprise to serve the industry. It was suggested that this is a more appropriate kind of corporate responsibility initiative than traditional social investment that focuses on support for cultural and sports activities, construction of libraries and clinics (or ice-rinks!), which is frequently unsustainable.

Q37. What are the most effective approaches for closing the gap between ‘local content’ and ‘nationalisation’ requirements and local capacity?

Q38. Do you see regional capacity building as strategic investment or corporate responsibility?

Q39. Are there examples of cultural change or behavioural shifts relating to environmental issues?

Q40. How does the timeframe and level of investment for capacity building fit with project schedules?

9. Thank You

This workshop background paper is based on the findings of our initial research, and is designed to act as a trigger for wider discussion among participants on the issues raised. We intend to publish a more detailed paper in early 2008, and are keen to hear any suggestions for future activities around this issue. We greatly appreciate your time and input into the process.