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## **THE EUROPEAN COMMISSION'S PROPOSALS ON EXTRACTIVE SECTOR TRANSPARENCY: A CIVIL SOCIETY VIEW**

On 25 October 2011, the European Commission took an important step towards addressing the problems of corruption and mismanagement in the natural resources sector that have kept many developing countries in poverty by proposing that European Union-listed and large EU-based extractive and timber companies should publicly disclose their tax and revenue payments to governments worldwide.

The effect of these proposals, couched as revisions to the existing EU Transparency Directive and Accounting Directives,<sup>1</sup> would be to provide citizens of resource-rich but poor countries in Africa and other developing regions – as well as investors and civil society more broadly - with accurate and timely information about the flow of revenues to governments from the oil, gas, mining and timber industries.

Developing countries rich in natural resources need to maximise the revenue from these finite resources as a source of capital for development that is potentially far greater than inflows of foreign investment or aid. In 2008, exports of oil, gas and minerals from Africa were worth roughly 9 times the value of international aid to the continent (\$393 billion vs \$44 billion), and over 10 times the value of exports of agricultural produce (\$37.9 billion).<sup>2</sup>

The proposed disclosures would provide European investors with detailed information about the operations of extractive companies and their risk exposure in different locations, while helping to promote a more stable investment environment for European business in developing countries by deterring corruption, promoting fair competition, and reducing risks of conflict.

Publish What You Pay (PWYP), a global coalition of civil society groups from more than 50 countries, has welcomed the proposals as a sound foundation for future legislation. However, we believe that to achieve their full effect, the proposals now need to be strengthened by the

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<sup>1</sup> European Commission, Disclosure of Payments to Governments,  
[http://ec.europa.eu/internal\\_market/accounting/other\\_en.htm](http://ec.europa.eu/internal_market/accounting/other_en.htm)

<sup>2</sup> For oil, gas, mineral and agricultural product exports from Africa: WTO, International Trade Statistics, 2009, [http://www.wto.org/english/res\\_e/statis\\_e/its2009\\_e/its09\\_merch\\_trade\\_product\\_e.pdf](http://www.wto.org/english/res_e/statis_e/its2009_e/its09_merch_trade_product_e.pdf), chart II.2; for 2008 aid flows to Africa: OECD 'Development aid at a glance 2011 – statistics by region', <http://www.oecd.org/dataoecd/40/27/42139250.pdf>

European Council and European Parliament.

A crucial element currently missing from the proposals is a requirement to ensure disclosure of financial information which would demonstrate that extractive companies are paying their fair share of taxes in developing countries. Increasing corporate accountability through broader disclosure would tackle tax avoidance and evasion.

PWYP urges the Council and Parliament to reinforce the proposals by setting out clear and effective definitions, clarifying ambiguities, removing loopholes and inserting key elements in the following priority areas:

1. Defining the scope of extractive reporting
2. Ensuring corporate tax accountability through broader disclosure
3. Materiality
4. Exemptions from reporting
5. Addressing all key risk areas in extractives
6. Geographical scope of reporting
7. Auditing, presentation and publication
8. Sector coverage and review

We consider attention to the above points essential to ensure that the proposals, once adopted into legislation, achieve the aims and objectives set out by the European Commission. These aims and objectives are:

- ‘to make governments accountable for the use of these [natural] resources and promote good governance’;<sup>3</sup>
- ‘to provide relevant information to civil society in order for them to hold government and business to account on receipts from MNCs for exploiting natural resources (oil and gas, minerals and primary forests)’.<sup>4</sup>

To conclude this briefing, we welcome the leadership of the European Commission, member states and members of the European Parliament in championing this legislation and summarise our recommendations for strengthening it further.

## **STRENGTHENING THE PROPOSALS**

The proposed legislation would apply to all European publicly listed companies, and large

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<sup>3</sup> Proposed Accounting Directive COM(2011) 684 final, [http://ec.europa.eu/internal\\_market/accounting/docs/other/20111025-legislative-proposal\\_ad\\_en.pdf](http://ec.europa.eu/internal_market/accounting/docs/other/20111025-legislative-proposal_ad_en.pdf), Explanatory Memorandum, p. 5.

<sup>4</sup> EC Impact Assessment, [http://ec.europa.eu/internal\\_market/accounting/docs/sme\\_accounting/review\\_directives/20111025-impact-assessment-part-2\\_en.pdf](http://ec.europa.eu/internal_market/accounting/docs/sme_accounting/review_directives/20111025-impact-assessment-part-2_en.pdf), p. 20.

unlisted companies, ‘with any activity involving the exploration, discovery, development, and extraction of minerals, oil and natural gas deposits’ or ‘in the logging of primary forests’.<sup>5</sup> The proposals would require such companies to ‘prepare and make public a report on payments made to governments on an annual basis’;<sup>6</sup> covering ‘the total amount of payments, including payments in kind, made to each government within a financial year’ and ‘the total amount per type of payment’;<sup>7</sup> and ‘where those payments have been attributed to a specific project the amount per type of payment, including payments in kind, made for each such project within a financial year, and the total amount of payments for each such project’.<sup>8</sup>

PWYP welcomes this proposed coverage. It is compatible with similar legislation passed by the United States in 2010 (Section 1504 of the Dodd-Frank Wall Street Reform and Consumer Protection Act);<sup>9</sup> and it adds important new areas by covering large unlisted companies as well as listed companies, and by also covering timber companies.

## 1. Defining the scope of extractive reporting

PWYP strongly supports the Commission proposal that disclosure by extractive companies be at the project level. Project-level disclosure is consistent with the baseline set by Section 1504 of the US Dodd-Frank Act. This level of disclosure is crucial for local communities and civil society to hold national and local governments to account for ensuring that the full local benefits of project development are delivered. It will also provide investors with a better picture of companies’ risks, which are often related to the geographic location of an investment in a particular region of a country.<sup>10</sup>

However, we believe that, to provide clear and comparable information, the definition of ‘project’ needs to be amended. The Commission has defined the term ‘project’ to mean ‘a specific operational reporting unit at the lowest level within the undertaking [i.e. the company] at which regular internal management reports are prepared to monitor its business’.<sup>11</sup>

This definition is presumably intended to balance the reporting needs of citizens, investors and civil society with a degree of flexibility so as to avoid ‘overburdening companies’.<sup>12</sup> However, it would have the clear drawback that allowing each company to define its own version of ‘project’ will lead to different companies, with distinct internal management structures,

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<sup>5</sup> Proposed Accounting Directive, Art. 36.

<sup>6</sup> Ibid., Art. 37.

<sup>7</sup> Ibid., Art. 38.

<sup>8</sup> Ibid., Art. 38.

<sup>9</sup> <http://www.sec.gov/about/laws/wallstreetreform-cpa.pdf>

<sup>10</sup> A common risk faced by extractive companies is hostility from local communities that bear the brunt of projects’ environmental and social impacts but do not receive the share of project revenues that should be transferred to them from central government under national law. This problem, writ large, has fuelled violent rebellions and independence sentiment in resource-rich regions of countries such as Nigeria (Niger Delta) and Indonesia (Papua and Aceh).

<sup>11</sup> Proposed Accounting Directive, Art. 36.

<sup>12</sup> EC Impact Assessment, p. 30.

producing data which is not comparable across companies, projects or countries. This would undermine the credibility of the legislation since companies will not be seen to be reporting on a common basis.

We recommend that 'project' be defined as the contract, licence, lease, concession or other legal agreement which gives rise to a company's tax and revenue liabilities in each country where it operates. This definition is logical because companies in the oil, gas, mining and timber industries typically exploit the resource within a geographical area, and on the basis of fiscal terms, which are embedded in such agreements.<sup>13</sup>

Certain payments which are more typically made at the country or entity level, such as corporate income tax, could be reported at that level.

## **2. Ensuring corporate tax accountability through broader disclosure**

The Commission has proposed that extractive and timber companies report on payments to governments based on the categories of the Extractive Industries Transparency Initiative (EITI). As supporters of the EITI, we welcome this proposal but we believe that payments disclosure alone is not sufficient to show that companies are paying their fair shares of taxes, a matter of deep and growing concern in many developing countries, particularly in Africa.

There is widespread agreement, including from the OECD, that tax avoidance and evasion cost developing countries more than they receive in aid.<sup>14</sup> The recently revealed Mopani mining tax scandal in Zambia has heightened this concern.<sup>15</sup> With growing global competition between companies from the West, China, India and other regions, companies will increasingly be expected to show that they provide a fair deal for poor countries. Disclosure of revenue payments is not enough, in itself, to show that these payments are appropriate to the scale of extraction undertaken or the profits made by the company.

We therefore recommend that, in addition to reporting revenue data as proposed by the Commission, extractive companies are required to report a range of financial information

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<sup>13</sup> PWYP's proposed definition is also consistent with the way extractive companies listing on the Hong King Stock Exchange since rule 18.05(6)(a) came into effect in June 2010 have voluntarily interpreted 'project' as referring to lease/licence-level operations (finding by International Human Rights Program research students at the University of Toronto Faculty of Law, Nov. 2011, unpublished).

<sup>14</sup> Angel Gurría, OECD Secretary-General, 'Commitment to aid flows must be combined with a crackdown on tax havens, and Britain can do more', <http://www.guardian.co.uk/commentisfree/2008/nov/27/comment-aid-development-tax-havens>; Christian Aid, *Death and Taxes*, May 2008, <http://www.christianaid.org.uk/images/deathandtaxes.pdf>

<sup>15</sup> Counter Balance, *The Mopani copper Mine, Zambia: How European development money has fed a mining scandal*, Dec. 2010, <http://www.counterbalance-eib.org/wp-content/uploads/2011/03/Mopani-Report-English-Web.pdf>; and <http://www.counterbalance-eib.org/?p=1270> for the open letter signed by MEPs calling for a moratorium on EU public financial support for mining projects in the wake of the Mopani scandal.

including production volumes, sales and profit.<sup>16</sup> It may be appropriate for companies to report some of this information on a per-country, rather than a per-project, basis.

The requirement to provide a wider range of data would also bring the legislation much closer in alignment with the stated aim to ‘provide relevant information to civil society in order for them to hold government and business to account’ (emphasis added).<sup>17</sup> It would also be consistent with the emerging debate among EITI stakeholders about whether to expand the EITI reporting requirements, including a proposal from the World Bank that EITI reporting should verify that companies have paid the correct levels of revenue to governments.<sup>18</sup>

### **3. Materiality**

The Commission has not yet determined what constitutes a ‘material’ payment – in other words, how large a payment stream has to be before companies are obliged to report it. However, the Commission has proposed that payments be disclosed ‘where the amount is material to the recipient government’ and that the Commission be delegated authority in respect of the specification of the concept of materiality of payments.<sup>19</sup>

The principle of defining materiality in relation to the government that receives the revenue payment is highly significant and very welcome. Sums of money which are small in proportion to the global balance sheet of an international oil or mining company may still be significant for the public accounts of a poor developing country – especially so in the case of regional and local governments, which fall within the scope of the Commission’s proposals.<sup>20</sup> This principle should be retained in any definition of materiality.

We recommend that, rather than the Commission being delegated the authority to specify the materiality of payments, the EU legislation define materiality as an absolute figure within the legislative texts. This will require only occasional adjustments over the years to account for inflation and ensure that payments are disclosed to a sufficient level of detail to deter corruption and enable meaningful public scrutiny.

In following the principle of defining materiality in relation to countries, many of which will in practice be developing countries with small budgets, the threshold should be set in relation to payment levels that are important to both national and local governments in such countries. A sensible threshold might be for any payment, or set of payments, amounting to more than

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<sup>16</sup> For full details of the scale of the problem and level of reporting required, see Eurodad, *Exposing the lost billions: How financial transparency by multinationals on a country by country basis can aid development*, Nov. 2011, [http://www.eurodad.org/uploadedFiles/Whats\\_New/Reports/CBC%20report\\_hi.pdf?n=7530](http://www.eurodad.org/uploadedFiles/Whats_New/Reports/CBC%20report_hi.pdf?n=7530)

<sup>17</sup> EC Impact Assessment, p. 20.

<sup>18</sup> The World Bank has proposed that EITI reporting should ‘verify that the payments and revenues are what they should be (by reference both to volume of production/sales as well as underlying contracts and other laws)’: World Bank oil gas and mining unit (SEGOM) and EITI Multi-donor Trust Fund (WB/MDTF), Companion matrix on mainstreaming EITI linkages, <http://eiti.org/files/English.pdf>

<sup>19</sup> Proposed Accounting Directive, Explanatory Memorandum, 4.9, 4.10.

<sup>20</sup> “Government” means any national, regional or local authority’, *ibid.*, Art. 36.

€15,000. This figure is compatible with that already used for extractive companies by the Alternative Investment Market of the London Stock Exchange (£10,000).

#### **4. Exemptions from reporting**

The Commission's proposals envisage that companies would not have to publicly report their payments to governments in cases where 'public disclosure of this type of payment is clearly prohibited by the criminal legislation of that country'.<sup>21</sup>

We understand that this provision regarding criminal legislation was inserted to respond to some companies' assertions that the laws of certain countries where they operate would prevent them from publishing financial information in the European Union.

However, we are yet to see evidence as to why this provision is necessary. A study by the Revenue Watch Institute and Columbia University in New York found no examples of countries whose laws specifically forbid the kind of disclosures proposed by the Commission. On the contrary, the report found that it is accepted practice for industry contracts to allow companies to disclose any information required by regulators in their home countries, as would be the case in the European Union. We look to industry to provide this information, and we have also requested this evidence base from the Commission.

Such an exemption would work in the opposite direction to the intention of the proposals. Corrupt autocracies in resource-rich countries would be perversely incentivised to pass opacity laws outlawing disclosure, which would undermine the aims of the EU legislation and prevent citizens from scrutinising their governments' receipts.

The proposed exemption also contradicts the position of the US Securities and Exchange Commission, which includes no exemptions of any kind in its proposed regulations for implementation of the payment disclosure provisions of the US Dodd-Frank Act.<sup>22</sup>

We recommend that the EU legislation allow no country exemptions of any kind.

#### **5. Addressing all key risk areas in extractives**

Regarding which extractive industry activities are covered by the proposals, we note that at present 'exploration, discovery, development, and extraction of minerals, oil and natural gas deposits' would fall within the Accounting Directive's definitional scope,<sup>23</sup> but 'transport, refining and storage' would be excluded as 'midstream' and 'downstream' operations.<sup>24</sup>

This scope of activities is less than that included in the US Dodd-Frank Act, where Section 1504

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<sup>21</sup> Ibid., Art. 38.

<sup>22</sup> <http://sec.gov/rules/proposed/2010/34-63549fr.pdf>

<sup>23</sup> Proposed Accounting Directive, Art. 36.

<sup>24</sup> EC Impact Assessment, footnote 68, p. 20.

defines 'Commercial development of oil, natural gas, or minerals' to include 'exploration, extraction, processing, export, and other significant actions relating to oil, natural gas, or minerals, or the acquisition of a license for any such activity, as determined by the Commission'.<sup>25</sup>

We would encourage this broader definition of the scope of activities. We note in particular the gap in the Commission's proposals regarding disclosure of payments relating to transport and export. In Europe energy supplies are particularly dependent upon transport through pipelines, and natural gas transport is a growing industry and of key geopolitical importance to European energy security. In Africa huge new pipeline networks are proposed and under construction, and the strategic importance of pipelines from the former Soviet Union is well-known. Revenues earned from the energy transit trade are also at risk of corruption and mismanagement, which contributes to political instability, and therefore need to be covered by the EU legislation.<sup>26</sup>

The transportation subsector can involve flagrant and destabilising instances of theft and corruption in the extractive industries. For example, illegal bunkering and diverting of fuel from pipelines for resale is estimated to cost the government of Nigeria \$5 billion a year.<sup>27</sup> Tracking volumes and the payments of fees and in-kind payments is critical to understanding the use and control of pipelines and other transport mechanisms so crucial to energy security.

We recommend that the EU legislation include, as a minimum, export and all transportation activities (as in Section 1504 of Dodd-Frank).

Extractive activities often involve the use of security forces, and companies often make payments to the state and related institutions for security services. These are a key area of risk for investors and for affected communities in many extractives sites. The activities for which payments to governments are reported need to include this important information, a point that may need to be clarified in the drafting process.

We recommend that the EU legislation explicitly specify the inclusion of payments to state security forces for security services.

## **6. Geographical scope of reporting**

The Commission proposals are stated as applying 'in each country where they [companies] operate'.<sup>28</sup> We support this approach and consider that, since a company's operations are not limited to exploration, discovery, development and extraction, disclosure of payments should apply to each country where the company has operations of any kind. This should include countries of registration and where companies have a financial trading presence, in order to

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<sup>25</sup> <http://www.sec.gov/about/laws/wallstreetreform-cpa.pdf>, pp. 80981-80982.

<sup>26</sup> See e.g. Global Witness, 'To secure its energy, Europe must end opacity', comment article on gas disputes between Russia and Ukraine, *Financial Times*, 15 January 2009.

<sup>27</sup> 'PWYP US comments on proposed rules disclosure of payments by resource extraction issuers', February 2011, <http://www.sec.gov/comments/s7-42-10/s74210-29.pdf>, p. 15.

<sup>28</sup> Proposed Accounting Directive, Explanatory Memorandum, 3.4.

provide a full picture of companies' payments to governments.

The latter is particularly relevant where firms are registered in offshore jurisdictions which do not require public disclosure of company accounts. It would also assist in identifying where profit shifting through transfer pricing abuse or thin capitalisation may have taken place.

Without comprehensive disclosure by companies of payments to governments in all countries where they have a presence of any kind, the legislation would not fully meet the Commission's stated intention 'to provide relevant information to civil society in order for them to hold government and business to account' (emphasis added).<sup>29</sup>

We recommend that the EU legislation explicitly require companies to report on payments to governments in all countries where they have an operational or a trading presence.

## **7. Auditing, presentation and publication**

Articles 37 and 39 of the proposed Accounting Directive require companies to publish 'a report on payments made to governments on an annual basis' or, if appropriate, to 'draw up a consolidated report on payments to governments'. The Preamble to the proposed Directive refers to a 'separate report on an annual basis'.<sup>30</sup> Nowhere in the draft legislation is there a reference to reports on payments to governments being audited or published as part of companies' annual financial statements.

PWYP believes that information on company payments to governments is essentially accounting information, of considerable value to investors. Moreover, the Commission's proposals are intended to 'complement' the Extractive Industries Transparency Initiative,<sup>31</sup> and EITI requirements 12 and 13 stipulate that company and government reports must be 'based on accounts audited to international standards' (emphasis added).<sup>32</sup> EU rules on country-by-country financial reporting not requiring auditing to international standards would undermine the credibility of the legislation and could prevent EU-listed and large unlisted EU companies operating overseas from accruing the reputational benefits of being seen to be transparent, in leading to the publication of information not subject to independent checks, and whose veracity may therefore be questioned.

We recommend that the EU legislation require country-by-country and project-by-project payments data to be fully audited and included in companies' annual financial statements.

It has been argued by some that the quantity of country-by-country and project-by-project information on payments to government could be excessive for printed reporting by some companies. We recommend that the EU legislation provide for a combination of summary

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<sup>29</sup> EC Impact Assessment, p. 20.

<sup>30</sup> Proposed Accounting Directive, Preamble, para 32, p.20.

<sup>31</sup> EC, 'Proposal for Directive on transparency requirements ... frequently asked questions', <http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/11/734>, question 16.

<sup>32</sup> <http://eiti.org/document/rules>

reporting in print and fully detailed online/electronic reporting, in line with developments underway to make data more useful for investors.

In addition, a European public entity – ESMA<sup>33</sup> or other – should compile the data for public online access, with the information electronically tagged by key analytical categories so that investors, civil society and governments can easily use, compare and understand the data. This dual approach would avoid issues of scale, cost and difficulty in analysing large volumes of data.

## **8. Sector coverage and review**

The problems related to a lack of financial information can be particularly acute for the extractive industries, yet these issues can occur in any sector. Therefore arguments in favour of this legislation for extractives and forestry also apply to other sectors. PWYP supports calls for greater information on the trading operations of all multinational companies and sees no reason why improved reporting requirements could not be extended to all major economic sectors.

While we favour this expansion of the proposals in this legislative process, Commissioner Barnier made it clear at the press conference launching the proposals that he saw the review clause<sup>34</sup> as offering an opportunity to strengthen the legislation and to consider extending its scope.<sup>35</sup> We believe it essential that the proposed review specified in Article 41 be required to take place after two years, rather than after up to five years. This will maintain the necessary pace of progress in enhancing government and corporate accountability.

We therefore recommend a first review after two years.

## **SUMMARY OF RECOMMENDATIONS**

Publish What You Pay greatly appreciates the European Commission's efforts to put forward these proposals, which will vastly improve the ability of resource-rich developing countries to benefit from their natural resource wealth. We now urge the European Parliament and Council to further strengthen the proposals by ensuring that:

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<sup>33</sup> European Securities and Markets Authority, <http://www.esma.europa.eu>

<sup>34</sup> Proposed Accounting Directive, Art. 41: 'The Commission shall review and report on the implementation and effectiveness of this Chapter, in particular as regards the scope of the reporting obligations and the modalities of the reporting on a project basis. The review should also take into account international developments and consider the effects on competitiveness and security of energy supply.'

<sup>35</sup> [http://ec.europa.eu/commission\\_2010-2014/barnier/docs/speeches/20111025\\_paquet\\_entreprises\\_responsables\\_fr.pdf](http://ec.europa.eu/commission_2010-2014/barnier/docs/speeches/20111025_paquet_entreprises_responsables_fr.pdf);  
<http://ec.europa.eu/avservices/player/streaming.cfm?type=ebsvod&sid=189352>

1. Reporting is on a country-by-country and project-by-project basis and covers all listed and large unlisted companies. 'Project' is defined as the contract, licence or other legal agreement which gives rise to a company's tax and revenue liabilities in each country where it operates.
2. In addition to reporting revenue data, extractive companies are required to report a wider range of financial information including production volumes, sales and profit.
3. The 'materiality' threshold is defined as an absolute figure within the legislative texts and is low enough to be useful for all levels of government in developing countries.
4. There are no exemptions from reporting.
5. The legislation includes, as a minimum, export and transportation activities (as in Section 1504 of Dodd-Frank) and explicitly requires the reporting of payments to state security forces.
6. Payments to all countries of either operation or trading are included in the requirements.
7. Reported data is required to be audited, included in companies' annual financial statements and also filed electronically in tagged standard formats and collated by, or on behalf, of the European Commission.
8. The effectiveness of the legislation is reviewed after two years.

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