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Fighting For Transparency In Emerging Markets

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Corruption and government mismanagement of public revenue carries a high price tag for companies operating overseas. While the cost of poor public **governance** doesn't appear as a line item on the balance sheet, companies – and their **investors** – most certainly pay the increased cost of operations in markets distorted by corruption and lax governmental controls. As **investors**, it is in our own best interest to build more transparent markets that make it difficult for money moving through legitimate public channels to be spent inappropriately on arms and palaces or siphoned off into private bank accounts.

The Problem

Many companies that refuse to bribe are still touched by corruption and mismanagement. In particular, companies in the oil, gas, and mining sector find that even when they play by the rules – paying billions of dollars in taxes, royalties, and signing bonuses into public coffers – the conditions that breed corruption create undesirable business environments. Beyond the obvious damage corruption and mismanagement inflict on local communities, they also have powerful knock-on effects for corporations and their ability to operate efficiently. Corruption and revenue mismanagement contribute to:

Lack of infrastructure: Revenue that could have been used to deliver essentials such as roads, hospitals, schools, and fresh water is unavailable. Companies are expected to provide their own infrastructure, and also step into the breach by serving local communities – a costly distraction from their core competencies. While expedient, the provision of such services belongs to governments. At best, this model is unsustainable and, at worst, may inappropriately undermine local government and decision-makers.

Underdevelopment of the small business community: Corruption undermines the growth of an efficient and competitive local business sector which prompts multinationals to go further a field to obtain goods and services. Local communities seeking job growth often resent outsourcing.

Escalation of conflict and political instability: Revenue may be re-directed to buy arms or fuel local or regional conflicts. Armed conflict disrupts business operations and creates unwanted – and potentially deadly – security risks for company staff and local people. Ongoing conflict also results in higher security and insurance costs as well as wage increases as expatriate employees demand 'combat pay.'

Diminishing the 'licence to operate': As local populations become isolated from the elites who benefit from resource wealth, the foreign companies come to be seen, rightly or wrongly, as complicit with corrupt behaviour. This impairs their local and global 'licence to operate,' rendering them vulnerable to arbitrary action by government. Recent examples include changes in taxes or contractual terms as has been seen in Venezuela or Bolivia, and the acts of sabotage and violence which have occurred in Nigeria and Peru. In the longer term, this 'guilt by association' can seriously compromise a company's commercial prospects in those markets.

Unfortunately, corruption and revenue mismanagement is vast and diffuse, making it difficult to eradicate. In many markets, companies wearily accept it as 'just another cost of doing business' that they factor into the risk-return calculation and cannot combat individually. However, eradicating corruption is not a hopeless cause – just a difficult one that requires varied strategies and multi-lateral approaches involving as many market players as possible.

Taking Action

The Extractive Industries Transparency Initiative (EITI) is attempting to improve governance standards in resource rich developing countries by boosting disclosure of government revenue earned from natural resource contracts. In developed economies in Europe and North America, payments such as taxes, royalties, and signature bonuses are a matter of public record which enhances accountability of governments to their citizens. In contrast, these payments are deliberately confidential in many developing countries, leaving them vulnerable to misuse and misappropriation by officials.

The EITI, launched in 2002 by British Prime Minister Tony Blair, encourages host governments and extractive-sector companies to sign agreements for companies to 'publish what they pay' and for governments to 'publish what they receive.' This gives civil society the data to identify revenue gaps and call for government accountability.

The EITI has grown rapidly. It now embraces a variety of extractive-sector companies, northern and southern governments, investors, multi-lateral financial institutions, and non-governmental organizations. To date, more than 20 developing countries have pledged to pilot the EITI. Azerbaijan and Nigeria have forged ahead and already publish audited revenue and payment figures for the extractive-sector companies operating within their borders, and Kazakhstan is close behind with a Memorandum of Understanding to follow suit. Each country drives the process according to its own laws and regulations, but must follow a common, internationally accredited set of disclosure and audit principles to ensure the integrity of the data and consistent rules for both domestic and international companies.

The EITI has won official endorsement of the G8 nations, with particularly strong support from the UK, the U.S., France, and Germany. In addition, Norway has played an especially important role, thanks to its experience as an oil-rich nation. The prudent Norwegian Petroleum Fund – that provides inter-generational savings – serves as a useful model for resource-dependent developing nations.

At this stage, all the major publicly traded international oil, gas, and mining companies who depend on competitive access to capital are vocal supporters of the EITI because of the commercial benefits of curbing corruption.

Advocating For Transparency

Institutional investors have played an important role in the EITI by helping to bring corporate and government parties to the table. In 2003, 38 institutions signed the Investors' Statement on Transparency in the Extractives Sector to signal unambiguously their support for the EITI and the creation of more transparent markets. The group has since grown to more than 60 investors who collectively control US\$8.6 trillion. The process was led by F&C Asset Management, a UK-based investor with US\$194 billion under management, as of June 30, 2006. Signatories include Bâtirente, Cal-PERS, the Canadian Labour Congress, Dresdner RCM Global Investors, Ethical Funds, Fidelity Investments, the Hospitals of Ontario Pension Plan, Merrill Lynch Investment Managers, the Ontario Teachers' Pension Plan, PGGM, Schroders Investment Management, SSgA Limited, and the York University Pension Fund.

The statement sends a clear message to host countries that capital markets value strong, transparent fiscal practices and support better governance. However, while its aim is to reduce investment risk and improve investment prospects, it remains up to extractive companies to decide on investment in individual projects and countries. The statement encourages positive change at the country level, but is not a call for divestment from companies or countries. Rather, investors have an opportunity to assist the companies they own by signaling to host countries that their cost of capital may come down if they invest in better governance.

Threats To Transparency

The success of EITI depends entirely on the degree of uptake by governments and extractive companies. While the growth of broad-based support for the initiative is impressive, key holdouts remain and their lack of participation could hinder the EITI's effectiveness.

To date, only a handful of host countries have achieved real progress in operationalizing the EITI principles. The strategy requires that individual host governments remove confidentiality requirements from contracts with extractive companies, permit or compel disclosure by companies, and disclose government receipts.

Several key oil and mineral-rich nations, such as Angola and Indonesia, appear reluctant to embrace transparency. Other countries, such as Ghana and Bolivia, have stalled after initial pledges of support. Yet, progress is more likely if host governments appreciate that companies and their investors will view them as more attractive investment locations if they embrace more robust governance practices and, conversely, that poor governance makes them riskier investment propositions and keeps their cost of capital unnecessarily high.

Likewise, while all the major oil companies and the leading mining companies have joined the EITI, some smaller players have not. In particular, resource companies headquartered in emerging markets – with the notable exception of Petrobras and Lukoil – have been less eager to promote EITI, perhaps because they see commercial opportunities in markets that lack transparency.

Also of concern is the commercial threat posed by nationally-owned companies, especially from emerging markets, whose rapidly-growing appetite for oil and minerals may interfere with their desire to maintain high standards of governance.

The EITI can only succeed if all companies play by the same rules and if host governments have the ability and will to resist the temptation to backslide.

Where Does Canada Stand?

While the EITI has enjoyed the unanimous backing of all G8 members, Canada has not been a particularly engaged supporter. One reason is that, as a major extractive nation itself, it is unwilling to submit to the EITI regime and would not expect standards of others that it did not expect of itself. This contrasts with the U.S., UK, and Norway, which, although major oil and mineral producers, do not intend to adopt EITI domestically. They consider it unnecessary due to their more effective and transparent fiscal management systems. Another reason is that Canada supports other anticorruption initiatives such as the UN Global Compact, the UN Convention Against Corruption, and the OECD Convention.

Our view is that strong government-to-government action – integrated with aid, debt relief, and trade policy – is essential to the success of the EITI. It is also indispensable to securing companies' support for EITI at the individual country level. Indeed, the unique strength of the EITI is its multi-stakeholder nature; the fact that governments, companies, civil society, multilateral institutions, and investors all coalesce to make it a success.

The list of host country candidates is long, and the need for diplomatic firepower acute so active support from all G8 members, Canada included, would certainly be valuable. Interestingly, leading Canadian companies, including Barrick Gold and Talisman Energy, have publicly backed the EITI. These companies and their foreign peers would benefit from strong support from the Canadian government. Likewise, a clear signal from their shareholders that the capital markets value and reward good governance through a lower cost of capital, is a powerful tool to encourage wider adoption by the host countries most in need of higher standards. Canadian institutional investors have a valuable opportunity to lend their support to the EITI and thereby work to bring stability to developing nations, expand investment opportunities in the oil and mining sectors, and improve investment returns for their funds.

Additional investor involvement and support is one of the key elements for encouraging participation in EITI, by resource-rich developing nations, by G8 countries, and by publicly traded extractive companies.

Unfortunately, the EITI is far from that so-called 'magic bullet' that will ensure transparency and wipe out corruption. Nevertheless, it is one of the first successful multi-lateral initiatives joining together the key actors from our global markets against corruption – and backing it up with concrete action. By uniting in favour of transparency, we can encourage better management of public revenues, help to fight corruption, and build stronger, healthier developing nations and more profitable markets for the companies in which we invest.

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