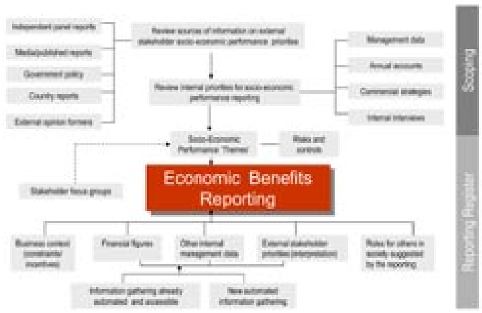
Executive Summary

Bridging the Economic Benefits Gap:

A Management Framework for Improved Economic and Socio-Economic Performance Reporting by Energy Companies



October 2004

odi

programme on
Business and
Development Performance

Bridging the Economic Benefits Gap:
A Management Framework for Improved Economic and Socio-Economic Performance Reporting by Energy Companies

October 2004

Author

Dr Michael Warner
Programme Manager
Business and Development Performance

Overseas Development Institute
111 Westminster Bridge Road
London SE1 7JD, UK

email: m.warner@odi.org.uk
telephone: +44 (0)20 7922 0300
www.odi.org.uk/pppg/activities/country_level/odpci

The views in this paper reflect those of the author alone
Cover Photographs: courtesy of Alan Nicol and Michael Warner

Funded by BP plc

Executive Summary

This report presents the findings of a six-month study undertaken by the Overseas Development Institute from November 2003 to July 2004. It is a response to an identified 'economic benefits gap' inherent in many oil and gas operations around the world. The report explores the positive economic and socio-economic impacts of energy companies on their host society – both the conventional and the less conventional – and offers a management framework for improving the systematisation, meaningfulness and influence of economic benefits reporting. This is not to negate the importance of reporting the other side of the equation: the negative economic and socio-economic effects of the oil business with respect to the 'oil curse,' 'boomtown' effects, adverse community impacts etc. The focus of this paper, however, is on the potential economic benefits stream of oil and gas projects, and how company reporting can be so arranged to enhance benefits realisation and enhancement.

Introduction

A number of the world's leading oil and gas corporations are experiencing a geographic shift in their upstream growth centres towards underdeveloped and emerging economies in Africa, Latin America, Asia and the Pacific. This shift carries new risks for both near-term profits and long-term access to business opportunities. The risks are tied to a 'benefits gap' emerging between the real and anticipated positive economic and socio-economic rate of return of investment for the host society, and the lack of management systems for tracking and reporting the efforts of companies in mitigating this risk.

The 'economic benefits gap' emerges in part because of characteristics inherent in the upstream oil and gas business: the long cost-recovery periods for capital investment, the short-term nature of the majority of employment opportunities, and social programmes narrowly targeted at directly affected people; and in part because of market and state failure including technical constraints to supply chain access for local firms, inefficiencies in public sector expenditure management at the national and provincial level, and low-level direct tax receipts by municipal and provincial authorities.

In economically more advanced, higher-income nations, the 'benefits gap' is more one of public perception, with a drift in comprehension of connectivity between the activities of the downstream energy business and its positive contribution to society in terms of mobility, power and products.

Persistent Challenges to Reporting Economic Performance

The study looked at a number of current initiatives in the area of corporate economic and socio-economic benefits analysis and reporting, including the OECD Multi-National Enterprise and UN Global Compact principles, the Dow Jones Sustainability and FTSE4GOOD rating indices, the GRI 2002 Sustainability Reporting Guidelines, the IFC method for assessing project economic impact, and a recent study on the impact of business on poverty undertaken by Emerging Market Economics with the UK Department for International Development. We conclude that the discipline of economic impact reporting is not well evolved, and suffers from a number of persistent challenges. These include:

- weak analysis and reporting of the commercial and public policy constraints and incentives that frame business strategy, and thus provide justification, or not, for a company's economic and socio-economic performance;

- a tendency at Group level towards reporting aggregated economic information that rapidly becomes meaningless to country-level stakeholders, and which fails to focus attention on those particular operations material to the earnings of the Group as a whole due to specific short-term political risks or unprotected long-term growth opportunities;

- a bias towards reporting Cash Value Added (CVA) and the breakdown thereof in the form of dividends, taxes, employee wages and benefits, re-invested earnings and charitable giving, and their presentation as indicators of an economic rate of return – a practice that, particularly in low- income and poorly governed countries, fails to account for extreme inequalities in economic benefits distribution;

- a dependency on gathering economic and socio-economic performance data from high-cost, stand-alone studies and surveys;

- a lack of attention to reporting the significance of economic performance in the context of the specific economic and social priorities of the host society, be that national economic development targets, the economic and social policies of local district authorities, the livelihood aspirations of communities or the economic interests of civil society groups; and

- the potentially adverse commercial consequences for energy businesses arising from continuous performance improvements with respect to some of those indicators chosen as the basis for economic reporting, such as wage levels, rate of local staff succession or use of local suppliers.

A Management Framework for Improved Economic Benefits Reporting

Designed to overcome the above challenges, the building blocks of a more comprehensive management framework for gathering, interpreting and reporting the economic and socio-economic performance of oil and gas business operations are presented in this report (*Section 3*). The design combines a *Scoping Exercise* with a *Reporting Register* of compiled information and an integral *Risk Assessment*. Together these features enable formulation of a new type of narrative on reported business benefits: one more meaningful and credible to a variety of audiences. Applications for such a framework include preparation of country-level environmental and social reports, country-level business updates, group-level annual sustainability reports, group-level financial reports (in particular their interpretation for medium-term earnings security and long-term access to business growth), and online country or project-based reporting.

Business-to-Host Society Connectivity

As part of the proposed framework, a checklist is used to aid the initial scoping of economic and socio-economic impacts to report. The main category headings in this checklist are presented in *Box A*. A further 80 sub-categories are identified in the report. As part of site visits undertaken for this study, the checklist was used to explore in more detail a number of areas of economic and socio-economic connectivity between energy companies and their host society (see *Box B* overleaf).

Box A Categories for Economic and Socio-Economic Reporting

- Products and services
- Monetary flows to the public sector
- Reinvested earnings
- Profits
- Dividends
- Political stability
- Macro economic stability
- Investment climate
- Transactions
- Employee benefits
- Procurement (suppliers and contractors)
- Infrastructure and equipment
- Banking sector
- Ethical and quality standards
- Security
- Charitable giving
- Eco-technology
- Bio-diversity and conservation
- Community investment
- Regional development (region of operations)

Box B Economic and Socio-Economic Connectivity between Energy Companies and their Host Society Explored in the Study

Upstream – oil and gas developments

- the contribution of oil or gas field developments to the provision of affordable gas and electricity supplies in-country;
- contributions of the business to macro-economic stability through payments to a state oil fund;
- meeting the local content requirements of production-sharing agreements;
- the potential for a positive effect on local financial institutions from the business passing financial transactions through domestic banks;
- indirect tax payments to government from national and foreign employees working for local contractors and subcontractors;
- the contribution of the business to skills enhancement through engagement with training and education institutions;
- diffusion of ethical and health and safety standards to contractors and suppliers;
- economic and socio-economic impacts of a business's community investment programmes.

Downstream – refining, retail marketing, chemicals and renewables

- contributions to economic development in underdeveloped countries from crude oil sourcing decisions;
- employment opportunities in depressed local markets;
- innovation in service stations, eg convenience stores;
- local employment and the local economic multiplier effect of service stations;
- operator support to develop domestic businesses;
- impact of oil tax collected by service stations on the economy, eg in meeting of pension requirements;
- charitable contributions; and
- energy businesses as leaders in research and development for clean fuel and eco-efficient technology, eg within refinery and retail operations.

Findings

From discussions with staff of both upstream and downstream operations, we conclude that an effective management framework for economic and socio-economic performance reporting needs to (i) be integrated with existing reporting procedures, (ii) be cost-effective, (iii) promote prioritisation in the choice of economic and socio-economic impacts to report, and (iv) guide the systematic gathering of information. Specific conclusions arising from this study are as follows:

- The risks to shareholders associated with the shift in geography of corporate growth centres towards poor and politically unstable countries, combined with a drift in comprehension of the mutuality of benefits between downstream manufacturing/retail businesses and wider society, suggests a move away from the global corporate reporting of economic performance based on generic, aggregated financial indicators or isolated qualitative 'good news stories.' Needed is a move towards the reporting of highest-priority, location-specific economic and socio-economic connectivity (or potential connectivity) between the energy business and society, reflecting genuine host country stakeholder concerns and goals.

- The checklist of economic and socio-economic performance themes and categories presented in this report offers an opportunity to broaden the range of economic benefits reporting beyond the conventions of charitable giving, community investment and breakdown of Cash Value Added (CVA).

- Countering the persistent challenges to effective economic and socio-economic performance reporting outlined in this report requires the collation of five types of information, and their formulation into a suite of individual *Reporting Registers*: (i) the business context – competitive realities, legal and regulatory requirements, public policy stipulations and incentives that frame business decisions and determine whether a company has overall control or only partial influence over the economic benefits stream generated by its operations; (ii) financial data – indicators that describe financial performance in relation to economic and socio-economic impacts and that can be tracked through the standard accounts (Income Statement, Balance Sheet, Cash Flow); (iii) non-financial management data that is readily accessible and that will enhance the reported narrative; (iv) external stakeholder priorities – benchmarks or targets reflecting external stakeholder concerns and goals that can be referenced to interpret the relevance of the company's performance to the intended audience; and (v) external roles – actions to be taken by entities outside the immediate business to embed, enhance or sustain the socio-economic or economic gains contributed by the company.

- Within each individual *Reporting Register*, all quantitative data should, as far as practicable, be linked directly to the relevant financial and other management system so that the figures can be called up 'on command.' For data-sets that currently require costly freestanding surveys, such as soliciting the geography and/or ownership profile of suppliers, ways need to be found to automate the data-gathering process: for example by inserting new reporting clauses into the contracts of the main engineering, procurement, construction and asset maintenance contractors.

- There is a danger in economic reporting of over-stating the contributions of an individual company by failing to make it clear that it is but one of a number of joint venture partners. This problem is most apparent when the company holds the position of project operator.

- For upstream projects in their development (pre-production) phase, the importance of more accurately reporting 'local content' cannot be overstated. Energy companies need to both (i) better define what is meant by 'local content,' be that the nationality of employees, ownership of supplier firms, sphere of geographic influence of suppliers, country of registration or incorporation etc; and (ii) reduce their dependency on freestanding surveys for gathering local content information, putting in place instead automated procedures.

- In the medium term, reporting the volume of transactions with domestic banks may provide an incentive for an improved range and reach of local financial products targeted at the domestic country's SME sector, including suppliers of the oil and gas business.

- Given the marked change in the type and magnitude of economic benefits experienced during the different exploration, development and production phases of major capital investments, annual reporting of economic and socio-economic performance should consider including forward projections of payments to the public sector, showing how these will vary over time in relation to anticipated expenditure and revenue 'curves.'

Conclusion

For underdeveloped countries where the national economy is often weak and the quality of public financial management poor, the trend for some trans-national corporations to disclose the breakdown of Cash Value Added of operations provides a shallow basis for reporting the economic and socio-economic return on investment. Offering financial numbers as economic surrogates provides audiences with little context for interpreting whether these are either meaningful to the economic priorities of local, regional or national society, or are material to the political risk and business growth concerns of shareholders. Put more candidly, in both developed and developing countries, few are impressed when a big company generates big numbers. What would impress more is a reporting narrative, backed by a rolling register of location-specific credible data, which gives an honest interpretation of the relevance of these numbers to the social, economic and investment priorities of those receiving the information.