THEORETICAL FRAMEWORK FOR FINANCIAL FLOWS IN THE EXTRACTIVE SECTOR

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1. THEORETICAL FRAMEWORK FOR FINANCIAL FLOWS IN THE EXTRACTIVE SECTOR

1.1 INTRODUCTION

This report is part of a PODER® project, "Transparency and Accountability in the Mexican Extractive Industry." It provides a theoretical framework for understanding and tracking financial flows in the extractive sector. Its contents are generalized to apply to all types of natural resource extraction in any global market. The immediate purpose of this framework is to facilitate the identification and comprehension of financial flows specific to the Mexican hydrocarbon and mining industries. The report is organized into two main sections: the first on legal flows in the extractive sector, and the second on illicit flows.

This report draws specific information and context from reports published by the OECD, IMF, World Bank, and United Nations. The framework presented draws inspiration from theoretical frameworks written by Global Witness, the World Bank, the OECD and the U4 Anti-Corruption Resource Institute, combined with original work by the author. Additionally, the understanding of various flows, particularly those relating to taxation and tax evasion, are based primarily on the work of opensecrets.org and the Tax Justice Network.

1.2 HYPOTHESIS

Power dynamics and economic transactions of key political, economic and social actors underlie current energy regulation and legislation. The Mexican energy industry regulatory regime was not created for the best possible governance of Mexican energy resources. Rather, it was designed to benefit the interests of key national and foreign energy sector actors.

Financial flows, both licit and illicit, shine light on underlying flows of influence and power. Hence the objective of this document is to provide a theoretical framework for tracking both illicit and legal financial flows in the extractive industry that we will later apply to reveal economic flows in the Mexican extractive sector.

2. THEORETICAL FRAMEWORK FOR LEGAL FINANCIAL FLOWS IN THE EXTRACTIVE SECTOR

2.1 INTRODUCTION

This section generically identifies the primary public and private sector actors in the extractive industry and the legal financial flows that may occur between them. Legal financial flows are those permitted by the existing extractive industry regulatory framework. Throughout this report the concept of a financial flow is interpreted broadly to include both explicit and implicit flows. Impicit flows may include setting policy, carrying out enforcement, or even changing public consensus. Though these indirect flows may not include the exchange of money, they allow for future profits and are crucial in understanding actors and often imply the existence of illicit flows.

The extractive sector merits a specific framework for financial flows. The extraction of natural resources is different from other economic activities in a number of ways that affect patterns of private sector investment and government taxation. First, the ownership of resources is vested in citizens.[1] This affects the way in which the extractive industry is perceived by the population, treated politically, and taxed. Second, unlike most forms of manufacturing, extraction is a process of asset depletion rather than simply production. Because mineral and petroleum resources are not just used, but depleted, economic theory suggests that savings rates out of resource revenues should be higher.[2]

Third, unlike most manufacturing investments, the resource investor must invest in the country where the resource is found. Manufacturing companies often respond to political or economic turmoil, labor organization or unwanted regulation by moving to a different state or jurisdiction. Such a reaction is not possible in the extractive industry, because the resources must be exploited where they lie.

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1. Ownership of natural resources by the citizen is established in the Resolution of the UN General Assembly on Permanent Sovereignty over Natural Resources (A/1803 (XVIII), December 14, 1962. *See*: www.ohchr.org/EN/ProfessionalInterest/Pages/NaturalResources.aspx
2. Natural resources revenues are derived from depleting a finite resource and are therefore intrinsically temporary. Unstable increases in consumption, derived from resource windfalls, or temporary and extremely high resource profits, are undesirable. Habits form and commitments are made that make declines in consumption very costly. Therefore the savings rate, or the investment in assets that will create future income, should be higher. For more on how developing countries should best use resource revenues. *See*: Paul Collier, "Managing Resource Revenues in Developing Economies," January 28, 2009. depot.gdnet.org/newkb/submissions/paul%20collier_paper_p2.pdf

Fourth, the time profile of investment is distinctive in the extractive sector. Extraction is characterized by high sunk costs and long periods of payback. In most manufacturing industries, profits begin to accrue after a relatively small initial capital investment and investment gradually builds up over a long period of time. For example, a company may build a small factory, begin manufacturing, and then continue to grow the factory or build more factories. In contrast, in resource extraction, the initial investment is extremely large compared to all future investment. In most extractive industries, no profits can be made until the bulk of capital investment is complete. The cost of digging an oil well, building a refinery, and creating the network of distribution infrastructure is enormous compared to the cost of pumping oil from an already working well. The time profile of investment incentivizes governments to confiscate a project once the large initial investment is made. This affects private companies' willingness to invest in countries whose governments they do not trust and incentivizes them to seek to unduly influence the governments of resource rich areas. Finally, the prices of natural resources are highly volatile.

DISTINCTIVE FEATURES OF FINANCIAL FLOWS IN EXTRACTIVE INDUSTRIES

1. Ownership of resources is vested in citizens

2. Resources are not just used, but depleted

3. Resources must be exploited where they lie

4. Requires large initial investments and a long payback period

2.2 FINANCIAL FLOWS BETWEEN AND WITHIN THE PRIVATE AND PUBLIC SECTOR

In the extractive sector, huge amounts of money move within and between the public and private sector. Legal financial flows take place within the private sector, from the private sector to the public sector, from the public sector to the private sector, and within the public sector.

Private sector actors in the extractive industry include companies that participate in the extractive industry value chain, their suppliers and clients, and private sector financial institutions that provide capital to extractive companies and facilitate access to capital through debt and equity markets. In recent years, financial institutions have increased their direct involvement in commodity trading.[3]

2.3 ASSET FLOWS WITHIN THE PRIVATE SECTOR

In the extractive sector, as in all sectors, assets can flow between two private sector actors in the form of contractual payments for goods and services, debt, and private or public equity investments. Private offerings consist of sale of securities to a small group of investors, often directly without an investment underwriter. Generally, the sale of securities to more than 35 investors is considered a public offering. Public offerings normally must be registered with the government agency that regulates the securities industry. In contrast to private equity, public equity is listed on a public exchange. Debt is the obligation of a future payment. It allows economic actors to use anticipated future income in the present, before it has actually been earned. In the private sector, companies may raise debt in the form of loans from commercial banks, loans from investors, loans or leases from other companies, or publically through bond markets.

Financing through debt and equity markets differ in a number of ways. Equity financing allows a company to acquire funds, often for investment, without incurring debt. By contrast, issuing a bond does increase the debt burden of the bond issuer because contractual interest payments must be paid. Unlike dividends paid to equity holders, they cannot be reduced or suspended. Debt has a tax advantage because interest payments on debt are tax deductible in the majority of taxation systems.

Equity holders have ownership of the business whose shares they hold: they have the right to vote on certain key issues. In addition, equity holders have claims on the future earnings of the firm. Bondholders do not gain ownership in the business or have any claims to the future profits of the borrower. The borrower's only obligation is to repay the loan with interest. For the investor,

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3. Over the past decade, the interaction between commodity markets and the financial system has increased sharply, commonly referred to as "financialization". Investment banks and other financial institutions have increased their investments in physical commodities and invested significant resources in physical trading, such as supply and production firms, warehouses, and logistics/transportation companies. For example, as of the summer of 2013, Morgan Stanley owned six power plants, a fleet of roughly 100 vessels, and several fuel and gas assets. The range of financial institutions directly involved in commodity trading is very broad, including brokers/dealers, private banks, commercial banks, merchant banks, insurance companies, investment managers, mutual funds, hedge funds, and private equity funds. Source: Diego Valiante and Christian Egenhofer, *Price Formation in Commodities Markets*, CEPS-ECMI Task Force Report (Brussels: Center for European Policy Studies, June 2013), www.ceps.eu/system/files/COM_TFR_ONLINE_DRAFT.pdf.

debt has the advantage that in the case that a company fails, creditors are paid against the proceeds from any remaining assets first.

2.4 ASSET FLOWS FROM PUBLIC TO PRIVATE SECTOR

Assets flow from the public to the private sector in the form of resource access, taxes and subsidies, and contract payments. Assuming that all unexploited resources are the property of the state, when a government gives a private company a license, concession, or contract to exploit a resource, this is a form of asset transfer. Assets are also transferred from the public sector to the private sector in the form of transfers to private sector producers and transfers to consumers that affect demand in the resource market. Additionally, in the case of a nationalized extractive company, flows can take the form of contract payments by a public company for goods and services provided by a private company.

2.4.1 PUBLIC TRANSFERS TO PRODUCERS

Assets are transferred from the public sector to private sector producers by governments and international institutions. International institutions, such as the IMF, World Bank, OECD, and regional development banks, transfer assets, generally collected from member governments, to private sector producers directly through aid and loans and by taking on certain risks through insurance and special loan terms. Governments transfer assets to private sector producers in the form of direct transfer of funds, foregone revenue, transfers of risk, and induced transfers.[4]

TRANSFER MECHANISMS: HOW GOVERNMENTS TRANSFER WEALTH TO PRIVATE COMPANIES

DIRECT TRANSFER OF FUNDS
A government makes a direct payment to a private sector actor.

FOREGONE REVENUE
A government foregoes normally collected taxes or other government revenue. This is equivalent to a transfer, though no exchange is made.

TRANSFER OF RISK
A government takes on private sector risk without changing the market insurance rate. This is equivalent to a transfer, though no exchange is made.

INDUCED TRANSFERS
A government gives a private sector actor certain access or privileges that allow them to increase revenue or lower costs. This is equivalent to a financial transfer, though no direct financial exchange is made.

4. OECD, *An OECD-Wide Inventory of Support to Fossil-Fuel Production or Use*, 2012, www.oecd.org/site/tadffss/Fossil%20Fuels%20Inventory_Policy_Brief.pdf.

GOVERNMENT SUPPORT MEASURES TO THE EXTRACTIVE INDUSTRY, WITH EXAMPLES

OBJECT OF GRANT (WHICH COST WAS LOWERED OR WHICH REVENUE INCREASED?)

GOVERNMENT TRANSFER MECHANISMS	RETURN ON PRODUCTION	OVERALL INCOME	COST OF INTERMEDIATE INPUTS	LABOR	LAND AND NATURAL RESOURCES	CAPITAL	KNOWLEDGE
DIRECT TRANSFER OF FUNDS	*Output bounty or deficiency payment*	*Operating, investment or capital grants; equity injections, acquisition of share capital or public dividend; development aid*	*Input-price subsidy*	*Wage subsidy*	*Capital grant linked to the acquisition of land*	*Capital grant linked to acquisition of capital*	*Government funded R&D*
TAX REVENUE FOREGONE	*Production tax credit*	*Reduced rate income tax*	*Reduction in excise tax on inputs*	*Reduction in social charges (payroll taxes)*	*Property-tax reduction or exemption*	*Investment tax credit*	*Tax credit for private R&D*
OTHER GOVT. REVENUE FOREGONE			*Under-pricing government goods and services*		*Under-pricing access to land or natural resources; reduction in royalty or extraction tax*		*Transfer or underpricing of government intellectual property rights*
TRANSFER OF RISK TO GOVT.	*Government buffer stock*	*Third-party liability limit for producers*	*Provision of security (e.g. military protection of supply lines)*	*Assumption of occupational health and accident liabilities*	*Credit guarantee linked to acquisition of land*	*Credit guarantee linked to capital; export credit and insurance*	
INDUCED TRANSFERS	*Import tariff or export subsidy*	*Monopoly concession*	*Monopoly concession; export restriction*	*Wage control*	*Land-use control*		*Deviations from intellectual property rights rules, improved market access and knowledge from trade promotion*

2.4.2 PUBLIC TRANSFERS TO CONSUMERS

Governments support natural resource consumption through transfers to consumers. Transfers to consumers are more common for petroleum than for other resources. These transfers create an implicit transfer to extractive companies by lowering the price paid by consumers and thereby increasing demand.

EXTRACTIVE INDUSTRY PUBLIC TRANSFERS TO CONSUMERS, WITH EXAMPLES

OBJECT OF GRANT (WHICH COST WAS LOWERED OR WHICH REVENUE INCREASED?)

GOVERNMENT TRANSFER MECHANISMS	UNIT COST OF CONSUMPTION	HOUSEHOLD OR BUSINESS INCOME
DIRECT TRANSFER OF FUNDS	*Unit subsidy*	*Government subsidized life-line electricity rate*
TAX REVENUE FOREGONE	*VAT or excise-tax concession on fuel*	*Tax deduction related to energy purchases that exceed given share of income*
OTHER GOVT. REVENUE FOREGONE	*Under-pricing of access to natural resource harvested by final consumer*	
TRANSFER OF RISK TO GOVT.	*Price-triggered subsidy*	*Cold-weather grant linked to income level (means-tested)*
INDUCED TRANSFERS	*Regulated price; cross subsidy*	*Mandated life-line electricity rate*

2.4.3 EXPORT CREDIT AGENCIES

One important actor in public to private asset transfers are Export Credit Agencies (ECAs). Official ECAs are highly specialized banks, insurance companies, finance corporations or dependencies of governments. Most OECD countries and a growing number of non-OECD counties have official ECAs.[5] Though differences exist between them, all ECAs offer some combination of loans, guarantees, insurance, and technical support to exporters. They operate with backing or approval of the national government and are dedicated to supporting national exports.

ECAs help national exporters by providing both supplier and buyer credits.[6] Supplier credits are extended to exporters and insure them against risks that private sector banks consider too great to assume, such as large investments in unstable countries. Buyer credits are extended to recipient country importers or governments for the purchase of national exports. The majority of ECA support goes to large multinational corporations in industrial sectors of strategic importance. Commercial aircraft, aerospace technology, arms, infrastructure and transportation, industrial plants, and energy industries depend most heavily on ECA support.[7] Notably, with the exception of aircraft and aerospace, the sectors most dependent on ECA financing are among the most corrupt[8] and are known for their environmental and human rights abuses.

Export Credit Agencies are the largest source of official support[9] for foreign trade and investment in developing countries. According to the International Monetary Fund (IMF), officially supported export credits represent just under half of developing countries' debt to all official creditors, including the World Bank, IMF, regional development banks, and aid agencies.[10] According to a 2001 estimate "one out of every eight dollars of world trade is financed by ECAs. Much of the remaining seven dollars is influenced by what ECAs do."[11]

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5. For a full list of official export credit agencies, *see*: www.oecd.org/tad/xcred/eca.htm
6. ECAs support exporters based on minimum national content, i.e. based on where the goods were manufactured and not where the company is domiciled. For example, a Japanese company could receive official export credits from the US EX-IM Bank for the sale of products produced in the US.
7. Christopher Wright, "Export Credit Agencies and Global Energy: Promoting National Exports in a Changing World," *Global Policy 2* (2011): 133–43, doi:10.1111/j.1758-5899.2011.00132.x.
8. Transparency International, *Bribe Payer's Index* 2011, n.d., bpi.transparency.org/bpi2011/results.
9. In this context, "officially supported" means government backed, rather than coming purely from private sector financial institutions.
10. *Export Credit Agencies and the World Trade Organization*, Issue Brief (Center for International Environmental Law, November 2003).
11. Delio E. Gianturco, *Export Credit Agencies: The Unsung Giants of International Trade and Finance* (London: Quorum Books, 2001). p. 1

Over the last decade the footprint of ECAs has grown further due to their increased role in developing and middle-income non-OECD countries and their use in trade promotion after the 2008-2009 international credit crisis.

There is no internationally aggregated information on official export credits. Berne Union is a private trade association for the global export insurance industry and members are often used as a proxy for ECA activity.[12] In 2013, Berne Union members supported USD 2.014 trillion in international trade and investment, up every one of the last five years from USD 1.497 trillion in 2009.[13]

All official ECAs receive some form of financial support from their government. Though many are setup as for-profit semi-private institutions, even those that are not directly subsidized receive some form of taxpayer support. In the form of lower borrowing rates, they benefit from the implicit subsidy of full recourse to the national treasury to pay claims when necessary. Moreover, most do not pay the taxes required of fully private financial institutions.

The economic rationale behind the creation of official ECAs is that they fill a gap in the credit market allowing for profitable investments that would not otherwise be possible. However, in practice, ECAs are often used to advance non-commercial goals. According to the Export-Import Bank's 1989 report to the U.S. Congress, the purpose of official support for export credits is not only to increase exports, but also to "further U.S. political, strategic, economic, and humanitarian goals."[14]

Despite the fact that ECAs are quasi-governmental institutions that rely on taxpayer support and have an enormous effect on international financial flows, they are held to much lower environmental, social, and transparency standards than other official financing institutions. Unlike other official creditors such as the IMF and World Bank, ECA's goals are not the promotion of development or poverty alleviation, but rather the promotion of their own country's political and economic goals. Their actions and the incentives they create are associated with corruption, human rights abuses, environmental degradation, and have contributed to crippling levels of debt in developing countries.[15]

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12. Bear Union is not a perfect proxy. Members include some private institutions and do not include all publically supported ECAs.
13. Berne Union, *Berne Union Statistics 2008-2013*, April 14, 2014, www.berneunion.org/statistics.
14. John E. Ray, *Managing Official Export Credits: The Quest for a Global Regime* (Washington, D.C.: Institute for International Economics, 1995). p. 5
15. For a more detailed discussion of the negative effects of ECAs, *see*: Aaron Goldzimer, *Globalization's Most Perverse Secret: The Role of Export Credit and Investment Insurance Agencies*, Presented at the Alternatives to Neoliberalism Conference sponsored by the New Rules for Global Finance Coalition, (May 2002), as well as the ECA watch website www.eca-watch.org

2.4.4 AID

Both national governments and international organizations transfer assets from the public sector to the extractive industry. In the context of promoting development in the extractive industry, international organizations often partner with private companies and make transfers to them, usually in the form of loans, logistical assistance, or occasionally, depending on the organization's mandate, aid.

On a national level, an increasingly important source of public-to-private transfer is development aid. These transfers may take the from of aid from national development agencies to communities affected by private extractive companies' actions. Canada's international aid policy has been re-oriented over the last several years towards enabling Canadian foreign investment. The Canadian International Development Agency's (CIDA) new "Economic Growth Strategy" will use aid money to help "developing countries create the right conditions to make capital available for companies".[16] For example the CIDA subsidizes corporate social responsibility projects. The CIDA's development projects in communities near Canadian mine sites act as an indirect transfer from the Canadian government to Canadian mining companies. The Canadian government is allowing mining companies to benefit from the profits associated with poor labor and environmental practices and buffering them from the negative externalities. By paying for development projects, the Canadian government increases the perceived legitimacy of the company and decreases the likelihood of costly community and labor unrest. In the past, Canadian mining companies contracted large Canadian NGOs to carry out development projects in communities near their mine sites. The CIDA is now taking on this expenditure.

HOW PUBLIC DEVELOPMENT AID NEAR AN EXTRACTIVE SITE CAN ACT AS A FINANCIAL TRANSFER TO THE EXTRACTIVE COMPANY, NOT THE COMMUNITY

Under an implicit social contract, the affected community receives development aid in exchange for the social and environmental hardships that the mine inflicts upon them. This aid is often promised to the community before the mine is built.

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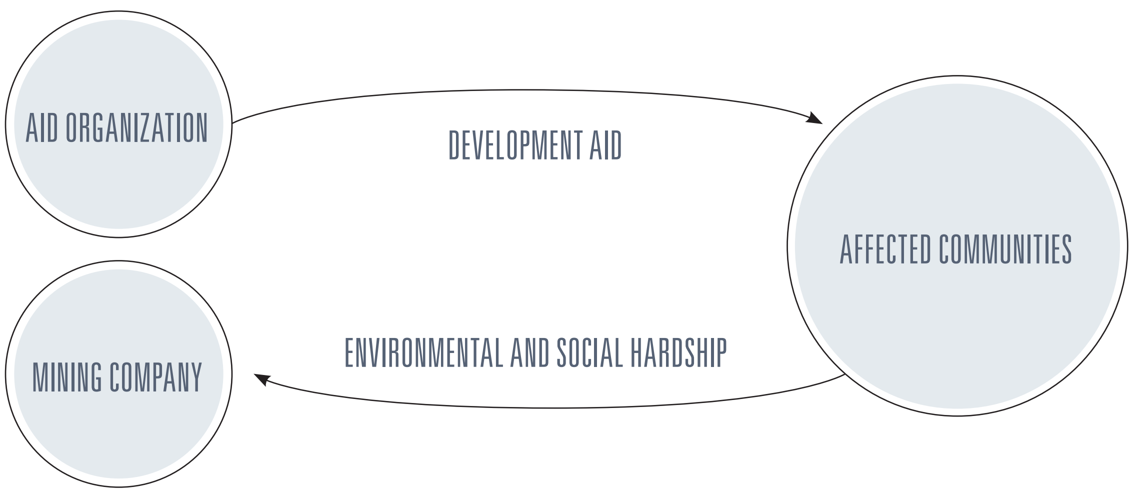
16. Julian Fantino, Canada's Minister of International Cooperation, in a speech before the blue-chip Economic Club of Canada in late 2012. Source: Louis Girard, "Harper Government Using 'humanitarian' Aid to Boost Canada's Global Mining Companies", *World Socialist Web Site*, February 11, 2013, www.wsws.org/en/articles/2013/02/11/cida-f11.html.

When a foreign aid organization funds development in a community affected by a mining company from the same county, the aid acts as a transfer to the company, not the community. The community receives the same amount of aid as before and the company incurs few costs.



Second, international organizations affect the extractive industry through assistance in policy formation and implementation. There are a number of new initiatives aimed at helping the world's poorest countries more effectively tax the international extractive companies operating within their borders. Examples include the OECD-DAC's Tax Collectors Without Borders program, and the International Cooperation in Transfer Pricing initiative, undertaken jointly by the OECD, IMF, World Bank and European Union. Additionally, the World Bank and IMF have been working together for decades to provide technical assistance in policy and legal reform and capacity building in the extractive sector. This includes IT and systems support, expertise and personnel.[17] This category of aid is technically an exchange between two public institutions: the recipient government and the international organization. However, by providing technical assistance, international organizations influenced the fiscal policy and legal framework of many resource rich developing countries, largely aligning them with the neoliberal outlook generally held by international organizations and the rich countries that fund them. In this way, though the transfer exists within the public sector, policy development and implementation aid acts as a transfer from the public sector to the private sector by creating policy and legal frameworks that benefit private sector actors.

Third, international development organizations also provide financing and risk coverage directly to private extractive companies in order to encourage them to establish projects in poor countries. For example, the World Bank Group provided USD 695.5 million in financing to the extractive industry in the fiscal year 2012.[18] USD 85 million focused on policy support and capacity building, USD 490.6 million was direct financing and USD 119.5 million was risk coverage.[19] The World Bank Group holds an extractive industry portfolio of USD 2.5 billion in more than 45 countries, with Africa and Latin America together accounting for about two thirds of the portfolio.[20] Loans account for over 75% of the World Bank Group portfolio and equity investments are the balance.[21]

HOW THE PUBLIC SECTOR TRANSFER WEALTH TO PRIVATE COMPANIES THROUGH AID

1. Aid from national development agencies to communities affected by private extractive companies' actions.

2. Policy development and implementation aid from international organizations to resource-rich developing countries.

3. Direct aid from international development organizations to extractive companies in order to encourage projects in poor countries.

17. Robin Harding, "Mobilizing Revenue from Extractives: Dealing with Tax Avoidance" (Side event presented at the World Bank Group and IMF Annual Meeting, World Bank Headquarters, Washington DC, October 12, 2013), www.worldbank.org/en/events/2013/10/02/mobilizing-revenue-from-extractives-dealing-with-tax-avoidance.
18. The World Bank Group, *The World Bank Group in Extractive Industries 2012 Annual Review*, accessed October 25, 2013, www.ifc.org/wps/wcm/connect/553076004dcf13eba0e8a4ab7d7326c0/WBG+EI+AR+2012.pdf?MOD=AJPERES.
19. *Ibid.*
20. *Ibid.*
21. *Ibid.*

2.5 ASSET FLOWS FROM PRIVATE TO PUBLIC SECTOR

The bulk of assets are transferred from private sector extractive companies to the public sector in the form of contract payments and taxes, paid as income taxes, royalties, and bonuses. Assets may also be transferred from the private to public sector in the form of preferential market access, risk-sharing contracts, and social spending, either legally required or voluntary. Additionally, when a nationalized extractive company is present, public to private flows can take the form of contract payments by private companies for goods and services provided by a public company or loans made by a private financial institution to a public company.

2.6 ASSET FLOWS WITHIN THE PUBLIC SECTOR

When the public sector is directly involved in the extractive industry through a nationalized extractive company, the financial flows between the federal government and the nationalized company are similar to those between the public and private sector in situations of private extractive companies. The nationalized company transfers capital to other branches of the public sector though taxes, social spending and market obligation. Generally, national companies are required to incorporate noncommercial objectives into their operations in a way that private companies are not, and financial transfers represent a more significant portion of their profits. National companies are used to provide employment and required to fund social infrastructure, such as schools and hospitals, and regional development, such as roads and bridges. They are used as a tool for income transfer, most commonly in the form of subsidized fuel prices. At times, national companies, seen as more financially viable than the government they are associated with, are asked to raise capital for the government for non-oil related activities.

SUMMARY TABLE: EXTRACTIVE INDUSTRY FLOWS BETWEEN AND WITHIN THE PUBLIC AND PRIVATE SECTORS

PRIVATE TO PRIVATE

- *Contract payments*
- *Debt*
- *Equity*

PUBLIC TO PRIVATE

GOVERNMENTS

- *Direct transfer of funds- "aid," subsidies, grants*
- *Tax and other government revenue foregone: tax incentives, exemptions and credits*
- *Transfer of risk: military protection, insurance*
- *Induced transfers: monopoly concessions, wage, credit and land use control*
- *Effect on demand caused by consumer taxes and subsidies*
- *Resource access: licenses; grants; concessions*
- *Contract payments from national oil companies to providers**

INTERNATIONAL INSTITUTIONS

- *Transfer of risk: loans with special terms*
- *Direct transfer of funds: Aid, Debt*

PRIVATE TO PUBLIC

DIRECT

- *Taxes: income taxes, royalties, bonuses*
- *Development, infrastructure funding, other non-commercial objectives, voluntary social spending (often through a company foundation)*
- *Domestic market obligation*
- *Risk sharing, equity stakes*
- *Contract payments**
- *Debt**

INDIRECT

- *Lobbying*

PUBLIC TO PUBLIC [22]

- *Earmarked government resource revenues*
- *Contract payments**
- *Taxes: income taxes, royalties, bonuses**
- *Development, infrastructure funding, other non-commercial objectives**
- *Domestic market obligation**
- *Debt**

**Specific to countries with nationalized extractive companies*
Source: Author

3. THEORETICAL FRAMEWORK FOR ILLICIT FINANCIAL FLOWS IN THE EXTRACTIVE SECTOR

3.1 INTRODUCTION

In order to understand all power transfers that shape the current extractive sector regime, all financial flows, including illicit

22. Financial flows between the government and extractive companies may be public to public in countries with nationalized extractive companies. In countries without nationalized extractive companies, resource revenues can only be legally moved within the public sector in the form of earmarked expenditures.

financial flows, must be considered. An illicit financial flow is the flow of money that at some point in some way broke the law. It could be illicit due to the way it was earned, moved, or spent. According to the United Nations Development Program, illicit financial flows "include, but are not limited to, cross-border transfers of the proceeds of tax evasion, corruption, trade in contraband goods, and criminal activities such as drug trafficking and counterfeiting".[23] An illicit financial flow can also be an exchange perceived as ethically wrong but technically legal under the law. Illicit but legal activity arises particularly frequently when the private sector, rather than the citizens the government is meant to represent, has more than its due share of influence over the judiciary framework.

Internationally, illicit financial flows are enormous. Global Financial Integrity[24] estimates that between 2000 and 2009, developing countries lost between USD 723 and USD 844 billion per annum due to illicit outflows.[25] The countries with the largest illicit outflows during this period were China (USD 2.5 trillion), Mexico (USD 453 billion), Russia (USD 427 billon), Saudi Arabia (USD 366 billion), Malaysia (USD 338 billion), Kuwait (USD 269 billion), and United Arab Emirates (USD 262 billion).[26] In China, most illicit outflows originate through trade mispricing. In most oil exporting countries, including Russia, Saudi Arabia, the United Arab Emirates, and Kuwait, outflows originate primarily through bribery, theft, kickbacks, and tax evasion.[27] Between 1970 and 2010, illicit financial flows from Mexico averaged 5.2% of GDP, peaking at 12.7% of GDP in 1995.[28] This estimate is conservative, as it does not include drug smuggling or human trafficking. Mexico is the only

23. Helen Clark, "Special Event on Illicit Financial Flows: Perspectives on Issues and Options for LDCs - UNDP Bhutan," accessed September 24, 2013, www2.undp.org.bt/Perspectives-on-Issues-and-Options-for-LDCs.htm.
24. A research and advocacy organization located in Washington, DC, USA
25. Dev Kar and Sarah Freitas, "Illicit Financial Flows from Developing Countries Over the Decade Ending 2009" (Global Financial Integrity, December 2011). *Hereinafter*: Kar and Freitas 2011, "Illicit Financial Flows"
26. *Ibid.*
27. Global Financial Integrity measured the cumulative effect of bribery, theft, kickbacks, and tax evasion through the "leakage of unrecorded capital through the balance of payments" using the World Bank Residual Model, based on change in external debt. This method measures a country's source of funds (inflows of capital) against its recorded use (outflows and/or expenditures of capital). An excess source of funds over the recorded use (or expenditures) points to a loss of unaccounted-for capital and indicates illicit financial outflow.
28. Dev Kar, "Mexico: Illicit Financial Flows, Macroeconomic Imbalances, and the Underground Economy" (Global Financial Integrity, 2012)

oil exporter for which trade mispricing is the preferred method of transferring illicit capital abroad, representing nearly 75% of illicit flows during the period of the study.[29, 30]

3.2 THE RESOURCE CURSE

The extractive industry has a propensity to stimulate illicit financial flows through different dynamics that are postulated in the theory of the "resource curse." The theory first arose in academic literature in the 1980s. Since then, the idea that countries rich in natural resources will experience negative economic, political, and social outcomes has become the consensus view. The resource curse shapes the thinking of researchers and officials of international financial institutions, such as the IMF and World Bank. Opinions on the causal mechanism of the resource curse vary. Some writers emphasize the way in which natural resource abundance affects trade and the economy: Natural resources can crowd-out other industries and negatively affect terms of trade. For example, a natural resource boom can lead to "Dutch Disease," in which the domestic currency appreciates, making non-resource trade less competitive and putting inflationary pressure on the economy. Other writers focus on the adverse political incentives created by resource abundance, leading to institutional erosion and civil conflict.[31] Additionally, natural resource abundance creates opportunities for rent-seeking behavior, and the importance of the extractive industry is highly positively correlated to a country's level of corruption.[32] In the following section, we review the main reasons behind the prevalence of illicit flows in the extractive industry.

29. *Ibid.*
30. *Supra* note 24: Kar and Freitas 2011, "Illicit Financial Flows"
31. For a more detailed review of academic literature on the resource curse, *see*: Andrew Rosser, *The Political Economy of the Resource Curse: A Literature Review* (Brighton: Institute of Development Studies, University of Sussex, 2006), r4d.dfid.gov.uk/pdf/outputs/futurestate/wp268.pdf.
32. Carlos Leite and Jen Weidmann, "Does Mother Nature Corrupt? Natural Resources, Corruption, and Economic Growth" (International Monitary Fund: African and Research Departments, July 1999), www.imf.org/external/pubs/ft/wp/1999/wp9985.pdf.

3.3 FACTORS CONTRIBUTING TO ILLICIT FINANCIAL FLOWS IN THE EXTRACTIVE INDUSTRY

The extractive sector is uniquely susceptible to illicit financial flows. Factors that provide opportunity and incentive for illicit flows include technical complexity, limited competition, concentration of decision-making, rent seeking, patronage, blurring of public and private interests, and fiscal autonomy.

3.3.1 TECHNICAL COMPLEXITY

The extractive sector is complex. The extraction process itself is highly technical. New, lucrative technologies, including deep-sea drilling and fracking, remain largely untested and therefore lack consensus on best practices or environmental effects. This complexity continues throughout the licensing, contracting, distribution, pricing, regulatory and sale process. Few actors fully understand how the industry operates, leading to asymmetric information and weakening oversight.[33]

3.3.2 LIMITED COMPETITION

The extractive industry tends towards centralization. Resource extraction is capital intensive. Only a small number of firms have access to the technology and capital that large, lucrative projects require. Additionally, natural resources are often viewed as strategically important and controlled partially or fully by the state, rather than the open market. These factors reduce competition among firms. When a large number of actors compete openly, they tend to oversee one another and hold one another accountable. It is against each actor's best interest if the other actors obtain an unfair advantage. However, when a sector is uncompetitive and has very few actors, this oversight does not take place, allowing space for corruption.[34]

33. Alexandra Gillies, "Fuelling Transparency and Accountability in the Natural Resources and Energy Markets" (presented at the 14th International Anti-Corruption Conference, Bangkok, Thailand, 2010), http://14iacc.org/wp-content/uploads/AlexandraGillesNaturalResourcesIACC.pdf. *Hereinafter*: Gillies 2010, "Fuelling Transparency"
34. *Ibid.*

3.3.3 CONCENTRATION OF DECISION MAKING

The extractive industry is often fully or partially controlled by the state. This allows officials with disproportionate influence to access revenues. With revenues and decision-making concentrated in the hands of a small number of officials, extractive industry earnings are often directed towards political or personal ends. Additionally, private sector access to resources (for example, concessions and licenses) is often awarded directly or in non-transparent ways that leave room for corruption.[35]

3.3.4 RENT SEEKING AND PATRONAGE

Rent seeking is when a company, organization or individual uses its resources to obtain an economic gain from others without reciprocating any benefits back to society through wealth creation. An example of rent seeking is when a company lobbies the government for loan subsidies, grants or tariff protection. These activities don't create any benefit for society; they only redistribute resources from the taxpayers to the special-interest group. Rent seeking behavior arises more frequently when various social groups compete for appropriable natural resource revenues. High natural resource revenues provide those in power with greater means and incentives to stay in power. Politicians with access to resource revenues will often use the revenues to suppress dissidents and foster support through widespread patronage.[36]

3.3.5 BLURRING OF PRIVATE AND PUBLIC INTERESTS

In most industries, the role of government is to ensure that commercial activity does not go against the public interest. In the extractive industry, the government often participates directly in the marketplace. Government officials may have vested financial interests in the sector. This creates a conflict of interest between the government as regulator and the government as market participant and thus weakens oversight.[37]

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35. *Ibid.*
36. Ivar Kolstad, Tina Søreide, and Aled Williams, "Corruption in Natural Resource Management– an Introduction," *U4 Issue*, February 2008.
37. *Supra* note 32: Gillies 2010, "Fuelling Transparency"

3.3.6 FISCAL AUTONOMY

Governments that control substantial resource revenues are less susceptible to external pressure for accountability and democratization. Natural resource revenues reduce government dependence on domestic taxes, eliminating an important source of citizen-driven accountability. Corrupt governments with significant natural resource revenue can essentially buy legitimacy from citizens with oil money, rather than earning it by reducing corruption or implementing functional representation. Additionally, because natural resource revenues dwarf international aid budgets, the leverage international organizations have over governments with natural resource revenues is limited.[38]

WHY THE EXTRACTIVE INDUSTRY IS UNIQUELY PRONE TO ILLICIT FINANCIAL FLOWS

1. It is technically complex

2. Competition is limited

3. Decision making is concentrated in the hands of a small number of actors

4. High revenues incentivize rent seeking and patronage

5. Private and public interests are blurred

6. Revenues give governments fiscal autonomy

3.4 TYPES OF ILLICIT FINANCIAL FLOWS

Illicit flows in the extractive sector fall into the categories of corruption, illegal exploitation, tax evasion, and theft by a third-party. These types of illicit financial flows are not mutually exclusive and are often found together. For example, a company may pay a bribe to exploit a resource beyond their concession area or avoid an export tax.[39]

38. *Ibid.*
39. Philippe Le Billon, "Extractive Sectors and Illicit Financial Flows: What Is the Role for Revenue Governance Initiatives," *Issuu*, November 2011, www.cmi.no/publications/file/4248-extractive-sectors-and-illicit-financial-flows.pdf. *Hereinafter*: Le Billon 2011, "Extractive Sector and Illicit Financial Flows"

3.4.1 CORRUPTION

Corruption is the misuse of public authority for personal interest. The OECD, the Council of Europe and the UN conventions do not explicitly define corruption. However, they have established a range of corrupt offences: bribery, trading in influence (distinguishable from lobbying, which can be interpreted as illicit but not illegal), embezzlement, misappropriation of property and obstruction of justice.[40] It is possible to imagine further, or more specific offenses beyond those defined by international conventions. In the extractive industry, the main beneficiaries of corruption are government officials and companies that gain undue advantage.

3.4.2 ILLEGAL RESOURCE EXPLOITATION

Illegal exploitation in the extractive sector includes procuring a concession for normally prohibited extraction, for example in a national park, extracting resources outside the area defined in a concession, underreporting volume or quality of the resource produced, and extracting resources beyond the contractual limit, for example extracting a mineral under an exploration license. Illegal exploitation also includes outright resource theft and unlicensed exploitation.[41]

3.4.3 TAX AVOIDANCE AND EVASION

Tax avoidance and evasion is a problem that arises in most industries. A particularly large number of opportunities for avoidance and evasion exist in the extractive industry because of its international nature as well as the power and influence of many actors. Tax avoidance, which exploits loopholes within the legal framework, becomes tax evasion when laws are broken, which in turn becomes tax fraud when documentation is falsified.

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39. "Defining Corruption," *OECD Observer*, March 2007, www.oecdobserver.org/news/archivestory.php/aid/2163/Defining_corruption.html.
40. *Supra* note 38: Le Billon 2011, "Extractive Sector and Illicit Financial Flows"

3.4.3.1 POLICY CORRUPTION

Tax evasion starts with the corrupting influence of the private sector in the creation of taxation policy. Companies lobby for fiscal reform in order to create what they consider to be “favorable investment climates”. However, citizens often find this pro-business fiscal policy to be overly generous, benefitting only a small number of actors. Influence over policy decisions is often technically legal, such as through carefully cultivated close relationships between legislators and special interest groups or the “revolving door”, whereby policy makers expect future jobs or board seats with key groups in exchange for policy favors. Extractive company boards often include high-ranking former politicians with continuing access to senior policy makers. Private sector actors can use legal lobbying mechanisms to cover up corrupt practices and coercion. Additionally, legal forms of lobbying are often illicit in the eyes of the citizens.[42] Oil companies in the USA expend a huge amount of money supporting candidates who will favor their interests. The oil and gas industry has contributed nearly USD 360 million to USA congressional and presidential campaigns since 1990, including nearly USD 73 million leading up to the 2012 election cycle.[43]

3.4.3.2 CONTRACTUAL AGREEMENTS

Favorable fiscal terms are often written into contracts. Private companies will often reach these terms through corruption or the promise of future corrupt rents. They may also negotiate favorable contracts legally, though the public often views such contracts as illicit. Extractive industry contracts may include tax holidays of up to 10 years. Full write-offs of capital costs, tax exemptions, for example import/export duty exemption, and special transfer pricing agreements. Low royalties and corporate profit taxes are also examples of overly favorable fiscal terms that may be written into contracts. Globally, a 3.5% royalty in the mining industry is the norm.[44] Unlike other jurisdictions in Latin America, such as Chile and Peru, Mexico does not currently require mining companies to pay

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42. Charles McPherson and Stephen MacSearraigh, “Corruption in the Petroleum Sector,” in *The Many Faces of Corruption: Tracking Vulnerabilities at the Sector Level* (World Bank, 2007).
43. “OpenSecrets.org: Center for Responsive Politics,” accessed October 1, 2013, www.opensecrets.org.
44. *Supra* note 38: Le Billon 2011, “Extractive Sector and Illicit Financial Flows”

any royalties. The global average corporate income tax rate is about 24% and rates between 10% and 20% are generally considered low. Mexican corporate income tax is 30%. Scheduled reductions in the corporate income tax to 29% in 2014 and 28% in 2015 were cancelled in the 2014 reform to the Income Tax Law.

GLOBAL AVERAGE VS. MEXICAN FISCAL TERMS FOR THE EXTRACTIVE INDUSTRY

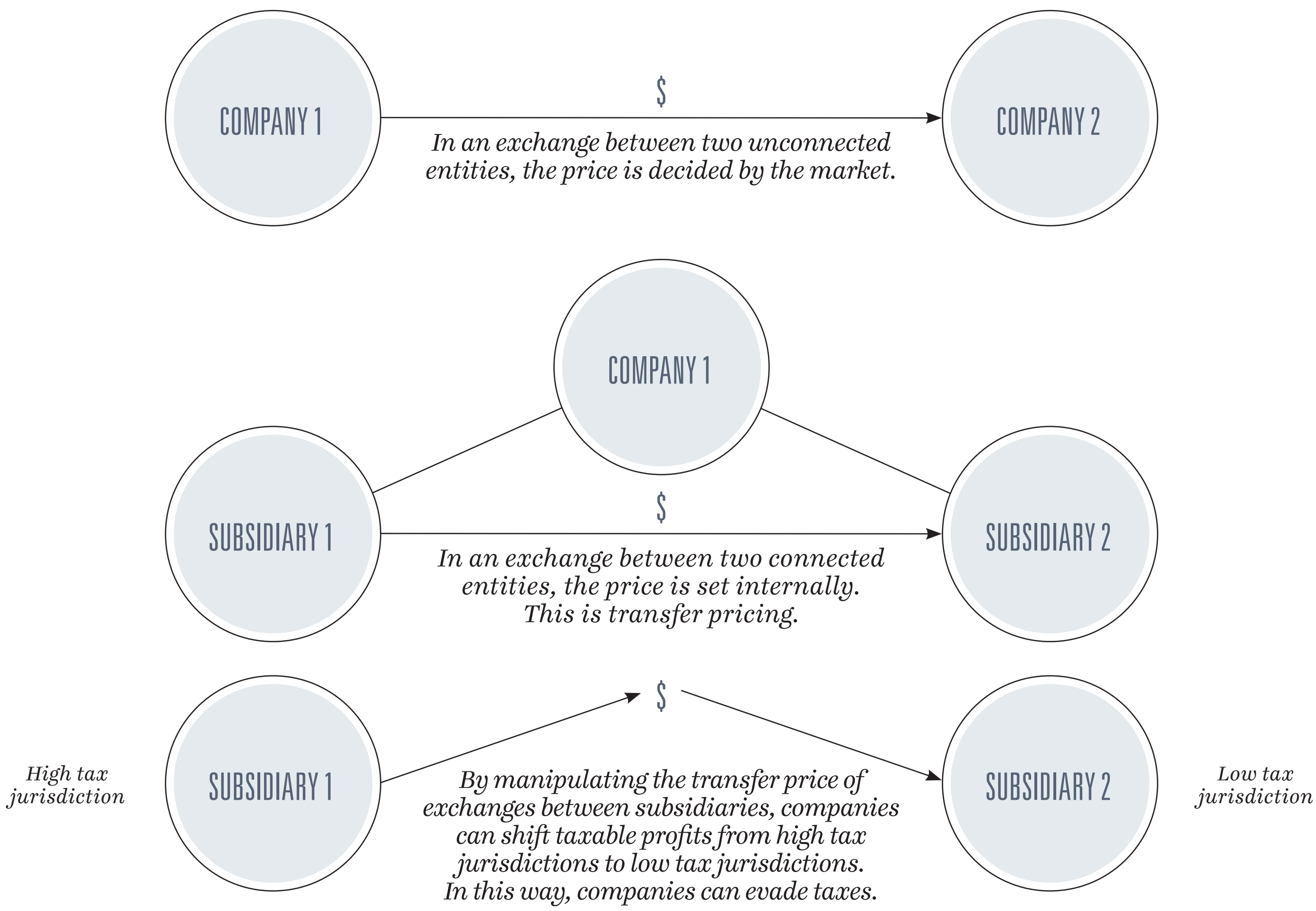
ROYALTIES	GLOBAL AVERAGE *3.5%*	MEXICO *0%*
CORPORATE INCOME TAX	GLOBAL AVERAGE *24%*	MEXICO *30%*

3.4.3.3 MISREPORTING AND TRANSFER MISPRICING

One of the most common forms of tax evasion is over- or under-invoicing taxable income. For example, underreporting the volume or value of production or over-reporting costs that can be written off. Particularly extreme cases indicate broad collusion between oversight authorities and extractive companies.

Tax avoidance is often achieved through transfer mispricing. Transfer pricing is the process of establishing the price of a transaction between two entities owned by the same person or company, such as two subsidiaries of the same company. The theoretical objective of transfer pricing is to avoid double-taxation by setting a fair (or "arm's length" in the words of the OECD Guidelines) price of a good sold across jurisdictions within a business group. However, fair transfer pricing is inherently problematic. In a normal market interaction, two independent, self-interested parties work together to negotiate a fair price. When a transaction occurs between two connected parties, as in transfer pricing, the fair price must be designated, rather than decided by the market.

Transfer mispricing, also known as transfer pricing manipulation or abusive transfer pricing, is rampant. It has a significant effect on international finance. The OECD estimated in 2002 that intragroup transfers constituted more than 60% of world trade.[45] Setting arbitrary prices has a small effect on the overall tax bill of a company group when all subsidiaries are located in the same country. However, when transfer mispricing takes place between subsidiaries subject to different tax regimes, the company group can exploit tax differences to increase its overall profit. A subsidiary paying higher taxes can purchase a good at an inflated price from a subsidiary subject to lower taxes. This shifts the company's profits to a lower tax jurisdiction.[46] The effect is especially strong when subsidiaries in offshore tax havens are involved.



45. John Neighbour, "Transfer Pricing: Keeping It at Arm's Length," *OECD Observer*, January 2002, www.oecdobserver.org/news/archivestory.php/aid/670/Transfer_pricing:_Keeping_it_at_arms_length.html.
46. Gideon Benari, "TrickyTax:Transfer Pricing," *Tax Justice Network*, April 2009, www.taxjustice.net/cms/upload/pdf/Tricky_Tax.pdf.

3.4.3.4 TAX HAVENS AND MONEY LAUNDERING

A tax haven is a country or independent area with permissive tax laws: either unusually low tax rates or lax transparency requirements. Companies also use subsidiaries in tax havens to hide illicit revenue streams. Companies registered in a number of jurisdictions, including the British Virgin Islands, the Maldives, Switzerland, the Netherlands[47] and the US state of Delaware are not required to publish information on their ownership. Actors who wish to conceal their financial flows can create of chain of companies that own other companies. Ownership chains are extremely difficult to track, especially if the companies are registered in one of the "safe haven" jurisdictions listed above. Even in non-tax havens, companies can register incorrect information about ownership in national corporate registries, or hire a service provider to do the same. On official documentation, it is possible to declare that a person not involved in management or who does not profit from the company owns a company.[48]

In this way, tax havens and offshore financial centers create an interface between illicit finances and the licit economy. They undermine national tax regimes and onshore regulation and allow companies and individuals to avoid their fiscal responsibility to the states in which they operate.[49] Banks are also important actors in the hiding and transfer of illicit assets. Extremely large international companies listed on major exchanges are somewhat constrained in their use of chains of ownership to launder money. Institutional shareholders and industry analysts are often vigilant in their research and expect a higher level of transparency. In order to process illicit funds, these large companies turn to banks that will turn a blind eye to evidence that their clients' considerable revenues are the proceeds of foreign corruption.[50]

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47. In the Netherlands, no information has to be published on an owner that controls less than 100% of the company. A full owner that wishes to remain hidden may simply put one or two percent of the company in the name of a friend or relative.
48. "An Idiot's Guide to Money Laundering" (Global Witness, June 2012), issuu.com/globalwitness/docs/an_idiot_s_guide_to_money_laundering/2?e=0.
49. "Taxjustice Network," *Taxjustice.net*, accessed September 27, 2013, www.taxjustice.net/cms/front_content.php?idcat=2&lang=1.
50. Two examples include Rigs Bank in the US and BNP Paribas in France. A US Senate investigation in 2004 found that in order to maintain an important client, Riggs Bank willfully ignored evidence of illicit behavior in Equatorial Guinea, and BNP Paribas has been named in oil-related money transfer scandals in the Congo and Iraq. Source: Charles McPherson and Stephen MacSearraigh, "Corruption in the Petroleum Sector."

3.4.4 THEFT BY A THIRD PARTY

Theft by the group extracting the resource falls into the category of over exploitation or tax evasion, and theft by the regulatory body falls into the category of corruption. However, it is also possible for an illicit flow to originate from outright theft of a resource or capital by a third party. Third-party theft is different from the other types of illicit flows described above in that it is not specific to the extractive sector, but rather a generalized problem throughout all sectors and all society. Significant financial flows originating from third-party theft in the extractive sector is usually a symptom of a larger problem, in which criminal groups have significant power and control over financial flows in a number of industries. Large-scale third-party theft in the extractive sector is often found in conjunction with corruption. Illegally acquired raw materials are not easily exchanged for cash. Generally, governments or large extractive companies control the supply chain that converts raw materials into marketable goods. In order for the third-party to dispose of these ill-gotten goods, a large extractive sector actor has to ignore regulation and turn a blind eye to evidence that the material they are acquiring was stolen.

SUMMARY: TYPES OF ILLICIT FINANCIAL FLOWS

	CORRUPTION	ILLEGAL EXPLOITATION	TAX EVASION	THIRD-PARTY THEFT
DEFINITION	*The misuse of public authority for personal interest*	*Extraction and production of a resource without the consent of the legitimate government, outside the regulatory framework, or in violation of international law*	*The illegal non-payment or underpayment of taxes*	*Outright theft of resources or capital by a third party or offering of illegal services*
MAIN FINANCIAL FLOWS	*Facilitation payments (bribes) paid by companies, money embezzled from tax collection and budgetary allocation*	*Undeclared corporate revenues from illegal resource exploitation*	*Inflated costs deducted from taxable revenues, smuggling of resources, assets transferred to lower tax jurisdictions though transfer mispricing*	*Profits made from sale of stolen resources, stolen capital, profits from protection rackets and other forms of extortion.*

Source: Le Billon, 2011; Author

3.5 POINTS OF ORIGIN OF ILLICIT FLOWS IN THE EXTRACTIVE SECTOR VALUE CHAIN

Illicit financial flows arise throughout the extractive sector, exist at the international, national and local levels, and nearly all types of actors are involved in some way. Each illicit flows originates from a moment in the extractive industry process in which an actor, whether in the private or public sector, has control over financial flows and the opportunity to illicitly redirect them. Illicit flows originate from five broadly defined sources: development of the regulatory framework, allocation of/petition for access, enforcement of/compliance with regulation, sale of the resource, and utilization of the revenue.

SOURCES OF ILLICIT FINANCIAL FLOWS

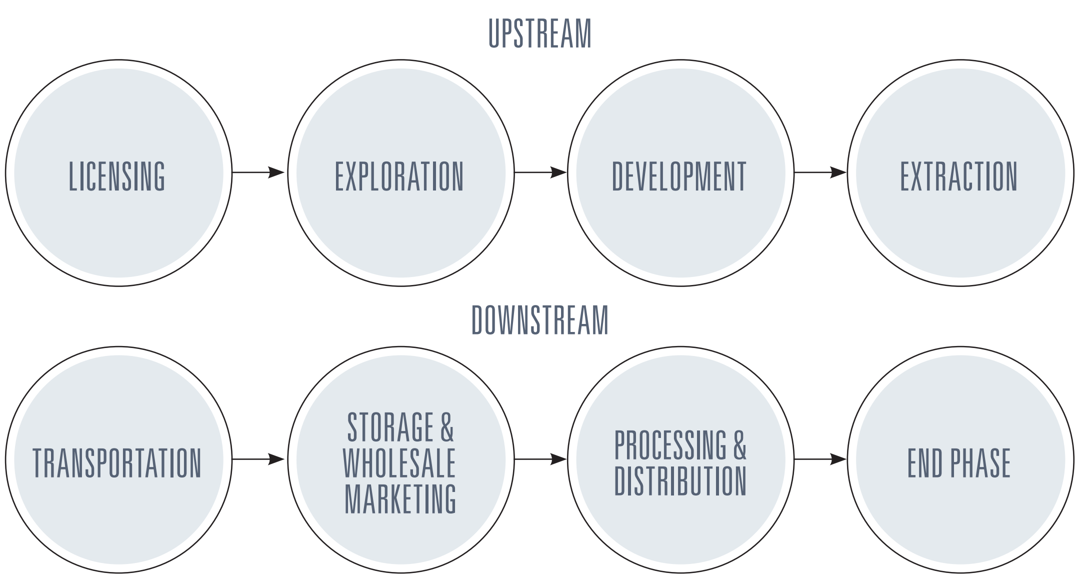
DEVELOPMENT OF REGULATORY FRAMEWORK	*Private sector actors invest significant resources in shaping public policy that affects their profitability. Financial flows associated with the development of the extractive industry regulatory framework may be illegal or legal. Legal flows can include lobbying, campaign contributions, and the "revolving door" phenomenon, while illegal flows could include outright bribery or government actors involved in the development of the regulatory framework.*
ALLOCATION OF/PETITION FOR ACCESS	*Highly valuable licenses and contracts are awarded in the extractive sector. Illicit flows in the award process can originate from bribery. Other more subtle forms of illicit flows come from the allocation of assets to advance personal or political goals rather than in accordance with national rules and policy. For example, a politician may award a contract to a company that supports them politically, or award a contract to an unqualified domestic company, rather than a qualified foreign company for political reasons. Tax evasion is written into resource contracts, often with the aid of bribery or coercion.* *Various moments of the bid-tender process are particularly vulnerable to corruption. Bid requests can be written or amended with specific companies in mind and licenses can be awarded to shell companies that will never deliver the good or service promised or legitimate companies used to launder illicit money. Many governments have clauses allowing the circumvention of the licensing process in certain circumstances. Corrupt parties can abuse these loopholes.*
ENFORCEMENT OF/COMPLIANCE WITH REGULATION	*Illicit flows originate in enforcement of the laws governing extraction through the uneven application of standards, due to bribery, conflict of interest and favoritism. The extraction of natural resources is governed by rules laid out in laws, regulations and specific contract agreements. These rules relate to fiscal, operations, local content, environmental, social, health and safety, and security standards. Not enforcing them properly can save a private company money or give them an opportunity to make money outside of the rights laid out in their contract, thus creating an illicit asset flow.*

SALE OF THE RESOURCE	*Illicit flows also originate in the sale of resources on the international and domestic markets. Companies and governments that sell natural resources have the opportunity to manipulate pricing regimes, sell to favored companies, solicit bribes and steal products.*
UTILIZATION OF THE REVENUE	*Legitimate resource revenues may be misdirected, hidden from the public, used for personal ends, or simply stolen. Utilization of resource revenues is particular susceptible to corruption because even misdirecting a small percent can represent a large amount of money. Data on revenue is often highly aggregated or "chunky," making it easier to hide missing revenues. Additionally, as discussed above, power is concentrated in the hands of top officials, resulting in weak oversight.*

Source: Gillies, 2010 and Author

3.6 DETECTING ILLICIT FINANCIAL FLOWS THROUGHOUT THE VALUE CHAIN

In order to detect illicit financial flows in the extractive industry, it is important to understand from which licit revenue streams they can originate, how and when in the value chain they occur, and what warning signs signal illicit activity. The natural resource value chain begins with the award of exploration rights and continues to utilization of revenues. Note that not every step in the value chain described below is applicable to every resource.



The chart below describes specific opportunities for corruption, illegal exploitation, tax evasion, and third-party theft during each of the stages of the extractive value chain, as well as signals that illicit activity may be occurring at each stage.

ILLICIT FINANCIAL FLOWS AND WARNING SIGNS THROUGHOUT THE VALUE CHAIN

TYPE OF ILLICIT FLOW

Development of regulatory framework: Illicit flows can take place before the value chain commences during the development of the regulatory framework. Additionally, the development of a weak regulatory framework creates opportunities for illicit flows throughout the value chain.

	CORRUPTION	ILLEGAL EXPLOITATION	TAX EVASION	THIRD-PARTY THEFT	WARNING SIGNS
LICENSING	*Unfair or illegal influence in the development of regulatory framework, award criteria, access to information, corruption in award process*	*Overriding normally prohibited resource exploitation*	*Developing fiscal regime, setting fiscal framework of contract*	*Fake licenses*	*Direct or non-transparent negotiation of licenses, awards to companies without demonstrated ability to perform, delays on permits and approval, seriously unbalanced contract terms, and waivers of bid bond requirements*
EXPLORATION	*Corruption in presentation of survey results*	*Extracting resources under an exploration license*	*Expenditure inflation*	*Extortion*	*Lack of policy clarity and opaque or incomplete legal or fiscal framework, weak inspection bodies*
DEVELOPMENT	*Corruption in contract amendments, cost-recovery plans and profile of production plans, bid-tender process for sub-contracts related to development*	*Setting of future production monitoring plan that is overly lenient*	*Tax-deductible procurement, over-invoicing*	*Extortion, theft or overcharging for materials*	*Permitting and approval delays, nontransparent procurement, limited use of international competitive bidding, aggressive "national interest" rhetoric, unusual repeat awards, rumors of abuse, weak inspection bodies*

Source: Le Billon, 2011; Author

	Corruption	Illegal Exploitation	Tax Evasion	Third-Party Theft	Warning Signs
Extraction	*Corruption in application of production regulations and contract amendments, bid-tender process for sub-contracts related to extraction*	*Fraudulent measurements and underreporting*	*Transfer mispricing and over-invoicing*	*Illegal exploitation by third-party, theft at extraction site, and extortion*	*Volume discrepancies (for example between producing fields and export measurement points), absence or frequent breakdowns in oil metering, and weakness in the volume inspection process, weak inspection bodies. For transfer mispricing and other forms of corporate tax evasion warning signs include lack of transparency, weak or nonexistent audits, and unnecessarily convoluted accounting, tax or financial structures*
Transport, Storage and Wholesale Marketing	*Corruption in resource purchase contracts, shipment authorization, and pipeline access*	*Diversion of resource flows and racketeering by transporters*	*Transfer mispricing and under-invoicing*	*Theft during transport, for example pipeline tapping and hijacking, extortion*	*Lack of transparency in the government sale of resources, official sales at prices below international benchmarks, reliance on middlemen, nontransparent rules of access to infrastructure, long queues, and favored customers*
Processing and Distribution	*Corruption in price controls and award of import and retail contracts*	*Diversion of refined resources and racketeering by transporters*	*Smuggling of untaxed or subsidized products*	*Theft at processing site, extortion*	*Product price controls, product shortages and queues, rumors of black market and smuggling, volume discrepancies, nontransparent product procurement, and claims of oil metering "difficulties"*
End Phase	*Evading decommissioning expenditures, including environmental mitigation*	*Post-decommissioning exploitation*	*Early exit or false bankruptcy*	*Extortion*	*Lack of transparency or outside inspection, and compliance with "optional guidelines" rather than enforceable laws*

Source: Le Billon, 2011; Author

4. CONCLUSION

This document develops a rigorous but flexible framework through which to analyze legal and illicit flows in the global extractive industry. Through this framework, it is possible to identify and contextualize a wider range of legal flows than typically considered, including flows relating to aid, lobbying, and private and public sector financing. Combining a dissection of legal flows, the vulnerability of the sector to illicit flows, and the extractive industry value chain, this analysis identifies moments of opportunity for illicit flows to take place. This report should be a useful tool for civil society and the public sector. It can be further developed to be applicable internationally and across various segments of the extractive sector.

5. FURTHER READING

There are a number of large independent international organizations dedicated to promoting transparency in the extractive sector. Over the last decade, a spike in commodity prices has directed international attention to natural resource governance. Citizens of and donors to natural resource-rich developing countries hoped the spike would lead to economic growth that in most cases has not materialized. A number of international organizations work on the issues of illicit financial flows and natural resource governance.

The Extractive Industry Transparency Initiative (EITI) is one of the leading international organizations in promoting extractive industry transparency. EITI was launched in 2003. It is a voluntary initiative under which governments and companies agree to submit information on payments to an independent audit in order to gain compliance status. As of August 2014, EITI's presence in Latin America was still weak. Peru and Guatemala were the only compliant countries in the region. A Pemex representative sits on the Board of EITI, but has been inactive. The Mexican government has asserted that because Pemex is subject to all federal standards and oversight, including the Federal Institute on Access to Information and Data Protection (Instituto Federal de Acceso a la Informacion y Proteccion de Datos, IFAI), transparency standards already surpass those of EITI. However, in 2013 the process of joining EITI was re-opened. There has been a renewed push to implement EITI in Mexico both within certain government offices, including SENER, and by Mexican and international civil society groups.

Up-to-date information on international extractive industry transparency initiatives as well as reports on the current state of transparency in the extractive industry are available through the websites of independent international organizations dedicated to promoting transparency in the extractive sector. These include:
- Extractive Industry Transparency Initiative: eiti.org
- Publish What You Pay: www.publishwhatyoupay.org
- National Resource Governance Institute (formerly Revenue Watch Institute): www.resourcegovernance.org
- Open Government Partnership: www.opengovpartnership.org
- Global Witness: globalwitness.org

A particularly useful report on how money laundering works:
- www.globalwitness.org/sites/default/files/Idiot's%20Guide%20to%20Money%20Laundering_for%20web.pdf

The U4 Anti-Corruption Resource Institute, a project of the CMI research institute, publishes informative reports focused on natural resource governance and illicit financial flows:
- www.u4.no/themes/natural-resource-management

Human Rights Watch and Oxfam publish journalistic pieces that deal directly and indirectly with resource governance and illicit financial flows:
- www.hrw.org
- www.oxfam.org

The Tax Justice Network has a useful website with more detailed information on tax evasion and the damage it can cause:
- www.taxjustice.net

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GLOSSARY

- Bid Bond

A debt secured by a bidder for a job with a bid-based selection process for the purpose of providing a guarantee to the project owner that the bidder will take on the job if selected. The existence of a bid bond provides the owner with assurance that the bidder has the financial means to accept the job for the price quoted in the bid.

- Credit Guarantee

A form of insurance that protect the interests of a seller from the chance of non-payment by a buyer.

- Cross Subsidy

A strategy in which profits from one activity are used to pay for another activity that is losing money or making less money

- Decommissioning

The planned shutdown or removal of a building, equipment, plant, etc., from operation or usage.

- Fracking

Or hydraulic fracturing, refers to a procedure used in oil and gas extraction. It is the practice of creating fractures in rocks and rock formations by injecting fluid into cracks to force them further open. The larger fissures allow more oil and gas to flow out of the formation and into the wellbore, from where it can be extracted.

- Government Buffer Stock

A supply of inputs held as a reserve to safeguard against unforeseen shortages or demands. Governments use buffer stock schemes to stabilize prices in volatile markets.

- Life-Line Electricity Rate

Lifeline electricity rates are targeted subsidies based on the consumption level of households. The subsidies are paid from the government to the consumer. Rates designed to promote universal access and emergency service.

• Operating Grants, Investment Grants and Capital Grants
A grant is a financial award given by a government to an eligible grantee. Grants are not expected to be repaid and typically require an application process and periodic reports from the grantee. An operating grant covers the grantee's operating expenses, or expenses that occur regularly, n investment grant is used to encourage investment by the grantee, and a capital grant is used to encourage acquisition of capital assets by the grantee, such as buildings, land and machinery.

• Output Bounty or Deficiency Payment
A form of direct subsidy linked to prices. Payments from the private sector to the government (bounties) or the government to the private sector (payments) that make up the difference between a target price for a good and the actual price received in the market. If the actual price is above the target price, the producing company delivers a bounty. If the actual price is below the target the producing company receives a payment.

• Price control
Government mandated minimum or maximum prices that can be charged for specified goods. Also known as "price floors" or "price ceilings".

• Protection Racket
A situation in which a criminal group demands payment from a business in exchange for agreeing not to harm them, or any situation whereby a criminal group provides protection to businesses through violence outside the sanction of the law.

• Public exchange
A marketplace in which securities, commodities, derivatives and other financial instruments are traded. Exchanges give companies, governments and other groups a platform to sell securities to the investing public.

• Racketeering
A criminal activity that is performed to benefit an organization such as a crime syndicate. Examples of racketeering activity include extortion, money laundering, loan sharking, obstruction of justice and bribery.

• Rent-Seeking Behavior
When a company, organization or individual uses their resources to obtain an economic gain from others without reciprocating any benefits back to society through wealth creation. An example of rent-seeking is when a company lobbies the government for loan subsidies, grants or tariff protection. These activities don't create any benefit for society; they only redistribute resources from the taxpayers to the special-interest group.

• Special Transfer Pricing Agreements
Special or unusual rules allowing companies to perform fiscally favorable transfer pricing. For example, a fiscal code may allow companies to price a resource based not on international markets, but on cost plus a fixed amount.

• Tax Holiday
A government incentive program that offers a tax reduction or elimination to businesses. Tax holidays are often used by governments in developing countries to help stimulate foreign investment.

• Third-Party Liability Limit
A Limit extent to which businesses are liable of accidents, injuries and propery damage sustained by third parties.

• Trade Mispricing
The deliberate over-invoicing of imports or under-invoicing of exports. Generally, companies misprice trade in order to transfer profits from one tax jurisdiction to another, thus avoiding paying taxes or levies in the country in which the trade is mispriced.

• Value Chain
Every step a business goes through, from raw materials to the eventual end-user.

• Write-Offs of Capital Costs
When a company may subtract all capital costs from their taxable revenue. A capital cost is any fixed, one-time expenses incurred on the purchase of land, buildings, construction, and equipment used in the production of goods or in the rendering of services.

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