Principles for Responsible Investment

Extractive Industries Transparency Initiative

USING THE EXTRACTIVE INDUSTRIES TRANSPARENCY INITIATIVE TO ENHANCE CREDIT RATINGS ASSESSMENTS

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The Extractive Industries Transparency Initiative (EITI) is a global standard designed to strengthen governance, ensure revenue transparency and inform public debate in the mining and petroleum sectors. Implemented by 49 countries ranging from Indonesia to the United States, it is supported by over 90 extractive companies state-owned enterprises, development finance institutions and institutional investors.

The PRI's Fixed Income Case Study series highlights examples of interesting and innovative approaches to responsible investment. Written by fixed income practitioners from around the world, the case studies cover topics such as integrating ESG, negative and positive screening, thematic investment and engagement.

Sharing these examples will enable investors to collectively build a concept of emerging good practice. The PRI aims to publish a set of these short pieces every quarter. If you would like to learn more or contribute your own case study please contact us.

WHAT IS THE EITI?

The Extractive Industries Transparency Initiative (EITI) is a global standard designed to strengthen governance, ensure revenue transparency and inform public debate in the mining and petroleum sectors. Implemented by 49 countries ranging from Indonesia to the United States, it is supported by over 90 extractive companies (including BHP, Chevron, ExxonMobil, Glencore, Rio Tinto, Shell, Total and Trafigura), state-owned enterprises (such as Pemex, Petrobras and Statoil), development finance institutions (such as the African Development Bank, Asian Development Bank and the World Bank Group) and institutional investors (including Allianz, Goldman Sachs, Schroders and UBS) with over US$19 trillion in combined assets under management.

Government, industry and civil society organisations cooperate through an EITI national multi-stakeholder group (MSG) in each country to implement the EITI Standard. Their annual EITI Reports reconcile payments from companies in the sector to government, but also include comprehensive market information on licensing, production, revenue collection, revenue allocation and the role of state-owned enterprises. An Independent Administrator ensures data quality and a comprehensive reconciliation of payments. Implementing countries are validated against the EITI Standard every three years.

> "There are certainly challenges in quantifying transparency improvements, but we tend to look at everything available on the topic."
>
> Craig Michaels, Standard & Poor's (S&P)

WHY FISCAL TRANSPARENCY MATTERS IN CREDIT RATING ASSESSMENTS

Particularly since the global financial crisis, the factors influencing qualitative judgments in credit ratings, such as those on institutional strength and governance, are facing more rigorous scrutiny.

Quantifying transparency remains challenging, but a growing body of literature links improvements in fiscal transparency with credit ratings and sovereign borrowing costs:

- A study by the Central Bank of Ireland's Laura Moretti on sovereign bond spreads in 18 emerging markets found that "more transparent countries enjoy lower spreads."[1]
- The London School of Economics' Jules Tilly studied the link between fiscal transparency, as measured by the Open Budget Index, and five-year credit default swaps in 36 countries from 2007 to 2011[2], finding that, while transparency had little impact on the cost of funding before the crisis, this has now changed: "In the post-2008 era, the relationship between fiscal transparency and investor perceptions has strengthened considerably."
- The IMF has found that more fiscal transparency (measured through the Report on Observance of Standards and Codes (ROSC)) reduces the uncertainty over a country's finances, with the improvement most pronounced in emerging economies.[3] In developed markets, more fiscal transparency improves fiscal policies and outcomes. Over time, both of these influence the primary fiscal balance and lead to a reduction of gross debt.
- Another IMF paper says: "A growing body of empirical research has highlighted the positive relationship between the degree of fiscal transparency and measures of fiscal sustainability (such as government deficits and debts), with a stronger correlation among low- and middle-income countries than among high-income countries."[4] For higher-income countries, the evidence points towards a positive relationship between fiscal transparency and market perceptions of fiscal solvency.

1 Laura Moretti (June 2012), "Transparency and Emerging Market Bond Spreads", http://www2.unine.ch/files/content/sites/irene/files/shared/documents/s%C3%A9minaires/Moretti.pdf

2 Jules Tilly (August 2013), "Fiscal Transparency and Sustainability of Public Debts in Times of Crisis: How to Strengthen Investor Confidence?", http://www.lse.ac.uk/IPA/images/Documents/PublicSphere/2013/8-fiscal-transparency-spreads-20121.pdf

3 IMF (June 2012), "Fiscal Transparency, Fiscal Performance and Credit Ratings", https://www.imf.org/external/pubs/ft/wp/2012/wp12156.pdf

4 IMF (7 August 2012), "Fiscal Transparency, Accountability and Risk", http://www.imf.org/external/np/pp/eng/2012/080712.pdf

HOW THE EITI COULD ENHANCE CREDIT RATING ASSESSMENTS

In rating sovereigns, credit rating agencies (CRAs) track several proxies for institutional strength, governance and efforts to curb corruption, relying primarily on third-party indicators such as: World Bank's annual Doing Business (DB) report ; World Banks' Worldwide Governance Indicators (WGI) reports; the United Nations Development Programme's Human Development Indicators (HDI); Transparency International's Corruption Perception Index (TI's CPI); IMF and World Bank's Reports on the Observance of Standards and Codes (ROSC)[5].

> "While we have our own impressions from our interactions with the government to help us judge institutional strength, we also look at third-party assessments."
>
> Christian de Guzman, Moody's

Adding the EITI to assessments could make credit ratings more comprehensive and reliable:

- The EITI helps governments ensure that the income from the extractive industries is correctly accounted for (and channelled to the treasury where it can be invested to promote growth and directed toward debt repayment).
- The EITI guards against misappropriation (which over time will impede a borrower's ability to make timely interest payments). Transparency over payments and revenues increases accountability and therefore the likelihood that the revenues generated are used efficiently equitably.
- Where countries have weak public financial management (and questionable official statistics), EITI implementation improves disclosure and is being used to strengthen government audit and assurance systems.
- The EITI helps to ensure that there is a robust national debate about whether the country has an effective and competitive tax system, again enhancing the government's long-term ability to make timely interest payments and reducing the likelihood of default.
- As the EITI moves toward project-by-project reporting, data disclosed become even more granular, enabling CRAs to examine specific projects that are likely to have a major impact on the government's fiscal position (e.g. Jubilee project in Ghana, Oyu Tolgoi in Mongolia, PNGLNG in Papua New Guinea, Bayu-Undan in Timor Leste).

Tracking EITI implementation is not as straightforward as following a ranking or index, but EITI Reports, and countries' other EITI outputs (including annual activity reports, Validations, and secretariat assessments) provide insight into the nature of debates, key recommendations and the blockages to meaningful reform. Ratings agencies could benefit from the quantitative and qualitative information in EITI Reports, to complement other third-party sources of information.

In more opaque frontier markets, disclosures under the EITI provide crucial new information not usually accessible to CRAs. In resource-dependent frontier markets, the EITI requires disclosures of interest to CRAs, including assessments of the quality of public data, clarification of regulatory oversight in extractive industries and, perhaps most crucially, the financial guarantees to state-owned enterprises in these sectors. Improved visibility on these SOEs can become even more important when global commodity prices are low.

Data disclosed through the EITI are increasingly quoted in frontier markets' sovereign bond prospectuses[6], commodity producers' share offerings[7] and fundraising brochures for private equity and investment funds.

5 See respective methodologies of the main three credit rating agencies (Standard & Poor's, Moody's and Fitch).

6 For instance Nigeria ($500m Eurobond in January 2011), Gabon ($1.5bn Eurobond in December 2013) and Azerbaijan ($1.25bn Eurobond in March 2014).

7 For instance PA Resources, Haranga Resources and Caracal Energy.

INSTITUTIONALISING REFORM IN THE PHILIPPINES

EITI implementation in the Philippines is driven by efforts to improve revenue collection but also drive broader reforms: the EITI is a process, not merely a series of reports. Once a country implements the EITI, it commits itself to a structure to drive reform efforts, with strong reputational lock-in effects, providing grounds for optimism for reforms to continue beyond changes in political power: "Even though a change of administration after the presidential elections in 2016 represents some uncertainty for reforms, the risks have shifted toward maintaining the impetus and direction of the process, away from a potential reversal or abandonment of advances achieved to date," S&P noted in its May 2014 upgrade.

Some of the key recommendations of the Philippines' first EITI report include:

- Rationalisation of subnational transfers to local government units;
- Clarification of tax incentives extended by the Board of Investment;
- Revisions to the National Inland Revenue Code;
- Improved oversight of the payments to indigenous peoples and social development and management projects.

It has also served to highlight the discrepancies inherent in reconciling companies' accrual-based accounting with the government's cash-based accounting system.

As part of preparing the report, details of 30 mining and six oil and gas contracts were published, providing information that can be used for modelling financial revenue flows.

"EITI is a concrete step towards enshrining transparency in governance. While it may only be for the extractive industry, the number of government agencies involved is substantial and includes the major revenue and licensing agencies of government. It is a statement as to how committed government is about up-scaling transparency in government operations and procedures. This can only be a positive as far as credit ratings is concerned, since a more transparent government bureaucracy lends itself to greater efficiency and effectiveness."

Maria Teresa S. Habitan,
Assistant Secretary of Finance, the Philippines