

Transparency of Extractive Industry Contracts: Understanding World Bank Group Influence

“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) Just as the IFC insists that countries have no justification for secrecy, the IFC has no justification for not requiring disclosure of investment agreements for all of its EI projects.

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 is important to protecting social justice and the environment.ⁱ The main objective of this issue brief is to provide background information that illustrates the World Bank Group's (WBG) substantial involvement in extractive industry (EI) investment contracts around the world – from design of common contract models, to assistance in negotiating contracts, to support for an EI royalty structure that is less transparent making contract disclosure even more critical. Ultimately, the magnitude and manner in which the WBG has been and continues to be involved in the extractive industries obliges the WBG to do everything it possibly can to make EI investment contract disclosure mandatory – starting with all of its own lending for EI projects and reform programs relevant to the EI sector.

The WBG supports revenue transparency in the extractive industries mainly through capacity building activities and through requiring individual private sector projects to disclose their payments to governments. In a couple of cases, WBG assistance has even secured the disclosure of investment contracts for very large EI projects, such as the IFC-supported mega project Azeri-Chirag-Gunashli (ACG) offshore oil field and its supporting pipeline, Baku-Tbilisi-Ceyhan (BTC). Unfortunately, WBG activities to improve transparency of the EI sector have been limited,ⁱⁱ and the main focus for contracts in particular has been to create a contract model that is “investor friendly” and not one that improves public transparency.

World Bank EI Reform Programs in Over a Hundred Countries

The WBG has played a significant role in reforming and designing the contractual frameworks in the extractive industries around the world with the main aim of making them more attractive to investors.ⁱⁱⁱ With regard to the mining sector, it is estimated that over 100 countries have reformed their mining laws and investment frameworks over the last two decades under the guidance of World Bank reform programs (Danielson, 2003; Naito, 2001). In addition, a significant number of resource-endowed countries have reformed their hydrocarbon laws and investment frameworks under Bank reform programs. Some of the World Bank's more recent EI sector reform programs include the countries of Afghanistan and Iraq – considered by some to be states that are still involved in violent conflicts with extremely limited and compromised government capacity to negotiate and oversee new development agreements in the EI sector.

Contract Models, Stabilization Clauses, and Negotiations

According to three World Bank published papers on strategies for mining development, two on Africa and one on Latin America and the Caribbean (World Bank, 1992^{iv}; Strongman, 1994; World Bank, 1996), the role of the Bank in mining sector reform includes, *inter alia*^v:

- Establishing clear mining policies with updated legislation and fair and competitive fiscal terms;
- Designing model investment agreements and assisting in negotiations with investors;
- Providing technical assistance for the privatization of parastatal companies; and
- Supporting the development of strong capabilities to administer the mining code and negotiate agreements.

Many assessments of World Bank EI reform programs in individual countries confirm that the Bank does indeed perform these activities, not only in the mining sector, but also as part of Bank reform programs in the hydrocarbons sector.^{vi}

It is important to note that support for the public disclosure of investment contracts is not stated as a role for the WBG in any of the Strategies published by the Bank, nor is there evidence of the WBG promoting it in their reform programs or as part of individual project investments, with the exception of a few very large projects. The IFC's Policy on Social and Environmental Sustainability (2006) states that only "significant" extractive industry projects (defined by the IFC as representing 10 percent or more of government revenue) are required to disclose relevant terms of key agreements that are of public concern, such as host government agreements (HGAs) and intergovernmental agreements (IGAs). Since the initiation of this IFC policy in 2006, not a single EI project has qualified as being "significant".

Contract Models – The Bank's general guidance on EI contract models has been to provide attractive measures for foreign investors such as: fair and competitive fiscal terms (with a specific support for lowering taxes/royalties); no size limitations; no minimal performance standards; full repatriation of profits; and longer contract terms (World Bank, 1992^{vii}; Strongman, 1994; World Bank, 1996; see also list of individual country studies in the End Notes). In addition, the Bank outlines elements to be avoided, including: mandatory provision of social services; restrictions on negotiating wages; limitations on expatriate personnel; and imposition of political and economic risks, such as the risk that the government may change the tax regime, or require infrastructure or community investments not originally agreed to (Strongman, 1994).

The necessity and reasoning behind the various contract elements encouraged by the Bank, and subsequently implemented by many governments, is not entirely clear. For example, the terms of the Bank's recommended model contract generally reflect the qualities desired by EI companies as described in certain industry surveys. Many of the industry responses in such surveys should be considered largely an industry "wish list;" they do not reflect the principal determinants of investment decisions by EI companies, such as geology, market prices, and security against terrorism/sabotage (Gibbon, et. al., 1993).

With regard to social and environmental considerations, the Bank recommends that the contracts "can also be used to ensure the preparation and implementation of adequate social impact and environmental mitigation plans and satisfactory health and safety operating standards" (World Bank, 1992). In addition, "the agreement can include training and local initiatives to increase the transfer of benefits to the host country and, especially, to the local community where the mine is developed" (World Bank, 1992).

In many countries with Bank-supported EI reform programs, the actual contract model has taken the form of two EI sector contracts that are the preferred contracts for industry - 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 with only one project in mind. Thus, even though the general contract model may be disclosed to the public, in order to know the actual obligations to government revenue and social and environmental responsibilities, each individual project contract would need to be disclosed. Further to the proliferation of PSAs around the world, the European Bank for Reconstruction and Development (EBRD) specifically supports PSAs as a matter of formal policy applied to both its project finance and technical assistance.^{viii} (For a more detailed discussion on EI contracts and the social importance of their contents, please see BIC's Issue Brief entitled Transparency of Extractive Industry Contracts: The Case for Disclosure, October 2007)

Stabilization Clauses – Many of the contract models and individual EI contracts negotiated during Bank-reform programs or part of specific IFC EI project investments offer private investors juridical stabilization clauses/agreements that guarantee for ten to twenty years the application of current statutes or contract-specified terms on taxes/royalties, labor matters, environmental responsibilities, and required social investments. In the Bank's Mining Strategies for Africa and for Latin America and the Caribbean (World Bank, 1992 and 1996) stabilization agreements are heralded as a characteristic for a successful mining investment regime. It is very important for stabilization agreements to be scrutinized by the public. For one, most World Bank EI reform programs take place in countries with very weak government capacity and with 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 damaging if the type of damage was not specified in the original contract or in the existing, usually weak, environmental laws.

Negotiation of Individual Project Contracts – In many Bank EI reform programs, the Bank assists in contract negotiations between the government and private industry. In addition, the WBG may be directly involved in a contract negotiation when it involves an IFC EI project investment, of which there are hundreds. According to the mining strategy for Africa (World Bank, 1992):

“A strong trusted presence [i.e., the Bank or Bank-associated consultant] is needed to act as a facilitator in negotiations between governments and companies. Many mining sector administrative institutions in Africa have not been exposed to the negotiation and operation of mining business in the rest of the world. This tends to make them ineffective representatives of their governments and difficult working partners for interested investors.”

Many of the specific EI contracts that have been negotiated as a result of Bank reform programs are the largest and most valuable EI concessions for a given country. Moreover, it is not uncommon for the awarding of a contract for a specific valuable EI concession to be formally listed as a Bank program performance benchmark. The very fact that the country needs a Bank reform program usually indicates that the country's most valuable EI resources are being negotiated at a time when the government is in a weak negotiation position or even during times of interim governments whose legitimacy may be questionable.

Bank-supported Royalty Structure makes Contract Transparency Essential

At least two World Bank publications promote the use of profit-based royalties over other royalty structures in the EI sector (Strongman, 1994; and Otto, 2006). One of the documents advises that “governments should emphasize earnings-related taxes (profit, dividend, and cash flow taxes) rather than

[other] royalties [e.g., unit-based or value-based^{ix}] as they are more attractive to investors and will cause less distortion to investment and operating decisions than [other] royalties” (Strongman, 1994).

Most EI investors favor taxation systems based on the ability to pay ... (e.g., profit-based and income-based^x) (Otto, 2006). These are grounded in the concept that taxation should be based on both the value of the mineral produced and certain allowable costs (such as capital costs, production costs, marketing costs, transportation costs, handling costs, and insurance costs) (Otto, 2006). However, the industry-preferred profit-based royalties are more difficult to assess and monitor than the unit-based or value-based royalties. Unit-based and value-based royalties do not take into account the relative profitability of an operation. They are based on the quantity of mineral produced or the value of mineral produced or sold (which would account for variance in the market price). According to one expert (Harries, 1996):

“Profit-based royalties are complex and often difficult to understand or confirm, requiring a lot of information and often the services of an accounting professional to calculate and confirm it. It is also open to abuse and often best avoided...”

Most importantly, profit-based royalties do not meet criteria that are most important to governments, including stability of revenue flow, revenue in early years, and administrative ease and transparency (Otto, 2006). Furthermore, profit-based royalties have the least predictable development outcome for a government and are difficult to determine at the project-level rather than at the corporate-level. Moreover, they cause the government to bear risks associated with inefficient project operators, use of lower levels of technology and competency of a company’s management team. Given the Bank’s tendency to favor profit-based royalty systems, there are most likely hundreds of EI contracts based on this system of payment. Thus, it is essential that contracts are disclosed in order for the public to know the specific allowable deductions and therefore, be able to monitor that correct payments are being made to the government. Moreover, if companies and governments understand from the outset that contracts are publicly disclosed, it may serve to produce contracts with fairer payment terms. (To read about the growing demand by governments to renegotiate EI contracts, please see BIC’s Issue Brief - Transparency of Extractive Industry Contracts: The Case for Disclosure, October 2007)

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End Notes

ⁱ To read more about why this is the case, please see BIC's Issue Brief entitled: *Transparency of Extractive Industry Contracts: The Case for Disclosure*. October 2007.

ⁱⁱ For a detailed assessment of WBG activities in support of EI revenue transparency, please see BIC's publication entitled: *Assessment of World Bank Group's Revenue Transparency in the Extractive Industries*. March 2007.

ⁱⁱⁱ For example, see "The World Bank Extractive Industries Review: The Role of Structural Reform Programs towards Sustainable Development Outcomes," (November 2003) and *Azerbaijan's Continued Struggle with Poverty and Oil Dependence: Concerns surrounding a Decade of IFI Lending*," (June 2005).

^{iv} "Technical Papers are published to communicate the results of the Bank's work to the development community...The findings, interpretations, and conclusions expressed in this paper are entirely those of the author(s) [which the Bank does not disclose on the document] and should not be attributed in any manner to the World Bank, to its affiliated organizations, or to members of its Board of Executive Directors or the countries they represent." (World Bank, 1992)

^v These documents list other Bank activities – only activities relevant to investment contracts are highlighted here.

^{vi} For example, see: 1. Chachage, C. S. L., Magnus Ericsson, and Peter Gibbon, *Mining and Structural Adjustment: Studies on Zimbabwe and Tanzania*. The Scandinavian Institute of African Studies, Research Report No. 92, Uppsala 1993; 2. OED, 2003. *Evaluation of the World Bank Group's Activities in the Extractive Industries: Background Paper – Review of the Portfolio of World Bank Extractive Industries Projects*. Operations Evaluation Department, World Bank. August 2003; 3. Reed, David. 1996. *Structural Adjustment, the Environment, and Sustainable Development*. Macroeconomics Program Office (MPO) – WWF, Earthscan; 4. Mainhardt-Gibbs, Heike, 2003. "The World Bank Extractive Industries Review: The Role of Structural Reform Programs towards Sustainable Development Outcomes," (November 2003); and 5. Mainhardt-Gibbs, Heike, 2005. *Azerbaijan's Continued Struggle with Poverty and Oil Dependence: Concerns surrounding a Decade of IFI Lending*," (June 2005).

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^{viii} The EBRD's Natural Resources Operations Policy states that the Bank's projects provide additionality by showing the market that Production Sharing Agreements are reliable, legal instruments upon which oil and gas financings can be structured. The featured example for the Policy is the Azerbaijan Chirag project. Furthermore, in the said policy's Annex I (Transition Impact of Natural Resource Projects) it states that the EBRD should, "provide support for development and enforcement of a framework law for PSAs through technical assistance; and provide support for [PSA] "test case" projects with large demonstration effects on future investments in both mining, and oil and gas."

^{ix} Unit-based and value-based royalties do not take into account the relative profitability of an operation because they simply look at the quantity of mineral produced or at some measure of the value of mineral produced or sold.

^x Such royalties/taxes are also commonly referred to as net profit royalty, net interest royalty, net proceeds royalty, etc...

^{xi} 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.