

## INTERVIEW

### The Financial Markets Are Beginning to Recognize the Value of the EITI Label,

David Diamond, Global Co-Head of ESG at Allianz Global Investors, tells AOG

- ▶ It is far easier to generate revenues from the extractive industries than to build a strong and diversified economy.
- ▶ The economic performance of most natural resource-rich countries lags behind that of other countries.
- ▶ 37 countries representing a total population of 900 million are currently implementing the **Extractive Industries Transparency Initiative (EITI)**.

*AOG : Why is the oil and gas industry an important sector for large institutional investors such as Allianz Global Investors (AllianzGI) ?*

■ **David Diamond** : While prices for natural resource commodities, such as oil, gas and precious metals, remain volatile, interest in extractive industries - oil, gas and mining - should continue over the long term, as investors pursue ever greater diversification strategies and hedges against any potential rise in inflation.

Global demand for these non-renewable natural resources is likely to be supported by three secular trends: a) a **50% growth in world population** by 2050 according to UN estimates; b) a **36% rise in global energy use** by 2035 according to the International Energy Agency; c) a **potential doubling of the emerging economies' share of global GDP** within 15 years, assuming IMF growth estimates continue at current rates.



Moreover, many of our clients' portfolios are managed relatively to an investment benchmark, such as the **MSCI Europe** or **MSCI World** equity indices. MSCI Europe is an equity index comprised of Europe's largest, listed companies (about 430 in total), whereas MSCI World brings together the largest companies worldwide (about 1,600). The energy sector counts among the most significant constituents of MSCI Europe, 9.9% of the index, and accounting for a comparable 10% of MSCI World. Oil majors figure prominently in both indices with **BP** and **Royal Dutch Shell** ranking within the top ten largest companies in Europe by market capitalisation, and **ExxonMobil** and **Chevron** ranked within the top five world-wide.

As a consequence, the energy sector is an important sector for large institutional investors to consider, as it contributes significantly to the risk/return profile of their investment portfolios.

**AOG** : What are for AllianzGI the *main risks* linked to this industry and how do you manage them?

■ **D. D.** : Extractive industries present numerous environmental, social and governance (ESG) challenges of interest to investors. After the BP-linked oil spill in the Gulf of Mexico higher costs linked to pollution controls are an issue for oil companies operating deep offshore platforms. Employee health and safety is an on-going concern for mining and metals companies seeking to reduce workplace accidents, such as Arcelor Mittal.

One particularly difficult challenge is securing long term supply for resources located in areas where political, economic and social instability is often the norm. Social unrest has regularly threatened Royal Dutch Shell operations in **Nigeria**, and during the “**Arab Spring**” for **Eni** in **Libya**. Reputational risk linked to accusations of bribery and corruption is also a recurring issue. Poor governance and lack of transparency often lie at the root of the problem, as local populations fail to see any socio-economic benefits from the financial wealth generated by resource exports. According to *The Economist*, resource nationalism has recently jumped to the top of the list of worries for global mining companies, notably in Africa, as countries seek to boost their share of resource revenues.

In order to manage the risks, Allianz Global Investors’ ESG Team analyses companies on the basis of our enhanced ESG (environmental, social and governance) research methodology. This consists of building a research framework identifying key, material ESG risks for each sector of economic activity. In the case of the energy sector the material ESG risks we identify center on a company’s business conduct (relationships with suppliers and clients, anti-bribery and corruption policies and practices, license to operate), environmental risk management, human capital management and lastly corporate governance practices.

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| <b>WHO'S WHO</b> | <p>&gt; <b>David Diamond</b><br/> <b>Global Co-Head of ESG, Allianz Global Investors</b></p>   |
|                  | <p>Year of joining company : 2008<br/> Number of years with company : 5<br/> Years of experience in securities business/ portfolio management : 17</p> <p><b>Employment History</b><br/> Allianz Global Investors, Global Co-Head of ESG, since 2012<br/> AllianzGI France / Europe, Head of SRI, including SRI Research, 2008-2012<br/> Amundi Group (ex-CAAM), Head of Shareholder Engagement &amp; Senior SRI Analyst, 5 years<br/> Crédit Lyonnais AM, SRI Analyst, 2 years<br/> BNP Paribas AM, European equity analyst, 3 years<br/> Paribas AM, International marketing &amp; external distribution, 2 years</p> <p><b>Academic Qualification</b><br/> 1996 : Double degree ESCP-Europe (Paris-Oxford-Berlin) – German Diplom Kauffman<br/> 1990 : Williams College, Massachusetts, USA - Bachelor of Arts</p> <p><b>Industry Initiatives</b><br/> Extractive Industries Transparency Initiative (EITI): board member since 2009 (re-elected in 2011)<br/> EFAMA – Responsible Investment Working Group (2010-13)<br/> French Social Investment Forum (French SIF): board member since 2009-2013<br/> UN PRI / French SIF European Research Prize – Jury (2010)<br/> SRI Committee of the French Association of Investment Management (AFG): member (ongoing)<br/> Global Reporting Initiative: member of investor materiality &amp; food sector supplement working groups (2008-10)</p> <p><small>Source : Allianz Global Investors.</small></p> |

Based on a thorough analysis, we benchmark all companies included in the sector ranking them from best to worst in terms of our overall ESG assessment. Furthermore, we challenge companies on their policies, practices and results through dialogue and engagement, notably with corporate managements. For example, in the oil industry we exchange on the ESG issues linked to activities in tar sands, shale gas and Arctic exploration. We also challenge them on other practices such as gas flaring in Nigeria and elsewhere. Our ESG research methodology includes keeping a close eye on company newsflow and any controversies raised by stakeholders, such as NGOs.

**AOG** : *AllianzGI supports greater **transparency** within the extractive industries. Why is this issue a key point for major institutional investors?*

■ **D. D.** : Governments in resource-rich countries are tempted to favour the export of natural resources in order to benefit from the financial bounty that they represent: it is simply easier to generate income from extractive industries than to build a strong and diversified economy. On the face of it, this activity is very profitable – at least in the medium term - for the governments themselves, the oil, gas and mining companies involved and their shareholders, including Allianz Global Investors.

However, this does not necessarily translate into sustainable long term approach. In regimes that are more frequently autocratic than democratic and rife with corruption, the income derived from resource extraction is more commonly distributed to the political, military and commercial elites rather than being invested in economic and social development projects.

Key is the fact that most countries rich in natural resources have tended to under-perform economically. Over 3.5 billion people live in countries rich in oil, gas and minerals, and the vast majority see few benefits. With good governance the exploitation of these resources could generate large revenues to foster economic growth and diversification, while reducing poverty. However, when governance is weak, it often results in corruption, poverty and conflict.

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**Ensuring the transparency of payments to a government can also help demonstrate the contribution that a company's investment makes to a country**

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These effects are not inevitable and encouraging greater transparency in countries rich in these resources could mitigate some of the potential negative impacts. Benefits to companies and investors focus on limiting political and reputational risks. Political instability caused by opaque governance is a clear threat to investment. In extractive industries, where investments are capital intensive and dependent on long-term stability to generate returns, reducing such instability is beneficial for business. Transparency of payments made to a government can also help to demonstrate the contribution that the company's investment makes to a country.

**AOG** : *You represent institutional investors on the board of the **Extractive Industries Transparency Initiative** (EITI). Is this voluntary initiative really working? What is the added value here?*

■ **D. D.** : The Extractive Industries Transparency Initiative is a scheme where countries voluntarily commit to a public reconciliation of the financial payments made by extractive

companies and the revenues received by the governments. EITI is a multi-stakeholder initiative whereby governments, companies, civil society and investors oversee the full process, locally in each country, supervised by the EITI International Board.

Today, 37 countries, totalling a population of over 900 million people, implement the EITI, and it is increasingly recognized as a global transparency standard, in turn supported by the **G8**, **G20** and institutions like the **World Bank**. Key stakeholders supporting the initiative include over 60 of the largest oil, gas and mining companies, 80 institutional investors and dozens of civil society organisations. Moreover, after **Norway**, the **United States** and **Australia** are the first OECD countries to express their intention to become EITI implementing countries.

For investors the added value of EITI is linked to the fact that financial markets are beginning to recognise the value of the EITI label. Of the 37 countries now implementing EITI, **Azerbaijan** was the first country to be declared EITI Compliant by the EITI Board in 2009. In May of the following year **Fitch Ratings** announced that they upgraded Azerbaijan's long-term foreign and local currency Issuer Default Ratings (IDRs) to 'BBB-' from 'BB+'. In the press release, Fitch indicated that it *"draws comfort from the transparency of the SOFAZ [the State Oil Fund that leads on EITI], underlined by Azerbaijan being the first country to be fully compliant with the international Extractive Industries Transparency Initiative."*

Although other rating agencies such as **S&P** have not yet followed suit so explicitly, the *S&P Sovereign Government Rating Methodology and Assumptions* includes a "Political Score", where the *"transparency and accountability of institutions, data and processes... including [a country's] perceived level of corruption"* are considered .

As such, a commitment to EITI may contribute to a country's improving its sovereign credit rating over the long term.

**AOG** : *Many NGOs, especially within the Publish What You Pay coalition, support the EITI but they stress that voluntary initiatives are not enough and that stricter regulation is required. You seem to share this view, perhaps with some caveats. Could you elaborate on this point?*

■ **D. D.** : Investors increasingly believe that both may be necessary.

Beyond such voluntary initiatives, however, regulation is likely to play an increasing role in assuring transparency for extractive companies. In the United States, **Dodd-Frank legislation**, as per the **Securities and Exchange Commission (SEC)**, now requires all SEC registered companies from the extractive sectors to publish government payments on not only a country-by-country basis but also project-by-project. The **European Union** has signalled its intention to follow suit.

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**Over and beyond voluntary initiatives,  
regulation will probably play an  
increasingly important role in  
guaranteeing greater transparency**

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Whether voluntary or regulatory, the investment case for transparency is clear. It is the first step leading to better governance in resource rich countries. Ultimately, this should produce a more stable investment climate of benefit to extractive companies, their shareholders and local populations.

**AOG** : *What is AllianzGI's position on transparency provisions included in the Dodd-Frank Wall Street Reform and Consumer Protection Act and on draft transparency legislation proposed by the European Commission?*

■ **D. D.** : In October 2011 over twenty institutional investors representing over €2.5 trillion in assets, including Allianz Global Investors, wrote to Michel Barnier, European Commissioner for Internal Market and Services, in qualified support for draft transparency legislation in the EU. This would require multinationals to disclose financial information such as production shares with governments, bonuses, royalties, and taxes for each country in which they operate via their annual statements.

The investors stated that they support the EU's initiative for increased transparency both through voluntary (EITI) and regulatory approaches. They stressed that the two are complementary and ultimately enhance the prospects for risk adjusted investment returns by improving disclosure, which contributes to more stable and transparent bidding markets for contracts, licences and permits, and lowers the risk that governments will seek to renegotiate or rescind contracts or nationalise projects.

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**It would be desirable to shift  
towards a single global  
disclosure regime as far as  
transparency is concerned.**

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However, they also warned the Commissioner against exposing extractive companies to conflicting legal requirements. To this end, the investors propose that regulators work towards a single global disclosure regime with a mutually recognised reporting process across jurisdictions in order to build consistent reporting standards across global markets.

