Alleviating the Resource Curse

The Opportunity Presented by Section 1504 of Dodd-Frank

Perspective

-

Andrew Holland

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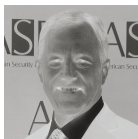

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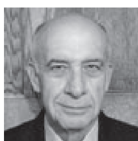

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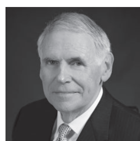

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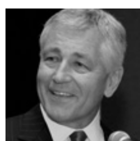

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American Competitiveness

In this Report:

Very soon, the Securities and Exchange Commission is expected to announce new proposed regulations under Section 1504 of the 2010 Dodd-Frank Financial Reform Act. The goal is to increase transparency and provide the public with greater access to information related to the payments that U.S.-listed companies make to foreign governments to extract oil, gas, and mineral resources. The rulemaking has been delayed by lawsuits and SEC inaction. But now the SEC has an opportunity to put in place a policy for disclosure that is accessible and effective.

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IN BRIEF

- Too often, poor and developing countries that experience a natural resource boom end up worse off than if they had never found the resource in the first place; the "resource curse."
- The best way to prevent the resource curse is for the government, companies, and civil society to come together and agree on regulations that increase transparency, allowing the rewards of resources to be shared in a just and efficient way.
- Many governments, however, are not responsive to such initiatives– and companies that disclose payments unilaterally are placed at a competitive disadvantage in contracts. Therefore, mandatory disclosure of payments to governments is warranted.
- The EU has already proposed transparency rules for companies listed on European markets, but the implementation is inconsistent across Member States, and it is difficult to compare the data across countries
- Extractive industries, once strongly opposed to any mandatory transparency disclosures, have now put together a model providing project-based transparency that is usable and effective.
- With one final requirement added to the industry model – disclosure of company-specific payments – this could provide the SEC with a way to provide world-leading transparency, without affecting competitiveness.

About the Author

Andrew Holland is the Director of Studies and Senior Fellow for Energy and Climate at the American Security Project. He was a Legislative Assistant on Energy, Environment, and Infrastructure for United States Senator Chuck Hagel of Nebraska from 2006 through 2008. He has written widely about energy, the environment, and how they relate to geopolitics.

The Need for Transparency

Finding natural resources like oil, gas, or minerals should be a boon to the people of the country where the resources have been found. Unfortunately, too many times, countries experience a “Resource Curse” where – instead of a boom that boosts incomes, GDP, and well-being – the value of natural resources are lost and people are left worse off. Sometimes, the country is hurt by the natural boom-bust cycle of global commodity markets or the value of their currency is changed by the value of natural resource exports – harming the competitiveness of other domestic products (the so-called Dutch Disease). Also too often, many of the benefits of a natural resource boom have only accrued to a well-connected elite, or have simply been stolen.

The best way to deal with this problem is with transparency. When citizens can see how much money their government is receiving from oil, gas, and mining companies, they can make informed decisions about where that money should go, and how their governments should use it. Corruption thrives when the public cannot track what revenues governments receive and how they are spent. Transparency is important for American taxpayers and stockholders as well. If American companies know that their competitors cannot bribe officials, they will feel more comfortable bidding for projects. The American government has an interest in transparency beyond pure altruism: extractive industry revenues in developing countries provide far more money than any American aid program possibly could – but it will only help the economy if it does not end up in the pockets of corrupt officials.

In order to bring more transparency to the extractive industries, in 2010, as a part of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Congress passed legislation that would mandate all companies engaged in the development of oil, natural gas, or minerals around the world to disclose all payments made to foreign governments. Inserted into the legislation in a bipartisan manner by Senators Lugar and Cardin, then members of the Senate Foreign Relations Committee, this legislation requires disclosure of all payments to foreign governments by companies registered with the SEC.

Unfortunately, rules implementing “Section 1504” (named for the section of the Dodd-Frank Wall Street Financial Reform Act) have been stymied for over five years. Even though the legislation says that the SEC must issue final rules on resource extraction transparency within 270 days of the passage of the Act, the rule has not been implemented. The courts rejected the SEC’s proposed rule in 2013, and there has been no re-proposal since then. In the meantime, the European Union has passed legislation requiring its Member States to enact a similar disclosure law, as have other countries, including Norway and Canada.

Now, finally, there are hopes for a breakthrough. The SEC has announced that it will propose a draft rule by the end of 2015, and meet to adopt a final rule in June 2016.[1] Additionally, the American Petroleum Institute (API) – long an opponent of this legislation – has proposed a model for how to comply with the disclosure requirements of Section 1504.

Put together, this means that the United States and American energy companies are poised to take a leadership position on global transparency.

Background: The Resource Curse

Many of world's most corrupt nations are both rich in natural resources and home to some of the world's poorest. The numbers can speak for themselves: in 2010 Equatorial Guinea, 75% of the population lived on less than $2 per day, but the per capita annual income was $35,000 per person – meaning that the rich and connected have collected returns from the country's oil windfall for themselves, while the vast majority of the country have seen little benefit.

Even worse, the act of securing and exporting resources themselves seem to breed corruption, authoritarianism, and even conflict. In Transparency International's 2014 ranking of the most corrupt nations in the world, the twelve member countries of OPEC had an average ranking of 109, and that does not even include such corrupt oil producing countries as Russia (ranked 136), the Democratic Republic of the Congo (ranked 154), or Sudan (ranked 173).[2]

**An oil installation in Sudan.
Image credit: Shannon Orcutt/SaveDarfur/Flickr**

A United Nations Environment Program (UNEP) study found that over the last 60 years, at least 40 percent of all civil conflicts around the world have been over natural resources (including high-value resources like timber, diamonds, gold and oil and scarce resources like arable land or water) – and these conflicts over natural resources are twice as likely to relapse.[3]

Recent research has renewed the robust academic debate about whether oil and other resources constitute a "curse" across all countries –some countries have benefitted from finding oil, while others have found ways to fail without having any resources. However, the factor that successful countries share with each other is transparency: citizens should know that their government officials are not stealing, and shareholders should know that their company isn't fostering corruption.

International Efforts to Bring Transparency to Resources

The United States and developed countries around the world have responded to the threats posed by the "resource curse" – in 1977, the Foreign Corrupt Practices Act (FCPA) went into effect. It prohibits companies from bribing foreign officials in order to secure government contracts and other business. The Securities and Exchange Commission (SEC) is responsible for enforcing the FCPA and it prosecutes companies and individuals for bribery around the world. More than 100 other developed-country governments have enacted similar laws.

Even with an explicit legal prohibition on bribery, however, it is not always clear what constitutes corruption, as contracts can be written that favor individuals or companies, and government resources can be allocated to preferred industries. For that reason, the "Publish What You Pay" initiative, started in the United Kingdom in the 1990s, called on companies to voluntarily disclose their payments to governments of resource rich countries.

The problem is that this created a competitiveness challenge: if only one company disclosed its payments, then host government could discriminate against that firm, give the contract to a less scrupulous firm, and continue its corrupt practices without much changing from a structural standpoint. The result in this case would be to penalize companies for implementing transparency. In fact, when BP announced its plan to disclose its payments to the government of Angola in 2001, Angola's state oil company threatened to unilaterally revoke BP's operating license.[4]

In order to deal with this competitiveness challenge, the Extractive Industries Transparency Initiative (EITI) was launched in 2003 at the urging of UK Prime Minister Tony Blair. This is a voluntary group by which governments, in collaboration with companies and civil society, disclose information on tax payments, licenses, contracts, production and other key elements around resource extraction. As of 2015, 49 countries are an active part of EITI.[5]

As important as the EITI has been, it remains a voluntary organization without the authority to compel countries or companies to comply with its standards. It relies on countries to join the initiative and implement rules that meet its standards. It relies on a vibrant collection of NGOs to participate alongside government and industry in order to monitor and report on violations. That means it has been unable to operate in some large energy-producing nations, like Russia, Iran, Sudan, and most Middle Eastern countries.

For that reason, government action to compel transparency is an important way forward.

SEC Inaction Cedes American Leadership to a Flawed EU Process

Since 2010, there has been a continuation of a push for disclosure from companies in the extractive industry sector. In Europe, the European Parliament passed a directive requiring all 29 member-states to enact legislation by the end of 2015 to require companies listed in those countries to disclose all payments to governments in and outside of Europe. The action is laudable, but the follow-through is lacking, partially due to the separate nature of European Union legislation, where each member state will enact the law in its own way. While the directive issued the requirement for disclosure, Brussels does not have the authority to aggregate these reports in a coherent fashion. This means that total revenue to governments cannot be calculated and disclosed, and there is the potential for inconsistent individual company reports and data. The end result will be an avalanche of data, but no central source that can provide actual value in fighting the resource curse.

Reporting according to the EU directive began this year, with Norway adopting an EU-based program and some oil and gas and mining companies electing to proceed with their own disclosures in advance of the rest of the EU mandates being announced. As expected, what we are seeing as part of these early returns is a hodgepodge of unusable data. Different assumptions and definitions are being used by different companies, with no consistency in identifying who among the various agencies of foreign governments is receiving what.

The SEC now has the opportunity to assert U.S. leadership and rectify this situation. If, as recent SEC announcements indicate, the Commission intends to move forward with a rule in 2016, this presents an opportunity to build effective transparency. The Commission should require reporting in a way that forces companies to account for payments in a consistent manner – one that will allow the public to create usable databases. These will show not just where the money comes from, but where it actually goes. This can be done in a way that allows any interested party to access, sort and use.

The Way Forward

The SEC now has the opportunity to write a rule that can set the world standard. Because the rule will apply to every energy and mining company that lists on US markets (a list that includes many foreign government controlled companies like China's CNOOC and Russia's Lukoil), this rule will be effective, unambiguous, and comprehensive. It will encourage the world's compliance with this standard.

If the SEC rules are better able to meet the standards of transparency needed, then they could end up earning primacy status – and companies around the world will advocate for their country to come up to American standards - "equivalency" with American rules. This means taking the best parts and the best intentions laid down in the EU rules while also establishing a system that is workable, transparent, and effective. The challenge is to do this in a way that avoids creating an undue reporting burden on companies.

Defining a "Project"

One of the key contentions throughout this long-running debate is whether payments should be disclosed at a "project" level, and – if so – what defines a "project." Across the 29 countries of the EU and the many companies that will be affected, there is no standard definition. This will make it very difficult to see effective cross-country and cross-company comparisons across the thousands of data points.

An important part of the SEC decision will be to define "project." This is important because civil society has made project-based reporting a key part of their calls for transparency – but with no legal definition, companies will be incented to report in ways that fit best with their respective accounting and contracting systems, but that will differ widely between companies. Today, there is no standard definition accepted across industry. In order to draft an effective rule, the SEC will have to first determine what a "project" is.

All resource extraction projects can be defined by three key attributes, the combination of which should define a project:

1. What resource is being extracted? There are substantial differences in the regulation and oversight between oil and gas, coal, copper, rare earths, and many other minerals.

2. How is the resource being developed? Whether it's surface mining, underground mining, onshore development, offshore, hydrofracking, or other methods.

3. Where is the development is taking place? Transparency is not only important at the national level, but also in the sub-national political subdivision, like a state or province. The International Organization for Standardization has a global system of standardized codes called ISO 3166 that gives a global standard for geographic areas.[6]

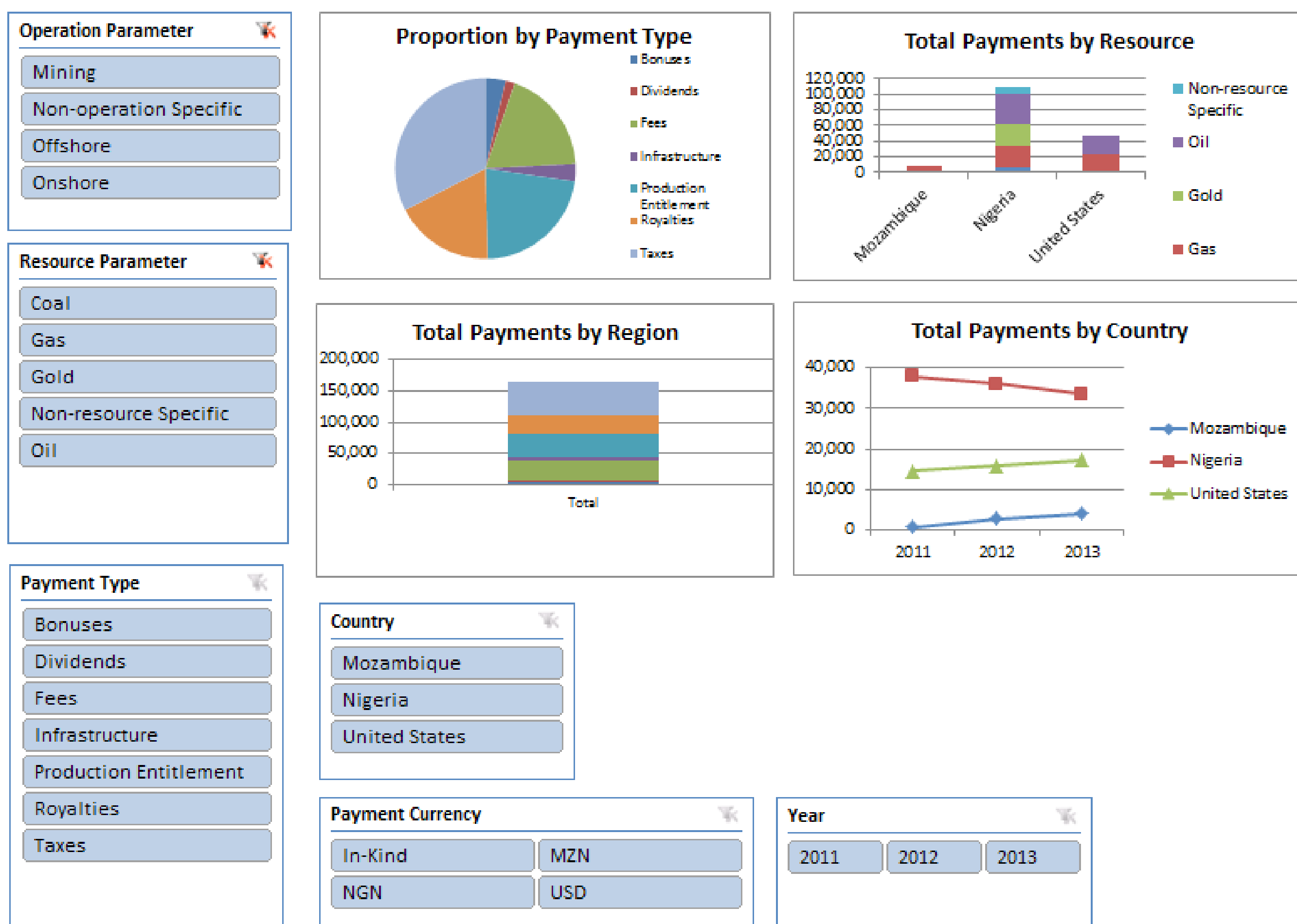
The combination of what resource, how it is extracted, and where it is extracted from is a comprehensible, easily accepted way of reporting that will produce meaningful results.

The API Model for 1504

In 2012, when the American Petroleum Institute (API) filed suit against the SEC rule, it was clear it was implacably opposed to any transparency rules – even going so far as invoking their First Amendment rights to freedom of speech - in that it forced them to provide information they did not wish to provide.[7] The trade association succeeded in its lawsuit because the judge ruled that the SEC had overstepped Congress's expressed intent. Since that 2013 decision, however, regulatory decisions around the world and increasing support by companies for the importance of transparency have fragmented that opposition. API's position, in turn, appears to have evolved on this issue over the years as well.

Recently, API quietly posted on its website a database model for government reporting that could be done consistently by companies and would be in alignment with existing accounting standards. A model of how it would work is available at: **http://publications.api.org/API1504/**.

This model would tag every reported payment with information on who is being paid, and from where the payment originates – identifying the specific government agency that received the payment and in what state, province or offshore lease area it came from. This would generate a database that citizens of countries could use to press for government accountability, and fight the Resource Curse.



Source: API

Unlike other models around the world, the database this model will create would provide easily accessible, quantifiable data that users could then compare across countries and by the type of payment.

The database would be able to provide a detailed breakdown of how governments are paid for resources. They could be sorted by project, by payee, and by the level of government that received the payments. All of this will allow for an unprecedented level of transparency in government revenues, going a long way to alleviate the resource curse. This is more effective and easier to understand than the randomly generated, one-off company reports that are and will continue to be generated under the EU rules.

One Final Addition Needed – Company Based Disclosure

The SEC should take a hard look at the API model: it provides a reporting regime that will produce actual, usable data to fight corruption and hold foreign governments to account. It is a systematic approach that will allow the US to take the lead in transparency on the basis of producing a policy that actually works in the real world.

However, there is one step further that API has not taken in its model: it asserts the SEC should only allow sorting by payee, not the payer. The association says that the names of the companies making the payment should remain protected. In today's world, and in the context of how the EU rules and EITI currently exist, that is no longer acceptable. For the API model to work, and to receive support from civil society and policymakers, disclosure of company payments must also be required.

Conclusion

Less than two decades after it started, the campaign for extractive industries transparency has come a long way from the non-governmental "Publish What You Pay" push to becoming a mandatory part of every company's accounting to the government. When the SEC publishes and implements its new regulations on Section 1504, it will be a great victory for those who advocate for more transparency and want to end the "resource curse" once and for all. Once the public is able to understand how much money they are rightfully due for their nation's resource blessing, they will demand accountability from their government. But without a workable system and platform in place for accessing that information, understanding it, and making it actionable as a means of direct advocacy, these objectives will not be met.

The SEC now has a chance to act – but it only has one chance to get it right, and the time available for the agency to do that is quickly running out. If the SEC fails to put forward a rule that improves on the directive already issued by the EU, it will be the flawed EU rules that will in effect become the new rules that U.S. companies will be forced to follow – pushing the new SEC rules into obsolescence before the ink even dries. While the EU rules still represent a significant improvement over the status quo, and would encourage far more transparency in this space than is currently present, they could leave disclosure too vague and ambiguous, and cede American leadership on the issue.

To some, mining and drilling regulations may seem far from the core business of the SEC, but there really is no better place to put it. Capital markets in the United States are already the most transparent and lucrative in the world – and serious global companies need to list on American markets. These regulations will only increase that transparency, while also helping to lift some of the world's poorest out of poverty. This is a prize that the SEC cannot overlook.

Endnotes

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7. Marsha Z. Gerber, "Court vacates Dodd Frank Section 1504 resource extraction rule" *Norton Rose Fullbright*, July 8, 2013. Available at: http://www.nortonrosefulbright.com/knowledge/publications/100839/court-vacates-dodd-frank-section-1504-resource-extraction-rule

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