

This series of notes for pension fund trustees has been compiled by the UK Social Investment Forum in collaboration with a group of its members and the Just Pensions programme.

Each note covers one FTSE industry sector in which UK pension funds invest. Potentially material social, ethical and environmental risks facing the largest sectors are highlighted and discussed in relation to their potential impact on shareholder value. In addition, one potentially material developing world issue relating to the sector's activities is explored in more detail.

The aim of the notes is to help pension fund trustees understand risks that lie outside the realms of traditional financial analysis but may influence the performance of their investments. Additional questions to aid trustees in their discussions with fund managers will be provided during the series.

For further information on the series, or to receive any individual sector note, please do not hesitate to contact the Just Pensions programme at [info@justpensions.org](mailto:info@justpensions.org) or on 020 7440 9712.

Just Pensions is a programme of the UK Social Investment Forum – the UK's membership network for Socially Responsible Investment. Just Pensions aims to educate and influence UK pension funds and other institutional investors about the importance of international development issues in their practice of SRI.



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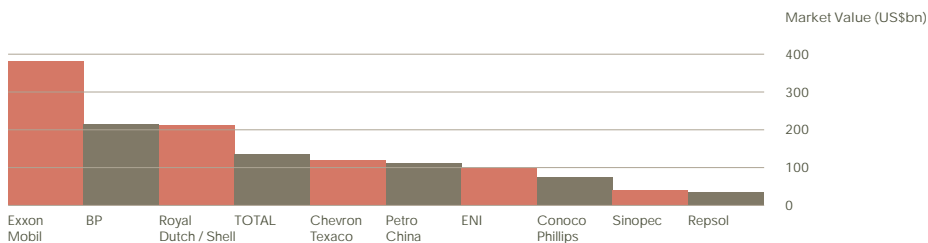
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# 9 Extractive Industries

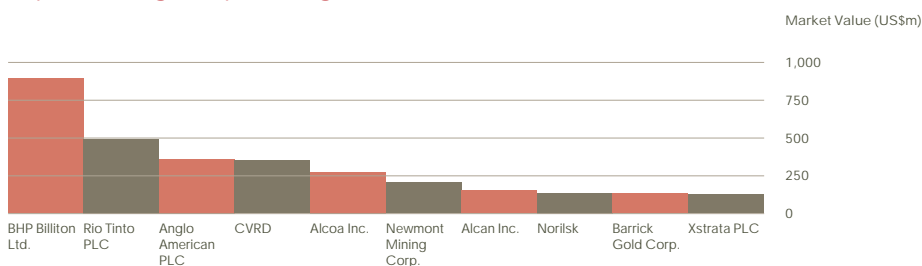
## Features of the oil, gas and mining sectors

- Significant influences on share value of these sectors include commodity price cycles (which are linked to global economic growth) and currency fluctuations (especially the US\$).
- Due to the nature of the industry, disruption to a project site's environment is inevitable.
- There is a precedent for collaboration between extractive companies on project sites, including with state owned and local companies.
- Key revenue drivers for oil & gas companies include reserve life and free cash flow generation per barrel. Significant costs include finding and developing reserves, lifting product and tax paid to host governments.
- In the mining sector commodity prices tend to drive company valuations. Key costs include exploration and development of a site, labour, smelting and refining.
- There has been high stakeholder interest in this sector for many years. Major companies therefore tend to have well developed CSR policies and programmes.

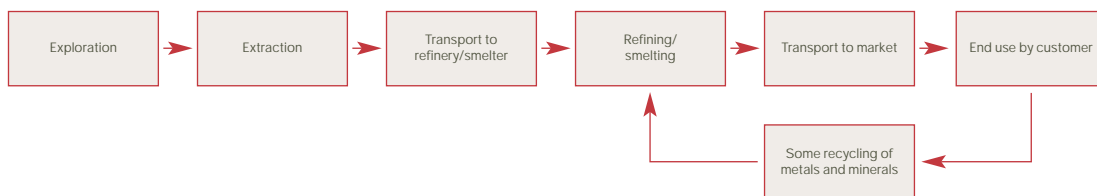
## Top 10 oil & gas companies (global)



## Top 10 mining companies (global)



## Value chain from exploration to customer use



This note forms part of a research programme to identify potentially material social, ethical and environmental risks for each industry sector. Due to the collaborative nature of the work, this analysis does not necessarily reflect the views of each of the fund managers involved.



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# Potentially material social, ethical & environmental risks

Please note that the risks identified in this section will apply differently to companies within the sector, according to their product range and exposure to various markets. Many of the risks highlighted below arise in relation to downstream activities such as chemical plants, refineries and smelters, as well as at points of extraction. These risks may be relevant to extractive companies today, and are expected to increase in significance in the long term.

## Access to reserves

Gaining access to reserves of natural resources is essential for extractive companies to secure ongoing and long term supply of their products. The process of finding and accessing new reserves is becoming increasingly complex due to their location in environmentally sensitive locations and within developing countries where risks related to the rule of law (eg expropriation, enforcement of regulations and human rights) are likely to be heightened. The factors discussed below, if poorly managed, may increase the risk of disruption to supply and/or a company failing to replace reserves. Conversely, a track record for managing these risks well may enhance a company's negotiating position with a host government.

**Assessments of environmental and social impacts** of proposed projects are now a common feature in gaining permission to extract resources. New sites require permits from local and/or national governments before operations can commence. Regulators' concerns over regional and local site impacts can increase the time and cost of gaining initial permission to exploit a reserve. Environmental and social conditions applied by The World Bank, International Finance Corporation and financial institutions subscribing to the Equator Principles (a framework to manage environmental and social issues in project financing) may affect the cost of capital.

**Demonstrating a benefit to the local community** from the project can be a requirement of local authorities. If workers, contractors and goods are sourced from abroad or outside the local area, communities may find that they miss out on jobs and trade. Where national governments retain tax revenue centrally and the income from projects is not seen to benefit day-to-day local living conditions, local communities can become resentful. If poverty exists close to a site of extraction or a distribution route cuts through a

deprived community, questions about the allocation of the benefits derived from the development and use of a country's natural resources are commonly raised. Companies may come under pressure to facilitate social development alongside their extraction projects. Governments will also be concerned to see that levels of tax, royalties and other revenues are appropriate.

**Negotiating compensation for loss of access to land**, loss of livelihoods arising from locally degraded environments, or the forced relocation of communities can be a costly and time consuming process. It is made more difficult where land ownership is poorly defined, especially if a national government does not recognise indigenous peoples' rights.

**Companies risk accusations of bribery** when bidding for new licenses in countries with opaque tender processes. Through the UK's Anti-terrorism, Crime and Security Act, and the USA's Foreign Corrupt Practices Act companies are now answerable in the courts of their home countries for actions undertaken overseas.

**Exit planning** is an increasingly important aspect of gaining permission to develop a site. Long term ecological as well as socio-economic rehabilitation plans may require investment in a project location for a significant period once extraction has ceased. The legacy of older sites, brought into operation before today's environmental and social standards were adopted, presents a risk of remediation and rehabilitation costs for which sufficient provisions may not have been made. Companies that explore or develop sites with a view to exiting through selling on to other operating companies may find that the value of their assets is reduced by unresolved health, safety, environmental or community issues.

## Long term viability of the sector in a carbon constrained economy

The burning of fossil fuels for use in energy and transport results in the release of CO<sub>2</sub>, the major contributor to global climate change. As political momentum to stabilise and reduce CO<sub>2</sub> emissions grows, the cost to users of carbon intensive fossil fuels is likely to rise. The EU Emissions Trading Scheme is an example of policy encouraging this trend as it is already driving up the cost of electricity for business as well as individuals. Companies seeking to supply countries adopting carbon control mechanisms could lose market share if they are unable to supply lower carbon emitting products, while companies with access to

'cleaner' resources, such as natural gas, stand to gain. The more countries that adopt policies towards reducing carbon emissions, the more pronounced this trend is likely to become. A shift in energy policy to favour nuclear power could positively impact mining companies with access to uranium. The link between extractive industries and global climate change makes these companies a likely target for ongoing NGO activism. Where governments are sensitive to public opinion, this may ultimately lead to a more stringent operating environment for those not prepared to adapt to a lower carbon economy.

## Efficiency of operations

Once a project has gained all the required permissions and financing to proceed, the efficiency with which the managing company extracts products from the site and delivers them to the market is a key determinant of success. Poor management of the factors discussed below may impede day-to-day operations at a site, thereby reducing operational efficiencies and reducing income from the project. Companies seeking access to new reserves (see above) need to demonstrate their ability to manage site operations efficiently.

**Health and safety** of employees and contractors working at an extraction site is an ongoing risk to operating companies. A poor health and safety record not only discourages people from joining the industry/company and imposes liabilities, but is also likely to increase regulatory pressure to improve standards. Companies with a global presence and brand name can come under great scrutiny as a result of a small number of accidents. Acquisition of an asset with a poor health and safety record may impact the reputation of the acquirer. Linking safety to executive pay may be an effective way to demonstrate board-level commitment to high safety standards.

**Ongoing local community acceptance** of a project is essential, as local "simmering resentment" can erupt with little warning causing considerable disruption to projects, substantially raising operating costs. If opposition is backed by an international NGO, a company can find itself under pressure in its home country as well as at the operating location. Causes of local dissent include local site pollution which affects the

health or income stream of local people (e.g. through air or water resource pollution); insufficient compensation for loss of access to land; and the perception that local communities have derived little benefit from the operation. Where local community unrest is significant the safety of workers at a contentious site may be at risk. The cost of security to protect staff travelling to/from the site may increase and the outsourcing of security functions (e.g. to national armies or private contractors) can be controversial.

**Country risk** across extractive companies' portfolios is tending to rise as new resources are increasingly located in non-OECD countries. Companies adept at assessing and managing the wider political, social, environmental and ethical risks of operating in a developing country are more likely to deliver projects efficiently. However, some political events cannot be predicted. Companies with a good understanding of local political and societal concerns will be better able to deal with significant changes to their operating environment as they occur.

**Highly profitable companies can be more exposed to political risk** as governments levy increased taxes and charges, often supported by public opinion, as a means of returning more of the cash generated by the exploitation of natural resources to the treasury. Transparency of payments to governments, as encouraged by the UK Government's Extractive Industries Transparency Initiative, is one step in enabling the populations of resource rich countries to hold their leaders to account for the use of funds generated.

*Question: How is your fund manager incorporating material risks into their company analysis?*

*Question: How is your fund manager engaging with companies on material risks?*

## The contribution of extractive operations to host country sustainable development

Companies in the extractive industries have faced criticism for failing to contribute significantly to the sustainable economic development of the countries from which they extract natural resources. It is easy to draw evocative comparisons between highly profitable companies and poor local communities, fuelling the debate as to whether the impact of the extractive sector is a net benefit or net detriment to host countries. Countries such as Bolivia, Congo, Niger and the Philippines perform poorly in relation to the United Nations' Millennium Development Goals, despite receiving significant incomes from oil, gas and mineral extraction. In recent years the concept of a "resource curse" has gained prominence in development thinking. Policy makers and company directors alike are grappling to understand why, contrary to expectations, natural resource extraction has not always lifted the populations of host countries out of poverty.

Academic research has identified a range of features common to countries whose economies have benefited from resource extraction, such as Australia, Botswana, Canada, Chile, Malaysia and Norway. These countries have all benefited from strong governments who have taken sound policy decisions to manage the impact of the extractive industry; i.e. 'good governance' has resulted in revenue generated through taxation of exported natural resources being invested to enhance national economic development.

The negative impacts of resource extraction, where poorly managed, reduce companies' access to resources and increase operating risks (see risks described overleaf). Investors are therefore keen to understand the role companies in this sector can play in reducing these impacts and to improve development outcomes. Environmental and social programmes are now common around project sites, and in many cases have been shown to improve local economic activity and reduce social and environmental impacts locally. However it is not yet clear whether this approach impacts sustainable development at the national scale. Extractive companies can also play an active part in promoting sound governance frameworks at both national and more local levels, while recognising the sovereignty of governments.

Maximising the development benefits of natural resource extraction requires partnership between host governments, civil society and companies. The ICMM (a mining sector industry body) has commissioned research aimed at helping clarify the links between mining companies' activities and economic development with the aim of improving their role in promoting benefit sharing from natural resources. Through its Extractive Industries Transparency Initiative the UK Government<sup>1</sup> is focusing on improving governance in resource rich countries with a view to improving accountability of revenues from the extractive industries. It is hoped that increased transparency will both reduce corruption and improve allocation of budgets to pro-development investment.

While revenues from extraction of oil, gas and coal (when invested appropriately) may increase economic development to the benefit of the poor, the burning of these fossil fuels for energy and transport is contributing to global climate change. A collaboration of development NGOs<sup>2</sup> recently highlighted the long term negative impact of global warming on human development, as drought and extreme weather events reduce income in vulnerable (especially rural) communities. The long term challenge to the extractives sector, host governments and consumers of fossil fuels is therefore to deliver economic development today in a way that is underpinned by environmental sustainability in the longer term.

<sup>1</sup>For further information on the Extractive Industries Transparency Initiative visit [www2.dfid.gov.uk/news/files/extractiveindustries.asp](http://www2.dfid.gov.uk/news/files/extractiveindustries.asp)

<sup>2</sup>For further information on the human development impact of Climate Change visit [www.iied.org/docs/climate/Up\\_in\\_Smoke.pdf](http://www.iied.org/docs/climate/Up_in_Smoke.pdf)