Drilling for Good Governance: Key Issues for Auditing the Extractive Sector and Extractive Revenues

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The Natural Resource Governance Institute (NRGI)

Ideas
• Extractive Industry Transparency Initiative (EITI)
• Resource Governance Index
• Natural Resource Charter
• International disclosure standards
• Research: Contracts, fiscal regimes, local content, revenue management, transparency and accountability

Technical Assistance
• Fiscal regimes and contracts (e.g., Liberia, Iraq, Mongolia, Guinea, Sierra Leone)
• Revenue management (e.g., Ghana, Indonesia, Libya, Nigeria, Peru, Timor-Leste)

Capacity Building
• Parliamentary training program
• Training hubs (e.g., Oxford, CEU, regional)
Why extractive governance matters

- In 27 countries, oil and gas contributes more than 50% of government revenues or 60% of exports
- In 10 more countries, minerals contribute more than 30% of government revenues or 40% of exports
- Oil-dependent countries are more secretive, less accountable and grow slower than similar natural resource poor countries
- Rents are extremely large and sector is susceptible to corruption and ‘loss’

<table>
<thead>
<tr>
<th>Country</th>
<th>EI rents in 2010 (USD)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Angola</td>
<td>$37.3 billion</td>
</tr>
<tr>
<td>Brazil</td>
<td>$104.9 billion</td>
</tr>
<tr>
<td>China</td>
<td>$451.8 billion</td>
</tr>
<tr>
<td>India</td>
<td>$102.6 billion</td>
</tr>
<tr>
<td>Nigeria</td>
<td>$72.4 billion</td>
</tr>
<tr>
<td>Zambia</td>
<td>$4.3 billion</td>
</tr>
</tbody>
</table>

Source: World Bank
Why extractive governance matters

- Relatively light interventions can generate millions or even billions of dollars for the government
  - Proper invoicing – Tanzania mining companies may over-invoice oil imports to save approx. $250 million in taxes annually
  - Contract renegotiation – Guinea iron ore royalty hike will generate $3 billion more annually starting in 2017
  - Addressing transfer pricing – Zambian Mopani Copper Mine sold copper to Glencore, its parent company, at far below market rates, avoiding millions of dollars in taxes

Source: Global Financial Integrity; Africa Progress Report
## Total sub-Saharan ODA and resource rents (billion USD)

<table>
<thead>
<tr>
<th></th>
<th>2000</th>
<th>2008</th>
</tr>
</thead>
<tbody>
<tr>
<td>ODA</td>
<td>$12bn</td>
<td>$36bn</td>
</tr>
<tr>
<td>Resource Rents</td>
<td>$39bn</td>
<td>$240bn</td>
</tr>
</tbody>
</table>

### The scale of the opportunity

*Source: World Bank, Changing Wealth of Nations & World Development Indicators*
PIMI Index

Source: IMF
Governance and transparency is missing where it is most needed

Index Scores by Resource-dependency

<table>
<thead>
<tr>
<th>Index Scores by Group</th>
<th>Resource-dependent countries</th>
<th>Non resource-dependent countries</th>
</tr>
</thead>
<tbody>
<tr>
<td>Composite</td>
<td>63</td>
<td>48</td>
</tr>
<tr>
<td>Institutional and Legal Setting</td>
<td>63</td>
<td>58</td>
</tr>
<tr>
<td>Reporting Practices</td>
<td>54</td>
<td>48</td>
</tr>
<tr>
<td>Safeguards and Quality Controls</td>
<td>63</td>
<td>51</td>
</tr>
<tr>
<td>Enabling Environment</td>
<td>35</td>
<td>52</td>
</tr>
</tbody>
</table>
Resource Governance Index: 80% of countries do not meet satisfactory governance standards.

Satisfactory (71-100)
Partial (51-70)
Weak (41-50)
Failing (0-40)
Share of the poor living under $2 a day in Non-Resource Rich Countries vs. Resource Rich Countries, 1990

- Share of Poor in Resource Rich Countries: 20%
- Share of Poor in Non-Resource Rich Countries: 80%
Share of the poor living under $2 a day in Non-Resource Rich Countries vs. Resource Rich Countries, 1990 & 2030
The Natural Resource Charter
Four key ‘risk areas’

- Licensing
- Tax collection
- State owned-company governance
- Revenue distribution and management
Risk 1: Licensing and contracts

• Top three ‘risk areas’
  • Poor company selection leading to weak technical capacity to explore or produce, or conflict with communities
  • Poor fiscal terms leading to renegotiation
  • Tax incentives
Common licensing in the petroleum sector

Agreement → Exploration/Development → Production
Common licensing in the mining sector

Exploration → Agreement → Production
Company selection

• Competitive bidding (auctions or tenders)
  • Fixed vs. variable terms
  • Open vs. pre-qualification
• Direct negotiations
Poor selection and conflict: Guinea

- BSGR paid $160 million for the license; sold 51% to Vale for $2.5 billion
- Former President Conté’s family and entourage reportedly received millions of dollars in gifts and shares
- License revoked in April 2014
- Rio Tinto suing Vale and BSGR
- Beny Steinmetz under investigation in Guinea, France, Switzerland, the UK, and the US.

Sources: Financial Times, New Yorker
EITI audit in Liberia revealed deficiencies in the concession allocation process

LEITI
Liberia Extractive Industries Transparency Initiative

Table 2 – Summary of findings

<table>
<thead>
<tr>
<th>Finding n°</th>
<th>Title</th>
<th>Related contract ref.</th>
<th>Priority</th>
<th>Government Agency responsible</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Cavalla Rubber Corporation and Golden Veroleum Agriculture Concessions awarded without going through competitive bidding process</td>
<td>1, 2</td>
<td>1</td>
<td>MOA and PPCC</td>
</tr>
<tr>
<td>2</td>
<td>Slime Derby Agriculture Concession awarded without going through the competitive bidding process</td>
<td>4</td>
<td>1</td>
<td>MOA and PPCC</td>
</tr>
<tr>
<td>3</td>
<td>Entity Concession Committees not appointed</td>
<td>1 to 5, 8 to 18 and 66 to 68</td>
<td>2</td>
<td>MOA, MLME, FDA and NOCAL</td>
</tr>
<tr>
<td>4</td>
<td>Certificate for Concession not sought or obtained</td>
<td>1 to 5, 8 to 19 and 66 to 68</td>
<td>1</td>
<td>MOA, MLME and NOCAL</td>
</tr>
<tr>
<td>5</td>
<td>Lack of Concession Procurement Plans</td>
<td>1 to 5, 8 to 19 and 66 to 68</td>
<td>2</td>
<td>MOA, MLME, FDA, NOCAL, PPCC and IMCC</td>
</tr>
<tr>
<td>6</td>
<td>Lack of stakeholder forums</td>
<td>1 to 5, 8 to 18, 42 to 54, 56 to 59 and 66 to 68</td>
<td>2</td>
<td>MOA, MLME, FDA, NOCAL, PPCC and IMCC</td>
</tr>
<tr>
<td>7</td>
<td>Agriculture Concession durations not compliant with the Public Lands Law</td>
<td>2, 4</td>
<td>3</td>
<td>MOA</td>
</tr>
<tr>
<td>8</td>
<td>Appointment of Inter-Ministerial Concession Committees not justified</td>
<td>3, 66, 67</td>
<td>2</td>
<td>IMCC, MOA and MLME</td>
</tr>
<tr>
<td>9</td>
<td>Concession Bid Evaluation Panels not constituted and works not substantiated</td>
<td>1, 2, 4 and 10 to 13</td>
<td>1</td>
<td>IMCC, MOA and FDA</td>
</tr>
<tr>
<td>10</td>
<td>Invitations to bid and bid documentation not approved by the Inter-Ministerial Concessions Committee</td>
<td>3, 10 to 13 and 68</td>
<td>2</td>
<td>IMCC, MOA , FDA and MLME</td>
</tr>
</tbody>
</table>

http://www.leiti.org.lr/
Philippines: Strong fiscal terms on paper… but generous tax incentives

- Standard royalty, income tax, VAT and withholding taxes, BUT...
- 6-8 year income tax holiday
- Deduction of all exploration and development costs from ALL taxable income
- In some cases 100% of infrastructure costs are tax deductible
$2.80/barrel:
Difference between fee bid by Exxon & the winning bid of CNPC/BP for Rumaila oil field.

$750m:
Extra accruing to Iraq per year from 1m barrels per day (bpd) production of the Rumaila field.

But, need to look at details of deal and factor for risk of negotiations / renegotiations.
Risk 2: Tax collection and contract compliance

- Tax avoidance: Transfer pricing and misinvoicing
- Production figures: Volume and quality of ore
- Legal loopholes: Tax deductible loans, tax holidays, no ring-fencing, and carry-forwards
- Capacity: Control, management and accounting systems
- Oil trading
Tools for tax collection and compliance

• Extractive Industry Transparency Initiative (EITI)
• Mandatory disclosure of payments (US and EU)
• Ending tax havens
• Monitoring contract compliance
Contract transparency – growing, but still an exception

Source: Resource Governance Index, 2013
A national multi-stakeholder group (government, industry & civil society) decides how their EITI process should work.

Companies disclose payments
- Licensing information
- Production data
- Contract transparency (encouraged)
- Beneficial ownership (encouraged)

Government discloses receipts
- State ownership
- Transfers to local government
- Social and infrastructure investments
- State-owned enterprises
- Transit payments (encouraged)

Government revenues and company payments are disclosed and independently assessed in an EITI Report.

The findings are communicated to create public awareness and debate about how the country should manage its resources better.
EITI in Nigeria revealed billion of dollars in unpaid taxes

- Over $800 million shortfall in company payments, more than annual Ministry of Education budget
- $443 million recovered
- $4.7 billion owed by the Nigerian National Petroleum Company (NNPC)
Using EITI for Policy Reform:
Natural Resource Governance Institute Guide to the EITI Standard

This Guide advises on how the EITI can generate meaningful information that improves natural resource governance.

The EITI Standard has 7 Requirements

1  2  3  4  5  6  7

Processes
Requirement 1

MSG
MSG Governance

CS
Civil Society Participation

Policies
Requirements 3 & 4

AR
Allocation of Rights

PD
Production Data

RC
Revenue Collection

SOE
State-owned Enterprises

SR
Subnational Revenues

RM
Revenue Management

SI
Social Impact

www.resourcegovernance.org/eitiguide
Risk 3: State-owned company governance

- Top three ‘risk areas’
  - Inefficient project development and revenue collection
  - Extra-budgetary expenditures leading to parallel budget
  - Financial risk for taxpayers
Benefits and risks of SOE participation

Benefits and Success Stories

- Development of national skills
- Long-term economic control and financial returns
- More effective state control over the pace and development of the industry
- Stimulator of local content and positive economic spillovers
Are taxpayers getting value for money?: Project development and revenue collection

Average revenue per employee, 2004

<table>
<thead>
<tr>
<th></th>
<th>Average Revenue (in $1,000)</th>
</tr>
</thead>
<tbody>
<tr>
<td>NOCs</td>
<td>$962,000</td>
</tr>
<tr>
<td>IOCs</td>
<td>$1.8 million</td>
</tr>
</tbody>
</table>

Source, Victor 2007
Should certain SOEs be audited as parallel treasuries?

NOC Exports as a share of total government revenue, 2010

Source: http://www.resourcegovernance.org/sites/default/files/OilSales-Transparency.pdf
Angola: Extra-budgetary expenditures

$32 Billion
Venezuela: Extra-budgetary expenditures

PDVSA (Venezuela) Spending, $ billions, 2012

Source: Latin American Herald Tribune
Cost of fuel subsidies

Source IEA, World Energy Outlook 2010, Figure 19.3
Financial risk to taxpayers

• Mexico
  • PEMEX’s $127 billion in unfunded pension liabilities; one third to be taken over by Mexican government

• Nigeria
  • “Cash calls” are a major drain on taxpayers ($7 billion in 2010)
  • Petrol subsidies cost $11 billion in 2008-09
  • Refineries lose hundreds of millions of dollars per year

Sources: The Economist
Risk 4: Revenue distribution and management

• Top three ‘risk areas’
  • Extra-budgetary oil or mineral funds
  • Weak financial management at the national and subnational levels
  • Weak budget processes leading to poor public investment decisions
Sovereign wealth funds

Some have helped countries escape the “resource curse.”
- Chile
- Norway
- Some Persian Gulf states
- Several U.S. states

Others have been mismanaged, not met objectives or become slush funds.
Some in:
- Central Asia (e.g., Russia)
- Latin America (e.g., Venezuela)
- MENA (e.g., Libya)
- SE Asia (e.g., Brunei)
- Africa (e.g., Equatorial Guinea)

What has made the difference are the rules, institutions and oversight.
Subnational revenue distribution

• Lack of transparency in subnational transfers of oil, gas and mineral revenues

• Examples
  • DR Congo
  • Kazakhstan
  • Philippines
Weak budgetary controls (examples)

- Fiscal rules
  - Azerbaijan
  - Trinidad and Tobago
- Project appraisal and selection
- Procurement
  - Timor-Leste electricity project
Conclusions: Progress on public information

- Extractive Industries Transparency Initiative (EITI)
- Dodd-Frank (USA) & EU Transparency Directives
- Budget plans

Often unavailable or difficult to access
- Project level social or financial cost-benefit analysis
- Contracts / fiscal terms
- Project level costs and profits
- Licenses (national and subnational)
- State-owned company payments
- Extra-budgetary revenues and expenditures
- Budget execution audit
Questions auditors can ask

Financial audits
• Are licensing processes being followed?
• Are contracts being complied with?
• Are correct taxes being collected?
• Are national oil / mining companies following their mandates and accurately reporting revenues and expenditures?
• Are sovereign wealth funds meeting their objectives?
• Are correct resource revenues being transferred to subnational governments?
• Are project appraisal, selection and procurement processes followed?

Performance audits
• Is the national oil / mining company providing value for money?
• Is the government getting a fair deal?
• How can tax loopholes be closed?
Thank you

Questions and Discussion

abauer@resourcegovernance.org
Data example – Royalty payments in Burkina Faso, Société d’Exploitation Minière d’Afrique de l’Ouest, 2010

EITI Report:
SEMAFO paid fCFA 3,244,267,363 in royalties
How do we estimate the royalty owed?
Convention Minière Burkina Faso-SEMAFO, 2007, Art. 18.2

B- REGIME FISCAL

Le régime fiscal global applicable à l’Investisseur, à ses Sociétés affiliées et sous-traitants, dans le cadre des Opérations Minières liées au permis d’exploitation objet de la présente Convention se compose:

1. De taxes et redevances minières définies par le Code Minier et sa réglementation;
The Code and its regulations: 2010 = «a year of evolution»

Décret 2005-048, Art. 12
Royalties for gold = 3% of the FOB value

Décret 2010-075/PRES/MEF
Royalties for gold =
• 3% of the FOB value if gold price ≤ $1,000/oz;
• 4% of the FOB value if $1,000 < gold price ≤ $1,300/oz
• 5% of the FOB value if gold price > $1,300/oz

This decree was promulgated on December 1, 2010.
First issue: does the new decree apply to this project?

<table>
<thead>
<tr>
<th>Contract signed in 2007</th>
<th>Assumption for our estimate:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stabilization clause</td>
<td>The new royalty rate applied to this project as of December 1, 2010</td>
</tr>
</tbody>
</table>

| New decree: « applies the results of a dialogue between the Government and the private sector » | But hold onto the question! |
| Perspective from colleagues and sources |                           |
Where do we find the necessary information?

**Necessary information**
Production
Price

**Sources of information**
Production: EITI Report (Ministry reports, company reports)

Price: International indexes (London Fixing)

2010: 5,095 kg (EITI report, p. 36)

2010:
Average annual gold price = $1,225.52/oz
(London Fixing, www.kitco.com)
The first 11 months: Production

Production, whole year (kg)  
(EITI report, p. 36)  

Conversion oz/kg  

\[ \text{Conversion oz/kg} \times 35.274 = \text{production, whole year (oz)} \]

\[= 5095 \times 35.274 = 179,721 \]

We estimate the production for the first 11 months in a very simplified manner.

Production, whole year (oz)  

\[\frac{179,721 \times 11}{12} = \text{production, estimated, Jan - Nov (oz)}\]

\[= 164,744\]
First 11 months: price

First 11 months: estimated royalty owed

Avg price, Jan - Nov ($/oz)  
1,290.93

Estimated production, Jan - Nov (oz)  
* 164,744

= Estimated gross revenue, Jan - Nov ($)  
199,493,071

Royalty @ 3% of value  
*0.03

= Estimated royalty owed, Jan - Nov ($)  
5,984,792
December: production

Production, whole year (oz) 179,721
(previous slide)

We estimate December production in the same simplified manner.

Production, whole year (oz) 179,721

/12

= estimated production, Dec (oz) 14,976
December: royalty rate and price

Royalties for gold =
- 3% of the FOB value if gold price \( \leq \) $1,000/oz;
- 4% of the FOB value if $1,000 < gold price \( \leq \) $1,300/oz
- 5% of the FOB value if gold price > $1,300/oz

So what rate do we apply here?

5%

Average price: $1,390.55

December: estimated royalty owed

Avg price, Dec ($/oz)                          1,390.50

Estimated production, Dec (oz)                * 14,976

= Estimated gross revenue, Dec ($)            20,825,962

Royalty @ 5% of value                         *0.05

= Estimated royalty owed, Dec ($)             1,041,291
Total estimate

Estimated royalty owed, Jan - Nov ($)  
5,984,792

Estimated royalty owed, Dec ($)  
+ 1,041,291

= Estimated royalty owed, 2010  
$7,026,090.25

In the EITI report, revenues are cited in fCFA, so we must multiply by the exchange rate: 486.18 fCFA/$ (average annual rate)

= Estimated royalty owed, total (fCFA)  
3,415,944,599

Exchange rate source: http://www.oanda.com/currency/average
Compare it with the actual revenues

<table>
<thead>
<tr>
<th>A. Actual revenues (ITIE)</th>
<th>B. Estimated revenues owed</th>
<th>C. Difference (A - B)</th>
</tr>
</thead>
<tbody>
<tr>
<td>3,244,267,363</td>
<td>3,415,267,363</td>
<td>— 171,677,196</td>
</tr>
</tbody>
</table>

**Preliminary observation:**

The gap is not enormous. (5% of total)
What could explain the gap?

1. We used non-precise estimates for monthly production and price, but in reality gold prices fluctuate over the course of the year.
What could explain the gap?

2. We also used an average annual exchange rate. In reality, the exchange rate varied over the course of the year, and that could influence the $/fCFA conversion.

<table>
<thead>
<tr>
<th>XOF</th>
<th>bid</th>
</tr>
</thead>
<tbody>
<tr>
<td>January</td>
<td>451.93081</td>
</tr>
<tr>
<td>February</td>
<td>471.38086</td>
</tr>
<tr>
<td>March</td>
<td>474.35255</td>
</tr>
<tr>
<td>April</td>
<td>479.76970</td>
</tr>
<tr>
<td>May</td>
<td>509.94697</td>
</tr>
<tr>
<td>June</td>
<td>526.46767</td>
</tr>
<tr>
<td>July</td>
<td>504.68774</td>
</tr>
<tr>
<td>August</td>
<td>498.13032</td>
</tr>
<tr>
<td>September</td>
<td>494.66700</td>
</tr>
<tr>
<td>October</td>
<td>463.45881</td>
</tr>
<tr>
<td>November</td>
<td>471.01113</td>
</tr>
<tr>
<td>December</td>
<td>487.75403</td>
</tr>
</tbody>
</table>
What could explain the gap?

3. Global gold price ≠ the sale price of Burkina Faso gold.

<table>
<thead>
<tr>
<th>2009 example</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cours de l’or SEMAFO</td>
</tr>
<tr>
<td>(Rapport ITIE, p. 17)</td>
</tr>
<tr>
<td>Prix moyen global d’or</td>
</tr>
<tr>
<td>(London Fixing)</td>
</tr>
<tr>
<td>$936/oz</td>
</tr>
<tr>
<td>$972/oz</td>
</tr>
</tbody>
</table>

This could be because of a lack of good control of transfer prices.

But not necessarily.
What we can and can’t do with the data

What can citizens do with open revenue data on extractives?

- Compare extractive payments to government budget aggregates
- Follow the change in extractive revenues over time
- Compare different information sources on extractive payments
- Compare government revenues from extractives with their total value
- Monitor if resource contracts are being adhered/enforced
- Evaluate if the country is getting a good deal
### Calculations

Production just started. Most of the payment is one-off upfront payment.

*Estimate based on spot reference price. In practice mostly sold in long-term contracts.*

<table>
<thead>
<tr>
<th>Data source</th>
<th>Year</th>
<th>Country</th>
<th>Project</th>
<th>Sector</th>
<th>Government revenue, mS</th>
<th>Production value (estimate), mS</th>
<th>Government revenue/value (illustrative only)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rio Tinto</td>
<td>2013</td>
<td>Namibia</td>
<td>Rössing mine</td>
<td>Uranium</td>
<td>12</td>
<td>176</td>
<td>7%</td>
</tr>
<tr>
<td>Rio Tinto</td>
<td>2013</td>
<td>Mongolia</td>
<td>Oyu Tolgoi</td>
<td>Copper, gold, silver</td>
<td>220</td>
<td>61</td>
<td>362%</td>
</tr>
<tr>
<td>Rio Tinto</td>
<td>2013</td>
<td>Chile</td>
<td>Escondida</td>
<td>Copper, gold, silver</td>
<td>380</td>
<td>6,727</td>
<td>6%</td>
</tr>
<tr>
<td>Tullow</td>
<td>2013</td>
<td>Ghana</td>
<td>Jubilee</td>
<td>Oil</td>
<td>300</td>
<td>1,245</td>
<td>24%</td>
</tr>
<tr>
<td>Tullow</td>
<td>2013</td>
<td>Equatorial Guinea</td>
<td>Multiple field</td>
<td>Oil</td>
<td>214</td>
<td>311</td>
<td>69%</td>
</tr>
<tr>
<td>Tullow</td>
<td>2013</td>
<td>Gabon</td>
<td>Ceiba, Okume Complex</td>
<td>Oil</td>
<td>227</td>
<td>494</td>
<td>46%</td>
</tr>
<tr>
<td>EITI</td>
<td>2009</td>
<td>Ghana</td>
<td>National</td>
<td>Mining</td>
<td>83</td>
<td>1,290</td>
<td>6%</td>
</tr>
<tr>
<td>EITI</td>
<td>2010</td>
<td>Ghana</td>
<td>National</td>
<td>Mining, oil, gas</td>
<td>212</td>
<td>1,763</td>
<td>12%</td>
</tr>
<tr>
<td>EITI</td>
<td>2011</td>
<td>Ghana</td>
<td>National</td>
<td>Mining, oil, gas</td>
<td>943</td>
<td>6,099</td>
<td>15%</td>
</tr>
</tbody>
</table>

- Different fields with each varying costs and risk profiles
- Different commodities yield different rents
- Some more mature fields but also some new drillings undertaken
- There is no meaningful interpretation of this column without additional contextual information
- Lower revenue as still in cost recovery phase