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Working Paper

Partners in Dialogue

Commodities and the Extractive Sector

Can transparency foster prosperity, progress and development?

1. Background

The extractive sector is the mainstay of many developing countries. It has, and will continue to play a significant role in the development of resource-dependent economies. If managed well, including in terms of transparency and revenue administration, the extractive sector can be a strong vector of growth, providing significant opportunities for countries to transform and diversify their economies. However, if not well managed, gas, oil and minerals can lead to the *paradox of plenty* or *resource curse*, which is a situation where resource-abundant countries experience less economic growth and lower development outcomes due to a decline in the competitiveness of other economic sectors, volatility of natural resource revenues, government mismanagement of resources and/or bad institutions.

In recent years, thanks to the increased global demand, notably from China and other emerging markets and high commodity prices, many resource-dependent - mainly African - countries have experienced unprecedentedly high growth rates. The challenge now is to leverage this high growth to make it truly transformative and inclusive, with long-term benefits for human and economic development.

Regulatory and fiscal reforms as well as trade and industrial policies, conducted at the national and regional level, to transform economies from their commodity dependency are indispensable to reap the benefits of the current boom. At the same time, countries and citizens need to ensure that they get a *fair share* of the revenues derived from their resources. This necessitates, as a first step, to operate in a transparent and well-governed global environment. It also requires a regulatory setting that is realistic and implementable by all stakeholders – governments, extractive industries, financial institutions and commodity traders. Today, there is a consensus about the importance of increased transparency and better regulations for better development outcomes. But one is yet to have a common understanding of what is *necessary, realistic and implementable* among different stakeholders.

2. Shared responsibility

Given the nature of the extractive sector, the responsibility of making it work for development is a shared one. ***Resource-dependent countries*** are primarily responsible for the efficient management of their resources and the revenues derived from them. However, ***home countries of extractive industries*** have an equally critical role to play in global governance to ensure that their companies operate in an ethical and transparent manner. This is not only crucial for resource-dependent countries, but also good for their own businesses because transparency can foster a regulatory level-playing field and prevent

reputational risks.

Besides extractive industries, physical ***commodity traders*** have an equally important role to play, as do ***their home countries*** or countries where they are registered. They play a pivotal role in the global commodity market structure. Yet, they are not fully part of the global transparency debate despite their growing importance in the commodity value chain in the last decade. Their role is likely to grow: For instance, they are expected to become more important players as banks retreat from physical commodity trading as a result of stricter regulations, capital constraints and lower profitability due to stable prices for commodities[1]. Furthermore, in recent years, many trading houses have extended their scope and reach while expanding control of supply chains as they acquire downstream assets in producing, logistics and storage facilities[2].

It is therefore timely to discuss the role of the extractive sector and of commodity trading in development, and in particular to what extent transparency and regulatory reforms can foster prosperity, progress and development in resource-dependent developing countries.

3. Key challenges for developing countries

The priority for resource-rich developing countries is to transform their extractive resources into prosperity, progress and development. But many have been trapped in poverty, poor human development and rising inequality. Changing this dire state of affairs require creating economic linkages between extractive sector and the rest of the economy, being able to develop a thriving industrial sector capable of absorbing the bulging youth population and creating productive employment, and diversify the economy away from commodity dependence.

To tap the full potential from resource revenues, greater transparency can significantly enhance available capital by means of good taxation, efficient government spending and sound overall fiscal management. While resource-rich countries need to take full responsibility of their transformative agenda, without coordinated efforts from countries where multinational extractive industries and commodity trading houses are domiciled, these countries will not be able to harness the full potential of their resources. In addition, it is crucial to get companies on board in the debate. While mandatory requirements are a big leap in the transparency debate, corporate self-regulation and private sector initiatives can sometimes be more efficient, in the sense that companies are the best placed to know to what extent they can go, without putting at risk their competitiveness. To encourage them to participate in the dialogue, they need to see the value added of their actions and be provided with the incentives to do so.

The key challenge is therefore to foster public debate that serves the interests of all those that are crucial to advance the agenda of development: resource-rich countries, countries where companies are domiciled and the corporate sector itself. The debate must be able to strike the balance between economic interests and development objectives, and need to come up with actionable outcomes that will be implemented. Resource-rich but otherwise poor countries must transform now, because resources are extracted only once and as the global demand for commodities is set to continue to rise, so will the challenges, if not addressed. Global leaders have a role to play to remain on the cutting edge of competitiveness as

[1] See Financial Times 31 March 2014: Banks' retreat empowers commodity trading houses. Neil Hume, Commodities Editor.

[2] Deloitte 2013. Trading Up: A look at some current issues facing energy and commodity traders.

new players catch up to gain market share and it is therefore in their interest to act collectively by finding synergies, despite their different approaches.

4. The international community – fields of action

4.1 Transparency initiatives: A necessary condition

Although not the only solution to address all the challenges facing countries plagued by the resource curse, transparency is an important pre-condition to shed some light on revenues derived from the extractive sector. Increased transparency, when it comes to contracts, revenue collection, revenue management and government spending, can indeed significantly contribute to reducing inequality, by raising public awareness on important aspects of resource (mis)management, through the entire supply chain from exploitation conditions down to distribution of rents. Transparency therefore matters because it has the potential to hold to account (i) the government, who is the custodian of resources and the manager of rents from the resources on behalf of the people; and (ii) extractive industries and traders, to whom the state have delegated the authorisation to turn resources into economic benefits. In the quest of transparency it should be kept in mind however, that increasing transparency rules and regulations come at a cost - for the industry and developing countries - in terms of administration and inefficiencies (one size fits all), but also in terms of sharing of business secrets. Especially small and medium-sized enterprises (SME) struggle to cope with the speed of new rules and regulations; and the know-how and additional manpower required to comply with them.

It is important to distinguish between **two perspectives** of looking at transparency, which have different implications for accountability: **(i) a country's administrative transparency**; and **(ii) corporate transparency**. A *country's administrative transparency* with regard to resource management allows citizens to hold their governments accountable and reveal possible corruption cases on contract allocation, revenues received, production shares received, expenditure and rent distribution etc. Similarly important is *corporate transparency* of businesses (including trading houses) and multinational corporations (MNC), so that governments themselves are able to hold private sector actors accountable for practices, such as profit shifting, transfer pricing, trade mispricing, illicit financial flows[3], etc. In the context of these international financial transactions, practices used to evade and avoid taxes play an important role. Such practices are often seen, also in developing countries, as being connected with a business model often used by multinational corporations, which is designed to ensure that profits become subject to taxation in places where tax rates are particularly low or non-existent (transfer pricing). According to various studies, companies involved notably also in the commodities industry have a strong tendency to make use of this practice[4].

At the international level, there are already a number of debates and initiatives aiming at the promotion of transparency and accountability in the extractive industries to increase the development impact in resource-rich countries. The Extractive Industry Transparency Initiative (EITI) requests companies in compliant countries to disclose taxes and other payments made to government in the oil, gas and mining sector. At the end of 2013, the scope was extended to cover production figures, licensing ownership and revenue allocation made by governments once revenue is collected. Another initiative, which is supported

[3] As defined by UNECA's Third Meeting of the Committee on Governance and Popular Participation, Addis Ababa, 20 and 21 February 2013. http://www.uneca.org/sites/default/files/uploaded-documents/CGPP/cgpp-3_illicit-financial-flow-english_final.pdf
[4] *Draining development?: Controlling flows of illicit funds from developing countries*, edited by Peter Reuter, 2012. A study conducted by the World Bank, containing a number of analyses on the subject. The study also provides a detailed explanation of the practice of transfer pricing.

by Switzerland as well as by the EU, is the OECD Due Diligence Guidance for Responsible Supply Chains of Minerals from Conflict-Affected and High-Risk Areas[5]. The EU decided to additionally strengthen this guidance by introducing new measures not long ago. The US[6] has passed legislations to request companies listed in their stock markets to disclose payments made to governments in foreign countries. In the EU, the new Accounting Directives and the revised Transparency Directive (both adopted in 2013) introduce a new obligation for listed, large non-listed and public-interest entities with activities in the extractive industry and the logging of primary forests to report the payments they make to governments. Both legislations are yet to be implemented, due to different reasons.

At the level of the OECD, action 13 of the Action Plan on base erosion and profit shifting (BEPS) requires governments to provide transfer pricing documentation to enhance transparency. Within this action MNCs will also be required to report on a country-by-country level by providing all relevant governments with needed information on their global allocation of income, economic activity and taxes paid among countries. This is expected to help tax authorities identify malpractices. Annex 1 gives an overview of the regulatory approaches.

Except for the US legislation that potentially covers exporting companies, provided they are listed in the US, most multilateral initiatives so far cover mainly activities of extractive industries. In this respect, ***trading*** activities remain largely outside the scope of the current legal frameworks and trading companies remain therefore unaccountable and have no obligations to disclose their financial accounts or their payments to governments with whom they deal. This is quite important in particular in the oil sector: in addition to receiving payments from extractive industries (in the form of taxes, royalties, etc.) many resource-dependent countries also receive in-kind proceeds, in the form of barrels of oil, due to their production sharing agreements. In this regard, they deal directly with commodity traders, which therefore remain potentially uncovered by the current regulatory framework (except for the EITI).

4.2 Voluntary initiatives and corporate social responsibility

The role that ***companies*** can play in development has gained in prominence, not only at the local level, where they have an decisive economic role through investment and employment creation, but increasingly in international debates, where they are solicited to make ethics as part of their core business. There is a growing recognition that as the extractive sector becomes more sophisticated and vertically integrated, new approaches and standards, inclusive of private actor, are needed.

A number of voluntary codes and mechanisms exist globally, many of them focusing on working conditions and human rights. Although laudable initiatives are generally seen to have a positive effect, research[7] however suggests that it is difficult to measure the long-term impact of these standards. Similarly, in the extractive sector a number of voluntary initiatives have emerged as important tools to address issues such as environmental, the prevention of corruption, due diligence to prevent the use of conflict minerals, social and ethical issues. These initiatives are recognized and acknowledged as bringing forward a broad sense of corporate responsibility, in particular when companies operate in difficult contexts (such as in fragile states or countries with weak institutions).

[5] http://www.oecd.org/corporate/mne/mining.htm
[6] Section 1504 of the US Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.
[7] See Newitt, K. 2013. Private Sector Voluntary Initiatives in Labour Standards. A background paper for the World Development Report 2013.

Although not solely applicable to the extractive sector and commodity trading business, corporate social responsibility (CSR) is increasingly becoming a ***core business*** element. Ethical corporate conduct is increasingly seen as crucial to gain a social license to operate, through positive business impacts on its employees, consumers, communities and society as a whole. Many companies have stepped up efforts to enhance corporate self-regulation as an integral part of their business models to ensure active compliance with laws, ethical standards and international norms. In the extractive sector, businesses are increasingly discussing ways to contribute to more inclusive development by creating shared value. This goes beyond CSR and is a new way of doing business by reconceiving the intersection between society and corporate performance.

While this conclusion does not deny the importance of CSR as a principle, it however calls for a more realistic assessment of the types of initiatives, standards and norms that are being developed, and how far they will meet the stated development objectives, if at all those can be measured. In the commodities trading sector, vis-à-vis the extractive sector, such attempts to involve the industry need to be tailor-made to the reality of the sector, since the physical presence of trading businesses in resource-rich countries is mostly limited to offices.

5. Building on synergies and differences in European and Swiss approach

Although approaches differ, the European Union and Switzerland have taken a leading role in addressing challenges pertaining to governance and transparency in the extractive sector. While Switzerland has focused mainly on commodity trading activities, essentially due to the strategic importance of the sector for its economy, the EU has, for its part, mainly led initiatives regarding extractive industries.

The European approach combines a series of regulatory and voluntary measures in various fields of actions; regulations on transparency and accountability require extractive companies listed on EU stock markets, large unlisted industries and public interest entities to publish what they pay to resource-rich countries' governments on a project and country level. While not applicable to the trading business, this initiative will allow public scrutiny to follow the money. European countries, members of G8 and G20 have on their part taken commitments regarding transparency in tax matters and illicit capital flows, although binding commitments are yet to follow. But these remain insufficient, in particular because *trading* activities in the extractive sector are not targeted by EU regulatory frameworks, although an attempt was made in 2011 to recognise the importance of physical markets in a Communication on Tackling the Challenges in Commodity Markets and Raw Materials. However, recent financial regulations may also have a bearing on trading activities in the extractive sector; for example, the European Market Infrastructure Regulation (EMIR) will increase transparency in derivative trading, including the trade in commodity derivatives, in keeping with the international standards by the G20 and the Financial Stability Board (FSB).

In 2013, the Swiss authorities conducted a background report[8] to examine the issue of commodity trading. The report emphasized the importance of the sector for the Swiss economy and highlighted the related possible challenges for development. The report made a series of recommendations to reduce risks and address potential negative side effects the sector could have in developing countries. Subsequently,

[8] See Background Report on Commodities. 27 March 2013:
http://www.news.admin.ch/NSBSubscriber/message/attachments/30136.pdf

in March 2014[9], a report on the status of the implementation of the recommendations was prepared. The 2014 report in particular highlighted legislative and voluntary efforts made so far, not only regarding the trading aspect, but also in the financial aspect of the sector. Further, according to recommendation 8 of the background report, the Swiss authorities recommend to examine "*the consequences of a potential introduction of transparency requirements – similar to those of the USA and the EU – for the Swiss commodity sector" and that "Switzerland should, moreover, advocate internationally a global standard that foresees transparency requirements that are clearly understandable and as similar as possible for all companies active in the extraction of resources."*

There is a general policy debate about the merits of industry self-regulatory approach as opposed to a mandatory institutional approach in an attempt to provide a balanced and nuanced framework, that take into account the competitiveness of the trading industry while remaining coherent with development objectives. At the same time, a concerted effort is required among the leading trading hubs: while one leader may set the benchmark for high standards, it is important to have coordinated efforts to avoid losing competitive edge towards those that have a light-touch approach towards regulations.

Leading commodity trading hubs, such as those present in the EU and in Switzerland, but especially also globally, need to engage in constructive dialogues, while seeking synergies and complementarity among their different approaches. Failure to do so might pose reputational risks both for their industries and for the countries where companies are domiciled. More importantly, it will antagonise their efforts and actions in support of developing countries with respect to development, human rights, social and environmental standards.

In an effort to move the debate forward, a number of key questions need to be thoroughly addressed, while ensuring coherence and complementary among them.

1. Concerted efforts *in developing countries* to strengthen transparency, accountability and governance structures at ***national and at regional levels***. While development partners have their own priorities in supporting developing countries, countries must be prepared to align themselves to already existing initiatives. They must also be prepared to work together to avoid duplication and to foster complementary support.

2. Switzerland is a major location for commodity trading activities. At the same time it is not the only one in Europe. There is no doubt fierce competition among different business hubs to get a larger share of the market. Mindful of such competition, countries may be reluctant to engage in regulatory reforms, for fear of driving businesses out of their countries, and still not succeed in addressing the challenge at hand. There are two key issues to consider. Firstly, how to address the issue of competition between different trading hubs and hence avoid a race to the bottom regarding norms and standards? Secondly, in doing so, how feasible is it to develop common guidelines – or better – have a ***trans-national governance framework*** that fits the values, needs and specificities of Europe and Switzerland, but are also acceptable on a global level? It seems clear that only a ***global approach*** to the topic can make a significant difference. Trading hubs like Singapore, the United Arab Emirates and China, stand ready to take any business ready to leave Switzerland and the EU due to increased regulatory pressure. And that would defeat the purpose of

[9] See Background Report on Commodities: Status Report on the Implementation of Recommendations. 26 March 2014: http://www.news.admin.ch/NSBSubscriber/message/attachments/34217.pdf

the regulations – especially for the developing countries.

Annex 1: Overview of regulatory initiatives

Initiatives	Scope	Expected impact on extractive sector	Impact on commodity trading
Regulatory framework for host countries:			
The Extractive Industries Transparency Initiative, EITI	Joining the EITI is voluntary but once countries join, implementation of standards become mandatory. Objective: Obligation to full disclosure of taxes and other payments made by oil, gas and mining companies to governments.	By disclosing this information, the countries' citizens are able to hold their governments for their revenue management accountable. Scope has been extended in 2013 to include production figures, licensing ownership, and disclosure by state owned companies, revenue allocation into state, local and other accounts etc. Publication of contracts is encouraged.	So far, it does not apply directly to commodity trading activities. EITI member countries are however obliged to disclose revenues generated e.g. by selling of oil to commodity trading companies.
Regulatory framework for home countries			
Section 1504 of US **Dodd Frank Wall Street Reform and Consumer Protection Act (**2010)	Requires US listed "resource extractive issuers" to disclose taxes, royalties and other payments made to the US and foreign governments.	With a US$ 100,000 threshold for reporting payments in the most recent fiscal year, the world's leading oil, gas and mining MNCs and extractive companies from the BRICS listed in the US are obliged to disclose their payments.	"Resource extraction issuers" include companies involved in exports of oil, natural gas and minerals. The SEC clarified that these could include companies engaged only in exports. Certain commodity traders listed in the US technically therefore fall under the purview the Act.
The **EU Transparency and Accounting directives**	Requires the disclosure of payments to governments on a *country and project* basis by public-interest entities, listed and large non-listed companies with activities in the extractive and logging industry.	It is designed to actively combat tax fraud and corruption, increase revenue transparency and foster better governance in the extractive sector.	The EU regulations do not include trading activities.
Canada and Norway are expected to pass similar legislations to the US and EU ones respectively.			
Other initiatives to improve transparency			
OECD's Action Plan on Base erosion and profit shifting (BEPS)[10]	Increased transparency by requiring MNEs to provide information on their global allocation of the income, eco-	The Action Plan comprises 15 actions equipping governments with domestic and international instruments needed	May not directly apply to commodity trading activities, but will probably

[10] In terms of the international changes that are underway, the most relevant is probably that of country-by-country reporting by MNEs. The OECD is in the process of finalising a reporting template for all MNEs to report to tax authorities where they operate –

	nomic activity and taxes paid among countries, so that e.g. countries with great natural resource abundance are able to collect their revenues and decrease illicit flows.	to address tax avoidance. Does not only apply to the commodities industry.	have an impact on the company structure
G20	Fully endorsed the OECD Action Plan on BEPS in their meetings in St. Petersburg in September 2013 and delivery is due 24 months later.	The G20 endorsement for the first time brings non-OECD and G20 countries together on tax matters, hinting at the increased commitment to enhance transparency and fight illegal tax fraud.	May not directly apply to commodity trading activities, but will probably have an influence on the company structure
G8 countries under UK presidency in 2013	Pushed for the promotion of greater transparency and tax compliance	The Lough Erne Declaration, despite failing to signal any binding commitment, call for information exchange, mandatory disclosure of information to the public, and the duty and information provision to help developing countries to collect taxes owed them	May not directly apply to commodity trading activities, but will probably have an influence on the company structure

see here for latest draft and details of the consultation process:
http://www.oecd.org/ctp/transfer-pricing/public-consultation-transfer-pricing-documentation.htm

The relevance here is that this type of reporting will provide a simple 'red flag' system to allow identification of the most egregious misalignments between profit and the location of actual economic activity (this is the focus, and language, of the OECD's Base Erosion and Profit Shifting initiative) – which in turn can help tax authorities to allocate scarce resources to explore or challenge the underlying transfer prices, on e.g. copper.

At the moment the OECD template would provide data privately to tax authorities, in contrast to the original proposal for the information to be public. One (very welcome) possibility would be for Switzerland to take a lead in making this information public to obtain the benefits of 'many eyes' checking, and to support the accountability of tax authorities and governments to their citizens, as well as of MNEs to tax authorities.

Annex 2: Key regulations affecting commodity companies

Regulation	Main regulatory changes	Impact on commodity traders
Basel III (worldwide) ▪ Scope: bank companies ▪ Full effect: 2018 ▪ Transition: from 2013	**Deleveraging of banks' balance sheets given new requirements** ▪ Maximum leverage ratio ▪ Minimum target capital ▪ Minimum liquidity ratio ▪ Credit-valuation adjustments	**Tightening access to financing as banks lower trade-finance exposures** ▪ Less availability of letters of credits, especially for higher-risk counterparties ▪ Difficulty to raise syndicated loans ▪ Higher costs across all trade-finance products
Dodd-Frank Act (US) ▪ Scope: "swap dealers" ▪ In effect from: July 2010[1] **EMIR[2] (EU)** ▪ Scope: all derivative trading[3] ▪ In effect from: 2013 **MiFID II[4] (EU)** ▪ Scope: systemic financial institutions[5] ▪ In effect from: 2014/15 earliest	**Stronger regulation of over-the-counter derivatives** ▪ Central clearing and reporting ▪ Capital and margin requirements ▪ Reporting to central trade repository ▪ Daily mark-to-market/collateral needs ▪ Trading on organized trading venues ▪ Position limits ▪ More regulatory oversight/intervention	**Increasing complexity and cost intensity of trading operating model** ▪ Systems and processes upgrades given new reporting requirements ▪ Increased working-capital needs (clearing fees, margin, collateral) ▪ Compliance upgrades (tracking trading thresholds, position limits, etc.)
Volcker Rule (US) ▪ Scope: banks, financial institutions ▪ In effect from: July 2010 ▪ Implementation from: Q4/2012[1]	**Limits to banks' trading activities** ▪ Ban of proprietary trading (financial, physical) ▪ Potential limits to banks' ownership/ control of physical trading assets (eg, storage)	**Changes to competitive set as banks exit/spin off commodity trading** ▪ Less market making, less hedging tools (further rising trade-finance costs) ▪ Banks to spin off commodity-trading units, potentially sell physical assets ▪ New opportunities for traders in paper trading, physical assets, M&A

1 Implementation from: Q4/2012 (further clarifications to rule likely after 2012 presidential election).
2 European Market Infrastructure Regulation.
3 Exemption: central clearing not required for trading by "nonfinancial" firms for hedging purposes or other trades below a certain clearing threshold.
4 The Markets in Financial Instruments Directive II.
5 Exemptions: commodity traders if trading is an "ancillary" business and dealing on own account and not a subsidiary of a financial group.

Source: McKinsey 2012. Commodity Trading at Strategic Crossroads. Working Papers on Risk No. 39.