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Transparency of Extractive Industry Contracts: The Case for Public Disclosure

"The nature of the extractive industries revenue streams…subject to contracts between the government and private companies that are mostly confidential …can help explain the proclivity toward corruption" (Otto, 2006; World Bank publication).

"[Investment] agreements can bridge the jurisdiction gap between different ministries and state agencies and if the law is silent, ambiguous, or inappropriate from the investor's point of view on vital matters, can have sufficient legal standing to take precedence over earlier statutes." (World Bank, 1992)

The main objective of this issue brief is to provide background information to illustrate that public disclosure of investment contracts (i.e., between governments and companies) in the extractive industries (i.e., oil, gas, and mining) is essential to tracking revenue streams and to protecting social justice and the environment. Extractive industry (EI) contracts involve public resources and often act as instruments of public policy on fiscal, social, and environmental matters. On this premise alone, citizens should be entitled to the contents of these contracts. Opening these contracts to public debate could help both to reduce corruption and produce fairer contract terms. The brief also demonstrates that arguments for the need to protect confidential business information over concerns of commercial disadvantages are unjustified. Moreover, there is both growing government discontent with EI contracts signed over the past two decades as well as mounting international support for contract disclosure as a standard of international best practice.

The Important Contents of Extractive Industry Contracts – Instruments of Public Policy

In many developing and emerging market countries, especially those with World Bank-supported EI reform programs, EI sector investment contracts often take the form of two types - the Production Sharing Agreement (PSA) in the hydrocarbons sector and the Mining Development Agreement in the mining sector. These agreements typically address a broad range of issues (e.g., fiscal, labor, social, environmental), supersede statutory law, and are negotiated for only one project. They establish the rights and responsibilities of both the private company (usually foreign) and the Government, and include the formulas used to calculate how profits will be divided between the investors and the Government. Other types of common EI contracts include Host Government Agreements, Power Purchasing Agreements, Concession Agreements, and Inter-Governmental Agreements.

Although a government's "model" contract may be publicly disclosed with the general terms and provisions, it is important to keep in mind, certain project-specific contracts (i.e., PSAs) can ultimately alter any clause during negotiations between the government and the investor. Thus, it is important that the investment contracts for each specific extractive industry project are disclosed. In contrast to what has been encouraged by the industry for developing countries, the US does not enter into to PSAs and does not typically negotiate royalty rates on individual oil and gas projects (Bugala, 2006).

EI contracts in developing and emerging market countries often include the following project-specific provisions that can supersede statutory law:

Obligations: expenditures, infrastructure, employment, training, health and safety, reporting and accounting requirements, environmental responsibilities, compensation to local communities and for relocation, and community development obligations.

Fiscal Provisions: license and area fees, taxes/royalties, signing bonuses, commodity based payments, pipeline tariff structures, guidelines for the operation of special funds and any exemptions of or liabilities to taxes and levies (e.g., exemptions are often given for VAT tax and import duties on related products and services). It should also be noted that precise definitions of the nature and calculation methods of taxes, payments, or royalties can sometimes be problematic and confusing. As Otto (2006) points out "not only are these definitions often complicated, but frequently agreements reflect definitions used in the company's home country, which may be at variance with those used in the host country." Furthermore, different types of royalty schemes are less transparent than others. For example, the industry preferred and World Bank supported profit-based royalties are more difficult to assess and monitor than unit-based or value-based royalties (for more information, please see BIC's Issue Brief – Extractive Industry Contract Transparency: Understanding World Bank Group Influence, October 2007).

Fiscal Considerations: foreign exchange arrangements, provisions for debt repayment, dividend and capital repatriation, escrow accounts, minimum debt equity ratios, revenue distribution requirements, and criteria to regulate inter-company transfers such as charges for management services, etc. (please see Corruption section below for information related to abuse through inter-company transfers).

State Participation: structure and level, financing terms of participation, resource allocation, power/resource purchase requirements, and operational control.

Legal Safeguards: arrangements for settlement of disputes, force-majeure provisions, guarantees against "improper" termination or confiscation by the government, including the requirement of international arbitration through agencies such as the International Center for the Settlement of Investment Disputes (ICSID).

Stabilization Agreements/Clauses: a guarantee, typically for ten to twenty years, of the application of current statutes or contract-specified terms on taxes/royalties, labor matters, environmental responsibilities, and required social investments. It is very important for stabilization agreements to be scrutinized by the public. Many developing and emerging market countries have weak government capacity and inadequate or inappropriate regulations. Even if the government has programs in place to improve capacity and regulations, these stabilization clauses would dictate that the eventually improved measures would not apply. The clauses also make it difficult for a government to suspend operations they may consider environmentally or socially damaging if the type of damage was not specified in the original contract or in the existing laws.

As illustrated above, EI contracts can often be instruments of public policy (e.g., supercede statutory laws) and involve public natural resources – as such, citizens are entitled to know what kind of deal their government has entered into. Moreover, if companies and governments understand from the outset that EI investment contracts will be publicly disclosed, it may very well serve to improve the quality of government decisions on a host of important public issues and to help determine whether adequate revenue flows will be provided to the government. As one US Interior Department auditor puts it – "…there are so many different types of deductions you can take in getting gas and oil to the market, and there are so many premiums and bonuses in the contracts…You have to take a detailed look at the contracts to know what's going on" (Andrews, 2006a).

Secrecy of Contracts Fuels Corruption

> "The nature of the extractive industries revenue streams… subject to contracts between the government and private companies that are mostly confidential [among other factors] …can help explain the proclivity toward corruption" (Otto, 2006; World Bank publication).

By governments - Because mineral resources tend to be concentrated, the resulting wealth passes through only a few hands—and so is more susceptible to misdirection. Furthermore, governments of resource-rich countries have little need to raise revenues through taxes. As a result, Arvind Subramanian of the IMF argues that such [governments] have no incentive to develop non-oil sources of wealth, and the ruled (but untaxed) consequently have little incentive [or ability] to hold their rulers accountable (*Economist*, 2005). Corruption in the extractive industries is not just a symptom of developing or resource-rich countries. In the US, a recent report prepared by the Interior Department's inspector general said that investigators suggested the agency [i.e. Mineral Management Service] was too cozy with oil companies and that internal critics had good reason to fear punishment (Andrews, 2007).

By companies - According to a World Bank publication (1992) - "Some investors may attempt to reduce their tax obligations in the host country through under-pricing mineral products sold to affiliate companies, over leveraging the projects financial structure, making excessive payments to parent or affiliated companies (for supplies, services, and overhead charges) and making shareholder loans with above-market interest rates." It is very difficult for private citizens to uncover cases of corporate corruption. Corporate corruption is usually uncovered by industry whistle-blowers with access to insider information. Public disclosure of EI investment contracts would serve to provide some of the necessary information to keep corporations in line. If negotiated correctly, investment contracts can be designed to ensure tighter control on companies pricing structure, project debt structure, the terms for tax deducible payments to associated companies, and data reporting requirements.

Even in countries with strong government capacity to manage EI revenue, uncovering company fraud and cheating, specifically through inter-company payments and pricing methods, can be difficult to tackle and hinges on individuals' access to information. In the US, several lawsuits under the False Claims Act have been brought against many of the nation's biggest oil and gas companies for significantly underpaying or cheating on royalty payments (for a list of lawsuits and investigations see Bugala, 2006 and Andrews, 2007; 2006). Many of these lawsuits were eventually settled with companies paying nearly $500 million, but various estimates put the oil and gas companies' under payments in the billions (Andrews, 2007 and Bugala, 2006). In the scandals over oil royalties, US government investigators, aided by industry whistle-blowers and the Project on Government Oversight, found that companies were using a host of tricks to understate their sale prices. These included buy-sell agreements in which producers swapped oil with each other at artificially low prices and then resold it at higher prices (Andrews, 2006a). Companies also sold oil at below-market prices to their own affiliates, classified high-priced "sweet" oil as much cheaper "sour" oil and padded their deductions for transportation costs (Andrews, 2006a).

It is important to note that most of the lawsuits and investigations carried out in the US could not have happened without the involvement of industry or ex-industry whistle-blowers (e.g., former Minerals Management Service[i] auditor and former oil trader at ARCO) who had insider access to information such as investment contracts. Thus, knowledge of the terms of investment contracts appears to facilitate the uncovering of corruption.

Growing Demands to Renegotiate or Cancel EI Investment Contracts

In some cases, the problem may not be that companies are cheating or committing fraud, but simply that the EI investment contracts were unfair to begin with. For example, contracts could include too many

deductions and incentives for companies and too little benefits for countries. Furthermore, many countries negotiated the privatization and investment contracts for their most valuable EI resources during times of economic crisis, often with interim governments, whose legitimacy may have been questionable, making the decisions. As such, many of the contracts negotiated provided overly generous terms to foreign EI firms and were not designed to balance revenue sharing once conditions improved.

For example, an independent assessment based on a leaked copy of the Production Sharing Agreement for the Russian Far East Sakhalin II oil and gas project, signed between the Russian government and a consortium consisting of Shell, Mitsui and Mitsubishi, determined that the terms of the contract were unfavorable for the government (Rutledge, 2004). In December 2006, Shell ceded control over the project to Russia's Gazprom amidst government pressure. Although the official reason given for government pressure on the project was environmental violations, industry analysts suspected the government pressure was targeted at securing better revenue terms for Russia (Busvine, 2006).

World-wide, countries already have or are moving towards renegotiating or even canceling their mining, oil, or gas investment contracts and implementing new royalty schemes. Starting in 2004, the governments of **Chile** and **Peru** paved the way for growing discontent with the inadequate benefits from EI projects by imposing new royalties and social spending (*The Economist*, 2007). In the last few years, the renegotiation-cancellation trend has picked up speed with countries such as: **Democratic Republic of Congo, Tanzania, Liberia, Guinea, Zambia, Bolivia, Ecuador, Bangladesh, and Indonesia** reconsidering mining contracts (see *The Economist*, 2007); and **Kazakhstan, Russia, Bolivia, and Venezuela** reconsidering oil and gas contracts. It is worth noting that many of these countries negotiated the questionable contracts under the guidance of World Bank EI sector reform programs (for more information, please see BIC's Issue Brief – Extractive Industry Contract Transparency: Understanding World Bank Group Influence, October 2007).

Even the **US** is scrambling to renegotiate oil and gas leases signed in the 1990s after discovering contract errors estimated to cost the US government $10 billion in royalty revenue over the next decade (Andrews, 2007).

Mounting Support for Disclosure – A Standard of International Best Practice

International support for the public disclosure of EI investment contracts is mounting – from the International Monetary Fund (IMF) to governments to the EI industry itself. Public disclosure of contracts should be considered a standard of international best practice that all EI companies, especially those seeking government- or IFI-related financing, are required to meet.

The IMF's Guide on Resource Revenue Transparency (June 2005) unequivocally recommends contract transparency. The Guide states that good practice requires that all EI investment contracts are publicly disclosed. Moreover, the IMF states that it could be argued that the government's hand is strengthened during negotiations if it was understood that contract outcomes would be disclosed to the legislature and public. Additional encouragement is contained in the International Finance Corporation's (IFC) Policy on Social and Environmental Sustainability, which requires "significant" extractive industry projects (defined by the IFC as representing 10 percent or more of government revenue) "to disclose relevant terms of key agreements that are of public concern, such as host government agreements (HGAs) and intergovernmental agreements (IGAs)." However, it should be recognized that this requirement is severely limited: since the initiation of this IFC policy in 2006, not a single EI project has qualified as being "significant".

In the case of IFI financing for extractives, many believe contract transparency should be a strict requirement for all IFI EI projects. For example, two extensive multi-stakeholder consultations - the World Bank Group's Extractive Industries Review (EIR) and the Canadian Government's National Roundtable

Discussions on Corporate Social Responsibility and the Canadian Extractive Sector in Developing Countries[ii] - both recommended that EI projects financed by IFIs be required to disclose their contracts. Furthermore, the US Foreign Operations Appropriations Bill H.R. 3057, signed into law in November 2005, states IFIs should not approve EI lending operations unless contracts are disclosed.

Before the IFC 2006 policy, IFC-financing required an important industry precedent set by BP's disclosure of its Production Sharing Agreement for the Azeri-Chirag-Gunashli (ACG) offshore oil field and supporting Baku-Tbilisi-Ceyhan (BTC) oil pipeline. Since then, some countries, such as Bolivia, Congo-Brazzaville, and Timor-Leste, have published all or a majority of their oil and gas deals. In addition, the Iraq Study Group, headed by former US Secretary of State, James A. Baker III, recommended that in order "to combat corruption, the U.S. government should urge the Iraqi government to post all oil contracts, volumes, and prices on the Web so that Iraqis and outside observers can track exports and export revenues" (Baker, 2006).

Debunking the Confidentiality Argument

Companies and governments have usually kept secret contractual terms and signing bonuses in the extractive industries. The private sector argues that the contents of these contracts must remain secret to protect confidential business information. They claim that such information as sales/royalty value when combined with project-level production data may reveal the cost structure/pricing strategy of a company and, thus, cause competitive harm.

Such secrecy is being challenged by the IMF, leading economists, industry experts, and even EI companies themselves. In its Guide on Resource Revenue Transparency (June 2005), for example, the IMF contends that "contract terms are likely to be widely known within the industry soon after signing, and thus, little by way of strategic advantage seems to be lost through publication of contracts." The economist, Jeffrey Sachs,[iii] concurs that there is no reason why government oil contracts should stay secret (Economist, December 20, 2005). Similarly, industry expert, James Otto (2006) appears to support the notion that the potential public good that would result from disclosure out weights the potential competitive harm to business. In a World Bank published book on mining royalties, he states the following (Otto, 2006):

> "On the one hand, companies have legitimate concerns regarding confidential information (e.g., specific payroll data) or information that, if disclosed, could result in commercial disadvantage (e.g., production cost data). … On the other hand, the ability of the public to access detailed information on individual operations can act as a check that may not be present when monitoring is conducted solely by regulatory agencies. …the presumption should be in favor of full disclosure; withholding data on confidentiality ground needs to be fully explained and justified."

Even from the point of view of some companies, there appears to be no significant reason the contracts must be confidential. In response to a survey of oil companies active in Azerbaijan conducted by the Economic Research Center (2006) which asked the companies among other questions: "Is the information on your company revenues under PSAs [Production Sharing Agreements] considered [to be] commercial secrecy?" - only SOCAR, the state oil company, answered that such information should remain confidential. Five companies (BP, Shell, Lukoil, Statoil, and Salyan Oil) stated that the information was only partially confidential, and one company replied "unsure". Furthermore, as stated above BP has disclosed its PSA for the ACG and BTC oil projects and published information about an oil bid in Angola (for which Angolan officials unfortunately rebuked them) (*The Economist*, 2005).

Overall, the arguments for EI contract confidentiality do not stand up against the potential public harm from non-disclosure. As a matter of public policy and to combat corruption, disclosure of investment contracts should be the standard requirement for all EI projects worldwide.

"Countries have no justification for secrecy," insists Rashad Kaldany of the World Bank's International Finance Corporation (IFC). "All of these [extractive industry investment] agreements will be made public in [the] future." (The Economist, December 20, 2005)

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End Notes

[i] The Minerals Management Service is the US government agency within the Interior Department responsible for collecting about $10 billion a year in royalties on oil and gas.

[ii] See National Roundtables on Corporate Social Responsibility (CSR) and the Canadian Extractive Industry in Developing Countries: Advisory Group Report. March 29, 2007. http://geo.international.gc.ca/cip-pic/library/Advisory%20Group%20Report%20-%20March%202007.pdf

[iii] In a study in 1995, Sachs showed that the resource-rich grow more slowly than other poor countries—even after such variables as initial per capita income and trade policies are taken into account.

[iv] At the time John Strongman wrote this document for the World Bank Group, he was an employee of the World Bank Group – his specific title was Principal Minerals Economist, Industry and Mining Division, Industry and Energy Department, Finance and Private Sector Development.