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Materiality of disclosure required by the Energy Security through Transparency Act

The extractive industries have unique exposure to material country-specific, tax/regulatory, and reputational risks. Exposure to these risks is heightened by the massive capital employed in the extractive industries, the importance of natural resource access and management to the national security and strategic objectives of the United States and other major energy consumers. Despite capital providers' increasing demands for information that would enable a fuller assessment of these risks, current disclosure requirements are inadequate. The Energy Security Through Transparency Act (ESTTA) (S. 1700) would require additional disclosures that would help capital providers to better account for these unique risks in making investment decisions. The disclosures required by the ESTTA could be used by investors to account for material[1] country-specific, tax/regulatory, reputational risks and would substantially improve investment decision making regarding the extractive industries sector.

Summary of key points:

- ***The extractive industries have unique exposure to material country-specific, reputational, and tax/regulatory risks.* (Pages 1 to 4)**
- ***Current disclosure of extractive industries companies' exposure to these risks is inadequate.* (Pages 4 to 7)**
- ***The Energy Security Through Transparency Act (ESTTA) (S. 1700) requires disclosure that would help capital providers account for these risks in their investment decisions.* (Pages 8 and 9)**

Materiality of Country-Specific Risks

Information regarding company payments of royalties, taxes and production entitlements on a country level may be used to model and benchmark a company's relative exposure to country-specific risks including political risks, such as the production disruptions due to conflict and the expropriation of assets or economic risks involving changes in exchange rates and inflation. Further information regarding the size and timing of payments, such as signature bonuses, provides insight into whether and how these payments will influence development costs or operating cash flow[2].

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[1] Materiality is defined by the Financial Accounting Standards Board (FASB) Statement of Financial Accounting Concepts No. 2, Qualitative Characteristics of Accounting Information as:
". . . the magnitude of an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement."

[2] International Accounting Standards Board. "Discussion Paper on Extractive Activities." April 10, 2010. http://www.iasb.org/NR/rdonlyres/735F0CFC-2F50-43D3-B5A1-0D62EB5DDB99/0/DPExtractiveActivitiesApr10.pdf

Shell's experience in Nigeria illustrates this point. The oil and gas output of Shell's subsidiary in Nigeria, the country's largest producer, dropped by 85 percent from 1.05 million barrels per day in 2005[3] to 360,000 barrels per day in 2008[4] due to shutdowns caused by conflict in the Niger River Delta. Lost production due to the conflict caused Nigeria to fall behind Angola as Africa's largest crude oil producer in 2009[5] and Shell has made it clear that Nigeria is no longer viewed as of source for growth the global reserves[6]. The full impact of the Shell's drop in production in Nigeria between 2005 and 2008 and its plans for the country cannot be modeled completely without information regarding the related tax, royalty and other obligations disclosed through the ESTTA. With this information, an investment analyst could adjust his or her production projections for the company and make a more informed decision about the company's future cash flows.

Information disclosed through the ESTTA may also be used to forecast the potential financial implications of disruptions in production, such as those in Nigeria in April 2008. As the market adjusts for the possibility of production disruptions using data provided by the ESTTA and other sources, the likelihood of oil prices shocks, such as those seen in 2008, would decrease as less investment capital flowed to companies with operations in countries where the risk of production disruptions was relatively high.

Materiality of Tax and Regulatory Risks

Understanding a company's taxation, royalty and other related obligations is particularly important in the extractive industries. First, these rates are often higher and subject to more complex and dynamic regulation depending on the country of operation than those of other sectors. Second, analysts evaluating extractive industries companies try to understand how much money has been spent to acquire reserves and to allocate those expenses to production of the resource or company cash flows. Without a country-level appreciation of the tax regime and how the company manages these obligations, analysts may have difficulty judging a company's relative performance and forecasting the cost curves necessary to estimate when the extraction of a resource will become uneconomical and an operation may close.

When a company's operations are in a country where government mismanagement or corruption are prevalent or industry regulations involving taxes and licensing may otherwise be subject to unexpected, unilateral change, disclosures of taxes, royalties and other obligations are particularly important in assessing the quantitative impact of these changes to a particular company's operations. For example, in 2006 the government of Venezuela abruptly raised royalty rates in the country's Orinoco fields from 1 percent to 16.67 percent. With the royalty data provided by the ESTTA, an investment analyst would be able to adjust his or her models to reflect these royalty changes and also may have been able to anticipate that the government of Venezuela would at some point raise its royalty rates from levels that were far below international averages.

There is increasing pressure on companies to be more transparent about their tax policies, positions and tax data generally, independent of this proposed legislation. For example the professional services firm PricewaterhouseCoopers (PwC) has developed a practice called Total Tax Contribution, through which it

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[3] Akwani, Obi. "Shell Cuts Nigerian Jobs by 43 Percent." *IMDiversity*. April 28, 2008. http://www.imdiversity.com/villages/global/business_finance/GlobalBusiness-ShellCutsJobs.asp

[4] Mbachu, Dulue and Kwiatkowski, Alexander. "Shell's Nigerian Exports Face 5th Month of Disruption." Bloomberg. June 17, 2009. http://www.bloomberg.com/apps/news?pid=20601085&sid=a__xSA7yEMDA

[5] U.S. Energy Information Administration. "Nigeria Country Analysis Brief." Accessed on March 3, 2010. http://www.eia.doe.gov/emeu/cabs/Nigeria/Oil.html

[6] Herron, James. Dow Jones Newswires. "Shell Sells 3 Nigeria Oil Blocks To Local Companies." January 29, 2010. http://online.wsj.com/article/BT-CO-20100129-713410.html

advises clients to disclose their payments to host governments on a country-by-country basis. The firm's literature regarding the practice includes the following points.

> Having a clear understanding of its total tax contribution can enable a business to make better-informed decisions, demonstrate its wider social and economic impact and better monitor and manage tax risk.
>
> . . .
>
> In PwC's view, every mining company needs to have this on a regular basis for all its operating markets. It is essential management information and may also be helpful to inform communication and engagement with government and other key stakeholders. [7]

In *Total Tax Contribution: What is your company's overall tax contribution?*, PwC alludes to the growing list of regulations and laws intended to ensure that companies make adequate contributions to public finances by curtailing activities such as tax avoidance[8]. PwC points out that the negative perceptions that lead to such laws are aggravated by the lack of information in the public domain about precisely what taxes and how much tax companies pay.

Materiality of Reputational Risks
A company's reputation and financial prospects can be harmed if it is perceived as 'not paying its fair share' to a host government or through association with corrupt government practices. Reputational damage may lead to liabilities for external costs associated with a company's operations, greater difficulty in permitting that could lead to project delays or cancelation or the loss of favorable tax status or other forms of government financial assistance[9].

In 2003, the Canadian gold mining company Glamis Gold managed to get the tax status of a maquila or manufacturer in Guatemala[10][11]. As a result of this classification, Montana Explorado, Glamis' local operating company, was exempt from import, value added and corporate taxes. In 2006, following intense global criticism that Montana's operations were not making a sufficient contribution to the economy of Guatemala, Glamis, which acquired by Goldcorp later that year, vacated their maquila status and began paying import, value added and corporate taxes as a mining company was required[12].

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[7] PricewaterhouseCoopers. *Total Tax Contribution: What is your company's overall tax contribution?.* http://www.pwc.co.uk/pdf/TTCframework.pdf

[8] For example, Section 835 of the Homeland Security Act of 2002 (Public Law 107-296,6 U.S.C 395 prohibits the Department of Homeland Security from contracting with certain US companies who have reincorporated overseas (corporate inversions). The US House of Representatives recently passed legislation (HR 4567) that includes a provision to expand this prohibition. The US congress is also considering legislation (HR 4520 and S1637) that includes a provision to modify the tax treatment of US companies that reincorporate overseas. The US congress has also considered legislation regarding US companies moving business operation overseas (offshore outsourcing). The US Senate has passed legislation (S1637) that includes a provision to prohibit offshore performance of government contracts.

[9] International Accounting Standards Board. "Discussion Paper on Extractive Activities." April 10, 2010. http://www.iasb.org/NR/rdonlyres/735F0CFC-2F50-43D3-B5A1-0D62EB5DDB99/0/DPExtractiveActivitiesApr10.pdf

[10] Infopress. "Que hay detrás de las exenciones a Montana?" April 28, 2006.

[11] Kumar, Claire. "Undermining the Poor: Mineral Taxation Reforms in Latin America." Christian Aid. August 2009. http://www.christianaid.org.uk/Images/undermining-the-poor.pdf

[12] Glamis Gold Ltd. Press Release. "Glamis Reaches Tax Agreement with Guatemala." July 18, 2006. http://www.goldcorp.com/_resources/glamis/pressreleases/2006/jul18-06.pdf

It is also worth noting that a company's exposure to reputational risk is not necessary correlated to the scale of the entity's investment in a particular country. This is among the reasons why consistent and comparable disclosure of the payments required by the ESTTA should include all of the countries in which a company operates, regardless of whether any particular country operation is considered material by quantitative measures. Such a determination is consistent with the guidance of SEC Staff Accounting Bulletin No. 99 on Materiality[13].

Investment Environment Stability

The disclosure of payments required by ESTTA would provide a new stream of reliable information in many countries lacking in freedom of information and with weak governments. As a result, this information could help to improve governance structures and stability within extractive industries operating countries. This would help capital providers make better long-term assumptions about the evolution and implementation of regulatory policies within a given country.

Shortcomings of Current SEC Disclosure Requirements

The public reporting currently required by the Securities and Exchange Commission supplies capital providers with very little of the information necessary to fully assess and account for the country-specific, tax/regulatory or reputational risks, as are outlined above. Currently, companies are required to comply with the Federal Accounting Standards Board (FASB) Standard 69, paragraph 12, which requires that: "The results of operations for oil and gas producing activities shall be disclosed for the year. That information shall be disclosed in the aggregate and for each geographic area for which reserve quantities are disclosed[14]."

Companies comply with this standard by reporting their payments to host governments; such as taxes, royalties and bonuses; in aggregated categories such as "production costs excluding taxes" and "taxes other than income." These payments are reported on a country-level where a company's operations are very substantial, but otherwise they are further aggregated on a geographic basis that is often at a continental or broader level. The resulting disclosure is not very useful in determining the extent of a company's operations in or its ongoing financial arrangements with a given country. This makes it difficult to determine reputational, regulatory or tax risk.

The Extractive Industries Transparency Initiative (EITI)

Seeking to ground post-9/11 energy security in political stability and good governance, UK Prime Minister Tony Blair proposed the Extractive Industries Transparency Initiative (EITI) in 2002. The initiative was launched in 2006 with a sophisticated multi-stakeholder governance and accountability structure. The EITI is a global, voluntary framework through which governments and extractive

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[13] The staff reminds registrants and the auditors of their financial statements that exclusive reliance on this (a 5 percent threshold) or any percentage or numerical threshold (for materiality) has no basis in the accounting literature or the law .

The Financial Accounting Standards Board (FASB) makes a similar determination in its Concepts Statement No. 2.

[M]agnitude by itself, without regard to the nature of the item and the circumstances in which the judgment has to be made, will not generally be a sufficient basis for a materiality judgment .

The SEC, FASB and the Supreme Court, in TSC Industries v. Northway, Inc. (1976) , also instruct that qualitative measures, such as reputational risk, may also be used in assessing materiality.

[14] Statement of Financial Accounting Standards No. 69. Disclosures about Oil and Gas Producing Activities. Financial Accounting Standards Board. http://www.fasb.org/pdf/fas69.pdf.

industries companies disclose their reciprocal payments, which in turn they reconcile with the active involvement of local civil society.

To date, 29 resource-exporting countries have begun implementing the EITI, two countries have completed implementation, and 46 of the world's largest oil, gas and mining companies have committed to support the initiative[15]. However, many governments whose countries could benefit from revenue transparency have declined to join the EITI, which after all remains a voluntary initiative. Moreover, the revenue data collected under the auspices of the EITI is often aggregated to a degree that diminishes its value, especially to civil society and capital providers. Further, the EITI reporting requirements have been interpreted differently in various implementing countries.

The result is that EITI produces data that maybe useful within a specific country, but is much less useful for the sort of country-by-country comparison and benchmarking of companies that the uniform ESTTA disclosures would make possible. The ESTTA will be a complement to EITI, and in fact, the reporting requirements of the bill are modeled after those of the EITI. In particular, the ESTTA mandatory disclosure would provide the consistent and timely data necessary to support fundamental investment analysis, which can be challenging using the outputs of the EITI process.

In March 2010, EITI Secretariat announced 20 of the 22 implementing countries missed the first-ever validation deadline[16], which represents a major challenge to a voluntary initiative such as this. Passage of the ESTTA into law would be a much need vote of confidence for the EITI process, which has been one of the best if not only chances for civil society in resource-rich developing countries to promote revenue transparency and accountable governance as the best means of lifting or avoiding the resource curse[17].

Voluntary Disclosure in Corporate Sustainability Reports

Several extractive industries companies including the U.S.-based gold miner Newmont Mining, the Norwegian oil and gas company StatoilHydro and Canadian oil and gas company Talisman have reported their royalties, tax and other host government benefit streams on a country-by-country basis for several years. While these voluntary disclosures are exemplary, the inconsistent auditing of the data and the irregular intervals and forms in which the disclosures are made are arguments for making these laudable efforts mandatory through legislation such as the ESTTA.

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[15] Extractive Industries Transparency Initiative Web site. Accessed on March 3, 2010. http://www.eitransparency.org/candidatecountries

[16] Extractive Industries Transparency Initiative Press Statement. "Decisive period for the first wave of countries implementing the EITI. March 17, 2010. http://eiti.org/blog/decisive-period-first-wave-countries-implementing-eiti

[17] Critical Resource. "'No easy wins for responsible investors' – Interview with Bennett Freeman." March 2010. http://www.c-resource.com/UserFiles/Bennett%20Freeman%20Q&A(2).pdf

Newmont Mining Voluntary Country-By-Country Royalty and Tax Disclosure, CY2008[18]

Royalties and Taxes by Country for 2008 (Millions USD)				
	Government Royalties	Taxes	Total	Percent of Total
Australia	35.1	2.2	37.3	6%
Bolivia	5.3	1.1	6.4	1%
Ghana	13.5	0.1	13.6	2%
Indonesia	12.3	271.4	283.7	38%
New Zealand	0.8	4.3	5.1	1%
Peru	0.1	207.6	207.7	29%
USA	0.0	166.5	166.5	23%
Total	**67.1**	**653.2**	**720.3**	**100%**

[18] Newmont Mining. "Beyond the Mine 2008." Accessed on March 3, 2010. http://www.beyondthemine.com/2008/?l=2&pid=4&parent=17&id=143

StatoilHydro Voluntary Tax, In-Kind Profit, and Bonus Disclosure, CY2008[19]

Twelve months ended 31 December

Overview of activities by country (in NOK million)	Indirect taxes paid (4)		Direct taxes paid (5)		Profit oil In kind (6)		Social investments (7)		Signature bonuses (8)	
	2008	2007	2008	2007	2008	2007	2008	2007 (3)	2008	2007
Algeria	2	5	1,459	752	3,990	1,140	14	15	-	-
Angola	2	-	10,094	4,412	17,881	10,598	33	17	-	-
Azerbaijan	0	-	1,952	1,167	1,914	1,022	15	12	-	-
Brazil	35	29	69	-	-	-	3	1	151	-
Canada	1,120	2	93	-	-	-	3	-	-	-
China	-	2	11	-	-	-	0	0	-	-
Denmark(1)	4,977	4,829	122	265	-	-	-	-	-	-
Egypt	-	-	-	-	-	-	1	-	-	47
Estonia	546	456	-	-	-	-	-	-	-	-
France	-	-	-	-	-	-	0	-	-	-
Georgia	-	-	-	-	-	-	5	1	-	-
Germany	1	-	116	105	-	-	3	3	-	-
Indonesia	9	-	-	-	-	-	-	-	-	38
Iran	45	63	-	-	-	-	0	-	-	-
Ireland	7	-	2	(14)	-	-	1	-	-	-
Latvia	1,138	946	34	15	-	-	-	-	-	-
Libya	241	168	-	61	-	529	-	-	-	-
Lithuania	738	606	22	4	-	-	-	-	-	-
Mozambique	1	-	0	0	-	-	-	-	-	-
The Netherlands	89	-	5	38	-	-	-	-	-	-
Nigeria	1	1	-	-	-	-	3	1	-	-
Norway(2)	10,024	9,182	124,251	94,149	-	-	122	142	-	-
Poland	154	121	-	37	-	-	-	-	-	-
Russia	84	56	-	153	-	54	12	-	-	-
Sweden	13,151	12,972	197	(17)	-	-	-	-	-	-
Tanzania	0	0	-	-	-	-	-	-	-	-
United Kingdom	30	32	271	140	-	-	3	3	-	-
USA	352	35	423	37	-	-	2	-	2,197*	0
Venezuela	8	26	483	1,047	-	-	13	45	-	-
Rest of the world	-	-	-	71	-	-	-	-	-	-
Total	32,757	29,530	139,604	102,422	23,785	133,43	233	241	2,348	85

[19] StatoilHyrdo. "Annual and Sustainability Report 2008." Accessed on March 3, 2010. http://www.statoil.com/AnnualReport2008/en/Finance/SpinOffs/Pages/4-4-1_OverviewOfActivitiesByCountry.aspx

Disclosure Requirements of the Energy Security through Transparency Act

The Energy Security through Transparency Act (S. 1700), introduced by Sens. Richard Lugar (R-IN) and Ben Cardin (D-MD) in September 2009, would fill the information gaps described above by requiring companies to disaggregate host government payment information and report it in a consistent manner and at reliable intervals. Payment disclosure on a country-by-country basis would give capital providers more useful data for estimating future cash flows adjusted for the types of country-specific risks mentioned above. This information may be used to make investment decisions, and its omission could reasonably be expected to make a difference in an investor's actions.

Specifically, the ESTTA would amend Section 13 of the Securities Exchange Act of 1934 13 (15 U.S.C. 78m) to require disclosure of payments by "resource extraction issuers" to "a foreign government for the purpose of the commercial development of oil, natural gas, or minerals" in the issuer's annual report filled with the SEC. The payments are to include "taxes, royalties, fees, licenses, production entitlements, bonuses, and other material benefits, as determined by the (SEC) [20]." The legislation also includes a "sense of Congress" that the U.S. should become an Extractive Industries Transparency Initiative (EITI) candidate.

The disclosures required under the ESTTA would provide material information to investors that would enable them to better evaluate actual or potential investments in extractive industries companies. A key aspect of investment evaluation is the adjustment for the specific risks presented by a particular investment. As this memo outlines, the ESTTA would provide data that is particularly useful for assessing country-specific, tax/regulatory, and reputational risks.

Increasing Prevalence of ESG Data in Financial Reporting

Demand for the data necessary to assess the impact of corporate policies and programs regarding environmental, social and governance (ESG) issues is increasing. One indication is the United Nations Environment Program's Principles for Responsible Investment through which approximately 300 financial institutions representing a total of over $12 trillion in assets under management have called for disclosure of information such as that required by the ESTTA due to its importance in their investment analysis and decision-making processes[21]. In addition, the International Accounting Standards Board (IASB) is considering an International Financial Reporting Standard (IFRS) requiring country-by-country royalty and tax reporting by companies in the extractive industries. The April 2010 IASB discussion paper regarding this proposed IFRS states the following.

> The project team's research found that the disclosure of payments made to governments provides information that would be of use to capital providers in making their investment and lending decisions[22].

The IASB working group's preliminary findings also indicate that geographical disaggregation of reserve volumes at a country level would provide relevant information due to the significance and prevalence of

[20] Publish What You Pay US Web Site. Accessed on March 3, 2010. https://org2.democracyinaction.org/o/5399/images/ESTT.pdf

[21] United Nations Principles for Responsible Investment Web Site. http://www.unpri.org/

[22] International Accounting Standards Board. "Discussion Paper on Extractive Activities." April 10, 2010. http://www.iasb.org/NR/rdonlyres/735F0CFC-2F50-43D3-B5A1-0D62EB5DDB99/0/DPExtractiveActivitiesApr10.pdf

the country-specific risks referenced above (e.g. taxation regime, legal and regulatory framework, governmental/sovereign risk)[23].

Conclusion

The world's exploitable conventional energy sources are receding further into areas where large-scale resource extraction has not taken place before. Unfortunately, many of these resource-producing operating environments pose reputational, regulatory and taxation risks that current reporting required of SEC-registered companies does not address adequately. Although some companies have taken productive voluntary steps to improve their disclosure, capital providers need the audited, consistent and comparable data regarding host government payments, such as taxes, royalties and bonuses that the Energy Security through Transparency Act (S. 1700) would provide. Consequently, the disclosure required by this legislation is material in that it includes information that could reasonably be expected to be used by capital provides to make investment decisions.

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[23] ibid.