NATURAL RESOURCE CHARTER

PREAMBLE

Countries with non-renewable natural resource wealth face special opportunities and special challenges. If used well, these resources can create greater prosperity for current and future generations; if used poorly, they can cause economic instability, social conflict and lasting environmental damage.

The purpose of the Resource Charter is to assist the governments and societies of countries rich in non-renewable resources to manage those resources in a way that generates economic growth, promotes the welfare of the population in general and is environmentally sustainable.

The drafters believe that the exploitation of natural resources should be carried out to help a country meet its broader social and economic goals, not as an end in itself. This means having a vision of how the resource sector fits in a country's economic future. For some countries, the best use of resource endowments may be to leave it in the ground for future use; for others, it may be to extract rapidly to generate revenues to sustain the investment necessary for growth and to meet urgent human needs. Whatever a country's ultimate development goals, we believe there are certain practical guidelines that can help it maximize the opportunities provided by resource wealth for social and economic development.

The Charter is directed primarily at policy makers in resource-rich countries. These are not the only important actors: international companies, intergovernmental organizations, civil society groups, and the governments of resource-importing states all have roles which affect the ability of societies to harness their endowments. Still, the most important decisions rest with the governments of resource-rich countries themselves, since they have both the sovereign right, and the moral responsibility, to use the country's natural wealth for the benefit of their people. Nonetheless, resource companies and their home governments play a critical role in supporting or weakening effective policy; thus, while not the primary audience for the Charter, their role vis-à-vis producing countries is addressed.

Turning natural resource wealth into sustainable development is not simple. Countries must decide whether or not to extract their resources, and if so, how quickly; whether to use national companies, or rely on the private sector; how to design laws, regulations, and contracts that can produce the greatest benefits for the country; how to avoid or mitigate the environmental and social costs of extraction; how to handle the economic volatility caused by fluctuating international markets; and how to use the revenues that accrue to the government to produce lasting benefits for the population.

Each of these choices have far-reaching consequences, and can shape a nation's development path for generations. Yet governments must make these decisions through a veil of uncertainty – uncertainty about the future value of the nation's resources, about the environmental and social consequences of extraction, and about the government's capacity to manage its new responsibilities. This Charter can help governments and citizens understand these decisions, so

they can choose the path that best meets their needs. While the choices made by the governments of resource-rich countries are inevitably central to whether opportunities are harnessed for development, what other governments do can either undermine or reinforce these opportunities. Hence, we include proposals for how other countries can best be supportive.

The Charter has been written by an independent group of economists, lawyers, and political scientists. We do not represent any institution or special interest. We share the belief that natural resource wealth can be a powerful tool for social and economic advancement, but only if countries are able to meet some special challenges. We try to offer advice that is useful, clearly expressed, and perhaps non-obvious.

The Charter is organized around twelve Precepts that offer guidance on core decisions that governments face – beginning with the decision to extract the resources, and ending with decisions about using the revenues they ultimately generate. To make this Charter easy to use, we provide three levels of detail about each of the Precepts. The first level briefly states the twelve Precepts, while the second level provides a more complete explanation of the issues that governments must confront, and the solutions we offer. The third level contains a more technical discussion of the underlying issues.

The Precepts (level 1)

1) The development of natural resources should be designed to secure the ***maximum benefit*** for the citizens of the host country.

2) Extractive resources are public assets and decisions around their exploitation should be ***transparent*** and subject to ***informed public oversight***.

3) ***Competition*** is a critical mechanism to secure value and integrity.

4) Fiscal terms must be robust to ***changing circumstances*** and ensure the country gets the full value from its resources.

5) ***National resource companies*** should be competitive and commercial operations. They should avoid conducting regulatory functions or other activities.

6) Resource projects may have serious ***environmental and social effects*** which must be accounted for and mitigated at all stages of the project cycle.

7) Resource revenues should be used primarily to promote ***sustained economic growth*** through enabling and maintaining high levels of domestic investment.

8) Effective utilization of resource revenues requires that ***domestic expenditure be built up gradually*** and be ***smoothed*** to take account of revenue volatility.

9) Government should use resource wealth as an opportunity to secure effective public expenditure and to increase the ***efficiency of public spending.***

10) Government policy should ***facilitate private sector investments*** in response to new opportunities and structural changes associated with resource wealth.

11) The ***home governments*** of extractive companies and ***international capital centers*** should require and enforce best practice.

12) ***All extraction companies*** should follow ***best practice*** in contracting, operations and payments.

Guide to Stakeholders (level 2)

Precept 1: **The development of natural resources should be designed to secure the *maximum benefit* for the citizens of the host country.**

Resource development, including the decision to develop, the adoption of fiscal and regulatory regimes, and the spending of resource revenues should be designed to ***provide economic growth and an equitable distribution of resource wealth*** to the citizens of the producing country. This requires a vision and a plan for both the development of the resource and for the use of the resource in realizing the country's larger development goals.

This development requires a government and its citizens to make many complex decisions in the effort to maximize the benefit of those resources to society now and in the future. Extractive activities are technologically demanding, capital intensive and may continue for decades, during which demand and prices may vary wildly. They often come with large environmental costs. From a very early stage in the resource identification process, decisions must be made regarding the choice to develop the resource now or later; whether the government should develop the resource itself through an existing or new state enterprise or whether to allow the private sector, including foreign investors, to do so. Decisions must also be made regarding the fiscal and contractual regime, including the incentives for investment; the regulation and control of the impacts of resource development; and the use of the revenues generated. Governments find themselves in many different stages of this process. Government may inherit mismanagement by previous governments or from investors. Prior development may have resulted in adverse social and environmental effects. Potential revenue may have been lost; it may have been wasted or used for the benefit of limited political and economic elite or, in the worse cases, simply stolen. Governments will face pressures to favor current consumption over investment.

Inherent to the extraction of natural resources are world price fluctuations, uncertainties, and long term implications from decision-making. As a consequence, decisions around natural resource extraction should be made in a context that attempts to best manage these uncertainties, including the eventual size and nature of the resource deposit and a possibly volatile and uncertain pricing environment. Further in designing and executing its strategy, the government must also take account of its existing institutional and human resources and its own prospective development.

Effective use of resources requires a plan or vision of what the country wants to do and how resources, if developed, can assist the country in getting there. These larger goals should inform all of the individual decisions along the way.

Precept 2: Extractive resources are public assets and decisions around their exploitation should be *transparent* and subject to *informed public oversight*.

Resource extraction in many countries has a long history and that history is in general not a happy one. In the past, valuable resources have often not been harnessed for broad and sustained improvements in living standards. Sometimes they have enriched foreigners, sometimes narrow local elites, and sometimes they have fuelled political violence. Control and information have been closely held in the hands of a few officials and the companies. ***Inevitably given this history, citizens are suspicious*** that governments or investors will mismanage resource extraction, whether through incompetence, malevolence, or disregard for broader society. This climate of suspicion is itself damaging both for the wider functioning of government and for the tranquility of the society.

Citizens can only be confident about the integrity of the resource extraction process if they know about it. Governments should adopt transparent processes for establishing and implementing resource policies, for awarding contracts, for taxing, collecting and managing revenues, and for taking spending decisions. The citizenry need to be properly informed about the decision to extract and the basic extractive policy framework. Resource decisions involve long-term commitments and these will be more credible if their rationale is understood by citizens. Resource exploitation will be more successful for the country if citizens understand the resource development path and support it. Legislatures should oversee the sector and approve major concessions.

***Citizens have a basic right to information about government activities and use of public assets*.** Public availability of information is recognized as an essential part of government accountability to its people. More and more countries are enshrining this principle in law. Seventy-eight countries now have so-called Freedom of Information laws stipulating in one form or another that all government information is public unless specifically prescribed by law. The IMF's *Code of Good Practices on Fiscal Transparency*[1] sets out strong rules for informing the public about the use of public assets, specifically including natural resources. In most countries, natural resources, particularly sub-soil minerals, are deemed the property of the state, and are hence public assets. The *Code of Good Practices has* been formally adopted by the IMF Executive Board and should therefore in principle be adhered to by all member governments. The wide international support and country participation in the voluntary Extractive Industries Transparency Initiative (EITI) has established that the public is entitled to information on the payments and revenues derived from extraction. The principle that the public has a right to full and timely information necessary to meaningfully participate in environmental and social decision-making, which resource extraction invariably involves, has been enshrined in international instruments including the Universal Declaration of Human Rights,[i] the Rio

[1] *Revised Code of Good Practices on Fiscal Transparency (2007)* International Monetary Fund.
[i] Universal Declaration of Human Rights, UNGA Res. 217A(III), 10 Dec. 1948.

Declaration,[ii] the Aarhus Convention,[iii] and the OECD Guidelines for Multinational Enterprises.[iv] The Aarhus Convention provides for only specified and limited exceptions to public disclosure, and that these exceptions "shall be interpreted in a restrictive way, taking into account the public interest served by disclosure and taking into account whether the information requested relates to emissions into the Environment."[v]

Transparency has other benefits beyond building public trust and meeting international standards of good governance. ***Transparency may lower the cost of capital.*** An IMF study of fiscal transparency found that "Fiscal transparency is associated with higher credit ratings even after controlling for various economic fundamentals."[2] The commercial rating agency Standard & Poor's cites governance of the extractive sector as strong factor in the risk ratings given to Sub-Saharan African countries and mentions Nigeria's participation in EITI as a consideration in giving the country its first sovereign risk rating.[3] S&P says EITI adherence by Nigeria and 14 other African countries "is a positive signal that these countries are committed to stronger transparency and accountability in resource management."[4] Nigeria's EITI also figured in the decision of official donors to grant Nigeria debt relief.

Public management of all aspects of the extraction process is likely to improve significantly. Experience shows that public disclosure requirements improve the quality of data the government gathers and maintains. Wide dissemination of critical information around extraction increases the likelihood that all relevant officials, including ministries of finance, energy and mining ministries, and environmental and regulatory agencies, will all have the information they need to do their jobs. Reliable and frequent data will make it easier for the governments that are heavily reliant on extractive revenues to plan and manage their budgets and long term strategic development plans. Making public information such as company payments to the government will make it easier for the government to know if it is collecting what it should and will make complex extractive concessions easier to enforce and monitor, overall. Finally, provided the extractive regime enjoys public legitimacy – which is itself only possible with public information -

[ii] Rio Declaration on Environment and Development, Report of the United Nations Conference on Environment and Development, A/Conf.151/26(VolI), Annex I, 3-14 June 1992.

[iii] Aarhus Convention on Access to Information, Public Participation in Decision-making and Access to Justice in Environmental Decision-making, Doc. ECE-CEP-43 (25 June 1998).

[iv] Universal Declaration of Human Rights, U.N.G.A. Res. 217A(III), Article 19, 10 Dec. 1948; Aarhus Convention on Access to Information, Public Participation in Decision-making and Access to Justice in Environmental Matters, Doc. ECE-CEP-43 (25 June 1998).

[v] Aarhus Convention on Access to Information, Public Participation in Decision-making and Access to Justice in Environmental Decision-making, Doc. Article 4(4), ECE-CEP-43 (25 June 1998).

[2] "Fiscal Transparency and Economic Outcomes," Farhan Hameed. IMF Working Paper December 2005.

[3] A government cannot borrow in international capital markets without a risk rating from a major ratings agency. "How Political Stability And Governance Affect Sovereign Ratings In Sub-Saharan Africa", Standard and Poor's Ratings Direct. January 23, 2008.

[4] *Ibid* page 10.

having key information in the public domain reduces the likelihood that successor governments will make arbitrary and ill-considered changes to a country's extraction regime.

***Transparency is critical at all stages of the extraction process and value chain*.** Policies and legal, regulatory, and contractual frameworks should be clear and public, as should procedures for the award of contracts where applicable. Contracts should be public[1], and the true identity of contract or concession-holders should be known. If there is a national resource company, it too must be clearly governed and transparent (Precept 5).

Fiscal and governing regimes should be set in law to the greatest extent possible. Licensing and contract terms should be disclosed. The Extractive Industry Transparency Initiative (EITI) has established the widely accepted principle that companies should publish what they pay and the government what it receives. All payments should flow into properly audited government accounts. Spending should be equally transparent and accounted for. Management of savings and stabilization funds should, at a minimum, follow the so-called "Santiago Principles"[2] adopted by the International Working Group on Sovereign Wealth Funds in September 2008 and the guidance on best practice in asset management in the IMF Guide on Resource Revenue Transparency and the Peterson Institute blueprint for sovereign wealth fund best practices.

[1] Certain limited proprietary information may be subject to confidentiality. Confidentiality concerns should in no case extend to financial terms nor should they prevent the publication of contracts.
[2] International Working Group of Sovereign Wealth Funds, "Generally Accepted Practices and Principles (GAPP) – Santiago Principles".

Precept 3: *Competition* is a critical mechanism to secure value and integrity.

Governments generally need to contract with private or external companies that have the expertise required for the stages of resource development, from exploration through to extraction and decommissioning. Such contracts have to secure maximum value to host country citizens while at the same time ensuring that adequate incentives are provided to investors and that exploration and production are undertaken efficiently. The context of natural resources makes the contractual relationship complex. The relationship is likely to be long term, perhaps lasting thirty years or more over the life of a project. There are numerous uncertainties regarding geology, costs and technology, resource prices and the capabilities of firms and of government. Government is likely to be at an informational disadvantage, knowing relatively little about technical matters and perhaps having little or no experience in the complex negotiations that are characteristic of the resource sectors. Competition can play an important role in addressing these disadvantages. ***Competition can be enhanced by good prior geological information and open bidding processes.***

Open and transparent competition for contracts and development rights is the key to ensuring maximum value and integrity. Competition between firms that are technically and financially competent has the effect of ensuring that government gets maximum value as firms compete to offer winning terms. Competition need not simply be on price, but competition on too many variables erodes transparency and increases administrative cost. In all cases competition should be on the basis of clear and transparent rules, this minimizing the possibility of back-room deals and abuse of discretion.[3]

The prospects for delivering these benefits are enhanced if a number of conditions are met.

Terms should be set in law to the greatest extent possible. Setting policy in law increases public input and support, enhances stability for the investor, ensures uniform treatment and reduces opportunities for gaming and side-dealing.

As much information as possible should be made public prior to award of contracts. This includes the fiscal regime under which firms will be operating; there is a wide range of options for the design of the regime and these are discussed further below. It also includes geological knowledge; publicly available findings of advanced survey work are likely to be beneficial in drawing firms into the bidding process.

The process for allocating the contracts between competing firms needs to be carefully designed. Where practical, ***auctions are generally the preferred mode, both on grounds of transparency and securing maximum value***. They are likely to require ***pre-selection of bidders*** in

[3] Corporate income taxes in the host country may be creditable against taxes payable in the home country and any tax design should preserve that feature because it allows the host country to shift some revenues to itself from the home country without additional burden on the investor.

order to ensure that all are reputable and technically qualified, and to limit the numbers entering the bidding round. The true beneficial owners of the firm should be known to prevent conflicts of interest and authorities steering business to firms in which they may have a share. The auction itself needs careful design, both in terms of selecting the bidding variables (e.g. royalty rate, production share, work program or profits tax) and the design of the auction process.

There may be an advantage in ***unbundling the contract into separate parts***. For example, certain activities, e.g., limited seismic acquisition and interpretation, could be subject to separate contracting from the letting of exploration rights.

Precept 4: Fiscal terms must be robust to *changing circumstances* and ensure the country gets the full value from its resources.

Resource projects are long term, involve large upfront capital expenditures, and are subject to significant uncertainties and risks – operational, economic, technological, geological, environmental, and political. Most notably the volatility of commodity prices means that revenue flows may vary widely. ***Changing circumstances***, over the life-cycle of the project and as external factors change, mean that the balance of power between government and investors changes, and so too do domestic political pressures on government.

The investor will be locked in by large fixed costs once the investment is made and may want to compensate for the risk of future policy changes by offering less favorable terms as a condition for proceeding. On the government's side contracts which produce results that later look unfair in high price or high margin environments, even when the risks and gains were allocated up front, may generate substantial political pressure for revision in spite of whatever contractual guarantees were initially made. Fiscal terms need to be designed to be ***robust to changing circumstances,*** particularly to large swings in commodity prices, to reduce the incentive for either side to demand a renegotiation that can disrupt production and increase costs for both. Fiscal terms need to be clearly understood by the government and the investors, and the rights of both need to be sufficiently clearly defined that the government can in fact realize the revenues due to it and the investor is reasonably protected against unilateral changes by future governments.

Well-designed fiscal regimes can provide the government with a revenue stream in all production periods but with an increased share of revenues as profitability increases. Fiscal terms need to contain mechanisms to provide some minimum revenue flow at low prices, as well as mechanisms to share in the profitability of the project. This suggests that they should contain both a royalty charge linked to production and a charge linked with profitability. The latter may be achieved through production sharing arrangements, the corporate or entity income tax (perhaps at a special resource sector rate3)[4], possibly supplemented with additional taxes linked to particularly high returns. Enforceability and administration will be enhanced if these contingent elements are linked to variables that are observable and verifiable, such as world prices.

Structural stability can be increased by basing contracts on otherwise applicable laws. Uniform application across operations combined with transparency will also help ensure that operators know that treatment is non-discriminatory, and thus operators have less incentive to attempt obtaining special deals.

[4] Corporate income taxes in the host country may be creditable against taxes payable in the home country and any tax design should preserve that feature because it allows the host country to shift some revenues to itself from the home country without additional burden on the investor.

While tax and royalty payments can be made contingent on some variables it is impossible to foresee and contract upon all possible future circumstances. Payments contingent on achieved profitability can provide some protection, but contracts need to explicitly recognize that during their term adjustments may be necessary to account for unforeseen circumstances. However, such ***renegotiation*** should be infrequent and should be conducted ***within parameters*** that preserve to the extent possible the reasonable expectations of the parties including a fair rate of return for investors.

Uniform application across operations combined with transparency will also help ensure that operators know that treatment is non-discriminatory, and thus operators have less incentive to attempt obtaining special deals.

Precept 5: *National resource companies* should be competitive and commercial operations. They should avoid conducting regulatory functions or other activities.

Many hydrocarbon or mineral rich countries have chosen to use public sector enterprises to develop part or their entire resource base. These companies may provide a vehicle for the country and its citizens to build their expertise and professionalism in the resource sector and may allow the country to better control the pace of resource development, secure supply, or achieve other governmental objectives including the development of ancillary and downstream industry.

On the other hand, many national companies have performed poorly. Furthermore, investments in national resource companies limit diversification and increase the country's reliance on the resource sector, making total government revenues (fiscal revenues plus returns from the state enterprise) more dependent on the resource sector and resource prices.

Because of its size and its preferred access to resources and finance, a national oil or mining company is often one of the most important political and economic actors in the country. This privileged position may lead to abuse by entrenched managers or favored government officials responding to their own personal incentives. The best antidotes are ***transparency in structure and activity and openness to competition***. Any initial public investment and organizational costs should be treated as government expenditure and be evaluated in the context of the alternative uses of public sector funds (Precepts 7 and 9).

Transparency can be facilitated by having the national company organized as a separate legal entity with clearly established authorities and objectives and by having governing and management boards separate from the government. Public oversight and control can be enhanced by (i) having public accounts maintained in accordance with international standards and subject to independent audit, (ii) clearly identifying any private ownership interests and transactions with such interest holders, (iii) having the national company makes the same disclosures required of publicly held companies, and (iv) conducting regular and systematic oversight through parliament or other oversight entities.

Commercial operations of the national petroleum or mining company should be in open and genuine competition with other companies in order to avoid inefficiencies associated with monopoly positions. Competition acts as a discipline on the efficiency of the national company and provides a useful yardstick in measuring its performance. Open and genuine competition may also be the best policing device for procurement, a major source of waste and abuse in some national companies. Competition is enhanced if the state enterprise is subject to the same fiscal regime, including royalties, as a private sector investor in this and other sectors. The state enterprise should also compete for investment and operating funds. New investments and additional operating cost ultimately come either at the expense of other government programs

(if internally generated funds are used rather than being paid as dividends to the state for use in other programs) or by increases in the public debt.

National resource companies sometimes take on regulatory functions for the sector but this can result in serious conflicts of interest between commercial and wider public interests. To avoid this, the government should separate the national resource company from the licensing, and technical and regulatory supervision of the resource sector, placing those functions instead in independent governmental entities. Where the functions are retained within the national company, conflicts of interest can be reduced and better monitored if they are segregated from commercial operations and subject to separate supervision and reporting.

National resource companies are often used to carry out social functions such as distributing subsidized fuel, with the costs absorbed in the budget of the national resource company. Use of the national resource company, however, makes the costs of such policies opaque and pushes the company into a more political role that is not consistent with professional and efficient operation. In the event that such programs are entrusted to the national resource company, the government and parliament's control and oversight can be improved by having the national company report separately and in detail the costs of the social programs that the company is tasked with, including the opportunity costs of such items as mandated discounted sales of fuel or other supplies. These costs should also be explicitly recognized in budget and national accounts.

Precept 6: Resource projects may have serious *environmental and social effects* which must be accounted for and mitigated at all stages of the project cycle.

Because of their location, nature and often their scale, resource projects can have significant environmental and social effects and the government must account for those in any plan to initiate exploration or to develop the resource. The initial decision to explore or develop should be informed by an ***understanding of the possible environmental and social consequences***, usually through a strategic or project impact assessment and these consequences need to be weighed in the decision of whether to invest. Public participation is an integral part of the process. If the decision is made to invest, then ***environmental and social monitoring*** should be maintained throughout the project's life consistent with a plan to minimize or mitigate possible adverse environmental and social consequences specific to the project.

The environmental costs of extraction are often borne disproportionately by those in the vicinity of the extraction process. These citizens have an overwhelming claim to be compensated through services or cash for these environmental costs. Indeed, without a clear commitment to provide reasonable compensation for these costs as well as equitable participation in the national benefits, local communities are liable to sabotage the extraction process and even assert ownership claims.

The government is responsible for setting, and enforcing, environmental standards and determining the rights of local communities for compensation. These standards may be set by reference to international standards such as the Equator Principles, now widely accepted. While governments must set standards and monitor their enforcement, the costs of mitigation, avoidance, and compensation are part of the economic cost of the project and must be accounted for.

The investor is in the best position to control or mitigate environmental damage during operations and is likely to be the most efficient party to conduct reclamation at the time of project closure. To ensure, however, that the investor does not evade or fail to carry out its obligations especially in the termination phase of operations, investors should in most instances be required to fund during the production life cycle an independent account that can be used to fund clean-up and reclamation or through bonding or other means to provide independent security. Any account should be held with a highly credit worthy entity, independent of investor and the government, with amounts payable in accordance with its terms. The funded amount should be adjusted over time as the estimates of future closing and reclamation costs become more refined. Closing plans must also address the social impacts of closure and the need to provide strategies for the ongoing viability of communities affected by closure.

Precept 7: Resource revenues should be used primarily to promote *sustained economic growth* through enabling and maintaining high levels of domestic investment.

The revenues from resource extraction are ***intrinsically time-limited***: natural assets will be depleted. Hence, even where citizen needs are acute, if the resource revenues are consumed but not invested, the resulting increase in ***living standards will not be sustained***. If the revenues are to be harnessed for a sustained increase in living standards, a substantial part of them must be invested outside the resource sector, in the nation's physical infrastructure, and in education, health care, and social protection. The very fact that a country has urgent unmet needs across a wide range ***implies that there are many opportunities to increase growth*** across the economy. Broad-based growth increases jobs and household incomes and is the only route by which countries are able to sustainably reduce poverty. Growth also gradually generates the non-resource tax revenues that can sustain enhanced social spending.

To be effective and enduring such growth requires ***sustained high levels of investment*** over an extended period. Many resource rich countries have low levels of infrastructure, skills, and labor productivity. This in turn produces an unpromising climate for private investment. For example, private investment in electricity generation may be unprofitable because transport infrastructure is too poor to support the firms that would be reliable purchasers of power. Investment in agriculture may be low because of lack of rural roads, irrigation or knowledge of appropriate technologies. A quantum increase in public revenues creates the ***opportunity to break the trap of low private investment***. By simultaneously increasing public investment across a wide range of needs, the return on private investment can be raised, thereby gearing up public investment with a private response.

However, precisely because the unmet needs are wide-ranging, the ***appropriate public investment takes many forms***, some not even conventionally treated as investment. In addition to physical infrastructure, spending on human capital - education, health, and social protection – can all interact to improve the climate for investment.

For low-income countries, domestic investments are preferable to overseas investments. High income countries – such as Norway – may find it appropriate to build up sovereign wealth funds to support future generations, but this strategy is inappropriate for low-income countries. Low-income countries are ***capital scarce***, lacking vital ***infrastructure***, ***public services and public goods***, including health and education services. This means that the return on appropriate domestic investment can be above what can be earned by investing on world markets.

The amount of investment which a country can absorb productively (its "absorptive capacity") may at any time be limited by both its human capital and infrastructure. The sequencing of investment should address these limitations early to permit more rapid levels of future investment and hence growth.

Countries which come into a commodity boom with high foreign debt levels can usefully apply some of the windfall to paying off outstanding debts. Debt reduction raises no domestic absorption issues, enhances the country's credit standing and appeal to investors, and most importantly, will reduce the cost of capital for the domestic private sector.

While the key objective is sustained growth, the citizens of many resource-rich countries are poor. They are currently much poorer than they and their children are likely to be in the future and so it is appropriate to use part of resource revenues for an immediate increase in living standards, including through direct conditional or unconditional cash transfers or "dividend" payments. Direct transfers get around spending bottlenecks and capacity constraints. Such a dividend also demonstrates that citizens are the ultimate owners of the resource. Although frequently used as a way to distribute benefits, subsidizing the domestic price of the extracted commodity is the least desirable way to increase household consumption. The cost to the government budget can become prohibitive when world prices rise, the subsidies encourage smuggling and parallel markets, and they spur wasteful consumption which reduces the earning power of the resource.

Expenditure programs need to be formulated with prudence, and due attention to the volatility of resource revenues. They should also be developed within the context of a medium term expenditure framework that properly assesses their internal consistency and economic impact. (See Precept 8).

Precept 8: Effective utilization of resource revenues requires that *domestic expenditure be built up gradually* and be *smoothed* to take account of revenue volatility.

Resource revenues fluctuate through time, varying with the development of new discoveries, with price changes and with fiscal provisions. Effective utilization of revenues requires that ***expenditure be smoothed*** and that investment and outlays be built up over time. A gradual build up may also be necessary to ensure the quality of public spending and to avoid adverse macroeconomic repercussions.

In budgeting it is critical to take account of volatility of commodity prices and revenue flows, something that recent experience has clearly demonstrated. Such a domestic expenditure pattern can be achieved by saving a portion of revenues during high price periods, holding the savings in a ”stabilization” fund, and then dissaving (drawing down) the saved revenues during low price periods. Smoothing can also be enhanced by limited foreign borrowing or adjustment of the rate of resource depletion.

The amounts paid into the stabilization fund should be held in international financial assets. If the government relies upon domestic savings it will cushion its own expenditure during a period of low prices only at the expense of passing all the contraction in resource revenue on to domestic households and firms as it liquidates its domestic savings. Hence, a better strategy is for the government to smooth public expenditure by means of foreign financial assets to avoid this adverse effect on domestic households and firms when the fund is drawn down. Such policies can be made more effective by transparency and by taking the response of private sector actors into account.

Since the purpose is to smooth public expenditures around fluctuations in revenue, this has implications both for the ***scale of foreign asset accumulation and its composition***. Although the objective is not to build a long run fund, the savings may need to be a substantial part of the revenues during boom periods at least until a significant cushion is established. Any stabilization fund should hold investments that are reasonably liquid and less exposed to fluctuations in value: the investments will need to be sold during periods of low global commodity prices and this may, for example, coincide with global recessions and low asset prices. Effectiveness will be enhanced if there are transparent rules or guidelines for triggering asset accumulation and withdrawals, with any deviations subject to public debate and formal procedures.

Smoothing of expenditures may also require ***borrowing*** in international capital markets. This may be particularly valuable in the interval between resource discovery and significant revenue flow, during which period an initial ramping up of expenditure is appropriate. However, it is important to signal prudence, both internationally and domestically. Prudence requires defenses against an inability to repay new loans, against a drop in commodity prices, and against delays in getting new discoveries into production. Care must be taken to not drive up the cost of capital to the private sector. An ***international facility*** (such as IBRD lending) is preferable to private

borrowing as a means to ensure this in part to avoid encumbering the resource itself and in part because the international entity will reinforce the government's direction of sustainable spending. Over the longer term, resource wealth should be used to reduce government debt, not increase it.

The postponement and hence smoothing of spending can alternatively be achieved by ***limiting the rate of resource depletion.*** If the resources are left in the ground economic principles suggests that their expected return will be competitive with the returns of foreign financial assets. Leaving resources in the ground also ***reduces the risk from future economic populism*** since assets in the ground are harder to spend quickly. The costs of any deferred development strategy include current unpopularity, and delaying ***diversification of the total asset portfolio*** of the country's economy that could be achieved by extraction and conversion of wealth into a broad portfolio of other assets.

Precept 9: Government should use resource wealth as an opportunity to secure effective public expenditure and to increase the *efficiency of public spending.*

The opportunities for sustained growth that are created by a large increase in public expenditure, such as is made feasible by new resource revenues, requires effective allocation and control of spending and careful attention to the macro-economic impacts on other sectors of the economy.

The first problem is the ***quality of public spending***. If public spending has been properly prioritized, extra spending will be less valuable than existing spending. Deterioration in the quality of spending may also occur as a result of political economy pressures: once lobby groups know that public spending will increase, they will increase their efforts to capture it for their own advantage, a process known as 'rent-seeking'. If the quality of extra public spending is low then the resource revenues cannot be transformed into substantially higher living standards.

The ***solution to the problem of low-quality public spending*** is to recognize that a substantial increase in public spending is also an opportunity for innovation in spending systems. It may be politically easier to introduce improved but tougher management for new spending than to reform existing spending.

Innovations in public spending systems are needed for two distinct objectives: integrity and efficiency. As in our discussion of integrity and efficiency in resource extraction, competition is an effective instrument in achieving both. The institutional equivalent of an auction for the sale of extraction rights is to require competitive tendering for all public procurement. In addition to competitive tendering there are some systems which are primarily for integrity. The decisions to approve expenditures should be made transparent through published budgets; once expenditures have been incurred they should be subject to the scrutiny of independent audit. Other systems are primarily for efficiency. Prior to approval, the costs of major expenditures should be compared to their likely benefits (cost-benefit analysis), and as noted in Precept 8, the investment program must take account of the absorptive capacity of the country. After completion such expenditures should be evaluated, the results being used both for accountability and for learning.

As part of the reform of public spending special attention also needs to be given to the absorptive capacity of the country, that is its ability to actually realize and carry out public investments. Limitations of human or physical capital may limit the efficiency of investment, and it is necessary to think through the sequence of investment in order to reduce these constraints so that further investment can be efficiently managed so as to realize the intended objective.

The second problem is that a large increase in spending financed from resource export earnings has ***macroeconomic repercussions*** which can damage sectors which indirectly are in competition with resource exports. Firms that produce other types of exports can be hurt by changes in exchange rates that make their exports less competitive, and firms which produce tradable

goods for the domestic market, such as manufactures, can be hurt because labor and other costs may be bid up by demands from the resource sector. These effects are known as 'Dutch disease'.

The ***solution to the problem of Dutch disease*** is in part to offset the damage done to producers of other exports and import-substitutes by lowering their costs. The way to do this on a sustainable basis is not through subsidies but through targeting infrastructure spending towards their particular needs, such as power, water, roads and ports. Additionally, the problem of Dutch disease can be reduced by smoothing peaks and troughs of commodity price fluctuations, as discussed in Precept 8. However, even with such smoothing the economy will need to adjust to periodic external shocks and this has implications for the design of economic policies that superficially might appear unrelated to resource extraction. A key policy that appears to improve the ability of resource-rich economies to weather shocks is labor market flexibility. This implies that policies for social protection might need to be distinctive in such economies, with greater focus on direct help to households and assisted job mobility rather than through the protection of existing jobs.

Precept 10: Government policy should facilitate private sector investments in response to new opportunities and structural changes associated with resource wealth.

Resource extraction can be harnessed to create employment and income in various sectors of the economy. Opportunities arise from the direct stimulus created by the resource sector, as well as from the availability of funds generated by resource revenues. This employment and income will be created largely by the private sector, but government has a role in ensuring that opportunities are taken up. It may be in resource related activity, in line with the view that the ***resource sector should yield direct benefits and local value added*** over and above tax and royalty payments. But countries will also want to ensure that non-resource sectors are enabled to grow.

The primary role of government is to create the investment climate and public goods that are complementary to private investment. First of all, this involves removal of obstacles to private investment. Since a resource boom brings about structural change in the economy it is particularly important that the business environment is supportive of new investments and flexible enough to allow redeployment of capital and labour across sectors of the economy. Potential bottlenecks – for example in the construction sector – can be identified and addressed. Openness to international trade helps to get around such bottlenecks.

Secondly, public investments can play a major role in raising the productivity of the economy and thereby stimulating private investment. In choosing public investments the government should prioritise those that are 'general purpose', such as health, education, and infrastructure which will benefit essentially all sectors of the economy and all regions.

Government may also choose to use incentives aimed at particular sectors or activities. Such policies carry risks, as witnessed by the numerous 'white elephants' left in many resource rich economies. If such policies are to be employed, then several design principles should be employed. The first principle is that ***investments should be credibly expected to attain long-run commercial viability.*** Investments that fail this test are likely to destroy rather than add value, and will be a continuing drain on public funds.

The case for government support for a new activity arises if there are 'market failures' which prevent firms from being able to undertake potentially high return investments. Many of these market failures can be removed by measures to improve the business environment, such as improving the financial sector, contract enforcement, and the system of regulation. Others are more deep-seated, and include spillover effects and coordination failures. The former arise when a firm creates benefits that accrue to other firms (such as training labour that then quits for another employer). The latter arises where inter-related private investments create a chicken and egg problem, with no private investor ready to make the first move.

Assessing the case for supporting particular sectors or investments requires careful analysis and diagnosis of the market failures that prevent the private sector from undertaking investments.

When sector specific policies are employed several further principles should inform the design of any support package. The most important is that ***support should be linked to success not failure.*** Open-ended support packages should be avoided and support should involve credible criteria for termination in the case of continuing poor performance. Lobbying by interested parties is frequently an obstacle to this, so decisions should be taken at a high level and in consultation with a wide section of society, consumers and taxpayers as well as producer interests.

In selecting sectors for promotion there is a tension between building resource related sectors and diversifying the economy away from dependence on a narrow resource base. Choices here are country specific, but there are several guiding principles. The first is that if the resource is easily traded internationally (eg oil and high value minerals) then the best option is likely to be to export the resource and use the funds to invest in other sectors. It is only where the resource is less readily traded (eg gas, low value minerals) that the case for developing downstream sectors is strong. Choices should be based on assessment of countries' capabilities and long-term comparative advantage. Is the country likely to attain world level efficiency in the sector? Do regional markets provide a long run basis for commercial viability? This assessment is difficult – the essence of economic development is that countries develop new capabilities and grow into new activities. Careful study of the experience of comparator countries is one way to form a judgement. Another is to identify areas where the private sector – international as well as domestic – displays an interest in investing.

Precept 11: The *home governments* of extractive companies and *international capital centers* should require and enforce best practice.

Governments under whose jurisdiction the parent companies of resource extraction entities reside have often acted in ways that undermined the good governance of resource extraction. For example, some governments have used their diplomatic power to lobby for special deals for their own companies, undermining the integrity of both the fiscal system and the process by which extraction rights are awarded. This use of diplomatic power is in excess of the influence commonly employed in normal tax treaty negotiations and other trade negotiations. Where the governments of resource-rich countries have decided to use ***transparent procedures*** such as auctions to award extraction rights, companies and the governments in which the parent companies of extraction entities reside should not use their influence to circumvent or to otherwise compromise these procedures.

Similarly, ***transparency of extraction revenue streams*** is vital to effective public oversight. Therefore, home governments should require the parent companies and all related entities over which they have jurisdiction to report their payments to governments in a form that enables public oversight while being consistent with taxpayer confidentiality rules. They should support EITI, and meet EITI reporting standards themselves where relevant and material. To universalize disclosure and to level the playing field for extraction companies, they should support an ***international accounting standard*** for reporting such payments and for reporting production, costs and revenues country-by-country. The latter would make it easier for producing countries to administer resource taxes effectively.

The major financial centers can help to limit the ***leakage of public resources*** through illicit channels, which is a problem particularly prevalent in some resource rich countries. The supervisory authorities of international banks should bar banks from engaging in transactions that involve looted assets. Due diligence requirements for transactions which could reasonably be suspected of being the diversion of resource revenues from their proper uses should be as strict as those that apply to the laundering of drug money or financing of terrorist organizations.

A concerted policy shift along these lines, perhaps coordinated through the G-8/G-20, would have the greatest impact. Extractive companies say that the greatest constraint on disclosure comes from the governments in producing states. ***Comprehensive home country regulation*** or an international accounting standard would protect companies from retaliation or discrimination and level the international playing field for the industry. Effective limits on the flow of looted assets through the international banking system requires the cooperation of the major financial centers, which already coordinate on drug and terrorist financing through the Financial Action Task Force and the Basel committee on banking supervision.

Precept 12: *All extraction companies* should follow *best practice* in contracting, operations and payments.

Many extractive companies operating across borders recognize that a failure of the host government to deliver benefits from extraction to the people can have significant adverse effects on the company's profitability, security of investment and ability to continue to operate. ***If grievances build up, there may be conflict, government demands for re-negotiation of terms of extraction or even out-right nationalization.*** Missteps by the company itself with regard to social and environmental protections can lead to unrest in producing areas that interferes with production and puts employees at risk. Company reputation risk is also heightened under these circumstances. Given the large up-front investments required for many extractive projects, and the captive nature of the asset, the costs for a company of such developments can very high. The risks may particularly acute in so called "fragile states" where the ability of the government to negotiate effectively and to monitor or enforce laws may be weakest and the opportunities for companies to exploit those weaknesses are the greatest.

A growing number of companies see it in their own interest to enhance their "social license to operate" and to take steps that go beyond the minimum legal requirements of their home or host governments. Major oil and mining companies have embraced EITI and work proactively to promote it. A number of extractive companies unilaterally disclose details of the physical and financial operations country by country, and provide social services to the communities where they operate. Some companies voluntarily seek to procure products and services locally.

Perhaps the broadest effort is that of the International Council on Mining & Metals (ICMM), an organization of 17 of the largest mining and metal companies including Anglo American, Anglo Gold Ashanti, Mitsubishi, Newmont, Rio Tinto and Vale. ICMM has created a Sustainable Development Framework defining best practices covering the full range of mining activities, from the decision to extract, to local content, to revenue transparency and mine closure and clean up. According to the ICMM, the Sustainable Mining Framework was developed through a multi-stakeholder process and followes closely the recommendations of the World Bank's Extractive Industries Review chaired by Dr. Emil Salim.

The ICMM has undertaken a series of studies to identify policies and practices that can increase the economic benefits that accrue from mining at the local and national levels.[5] The ICMM recognizes that extractive companies are not passive actors but can influence governance and economic outcomes beyond the extractive process. "The poor socio-economic performance of

[5] See for example "Sustainable Development in the Mining and Minerals Sector: The Case for Partnership at Local, National and Global Levels" Kathryn McPhail, International Council of Mines and Minerals May 2008, and "Resource Endowment Toolkit. The Challenge of Mineral Wealth: using resource endowments to foster sustainable development." International Council on Mining & Metals with UNCTAD and the World Bank. September 2008. See also ICMM "Statements" elaborating requirements for specific issues, including transparency and dealing with indigenous peoples. www.icmm.com

many resource-rich countries gives reasons to believe that extractive industry activities can have a non-trivial [and sometimes negative] impact on governments' and communities' incentives. This is particularly the case if the size of this industry is large relative to the overall size of the national economy."[6] After wide-ranging consultations with stakeholder groups and a review of relevant international conventions, the ICMM has agreed a far-reaching set of binding principles for its members, which includes 17 of the largest mining and metals companies. These principles are broadly consistent with and supportive of the Charter. Unfortunately, nothing comparable has been done by the petroleum industry.

There is an evolving body of law and practice that suggests that corporate responsibility goes beyond a legal license to operate and maximizing profits. There are the beginnings of internationally accepted norms for broader corporate responsibility. Many OECD countries encourage corporate responsibility, variously defined. Danish law requires large companies to report on their CSR policies. The UK Companies Act requires boards of directors to "have regard" for "the impact of the company's operations on the community and the environment." The community of socially responsible investors is growing rapidly, with some very large funds like the Norwegian Pension Fund barring investment in companies that do not observe international codes and standards or follow industry best practice. There is no inherent conflict between best practice and maximizing profitability over time.

Extractive activities intersect with many UN and other international conventions, including for the protection of the environment, human rights, labor. The United Nations is developing a set of principles for business and human rights, in collaboration with the business community. The UN's definition of human rights includes economic rights and the "right to development." The conceptual framework presented by the Special Representative of the Secretary-General has been endorsed unanimously by the UN's Human Rights Council and by leading business organizations including the International Chamber of Commerce and the ICMM. Special Representative John Ruggie describes the responsibility to respect human rights as a near-universal norm that exists "independently of State duties and variations in national law."[7]

Through the interaction of many formal and informal stakeholder processes, a body of international norms and industry best practice for the extractive industry is being built up. This includes the Extractive Industries Transparency Initiative, the transparency and environmental standards adopted by international financial institutions for their engagement in commercial extraction projects, guidelines for investors and extractive firms like the project risk assessment of the social license to operate developed by Critical Resource.[8] Industry organizations like the ICMM are developing industry guidelines for responsible extraction.

[6] ''Resource EndowmentToolkit… '' p. 24
[7] A/HRC/11/13, para. 48.
[8] Critical Resource Strategy & Analysis Ltd. www.c-resource.com

If the principles and policies recommended by this Charter are to be successful, extraction companies that can have such a large and long-lasting impact on the economic, environmental and social life of the host country must play a broad and actively supportive role. The accompanying technical paper (Level 3) for Precept 12 elaborates specific steps companies can take to support the Charter, drawing on the evolving international norms, standards and best practices.