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Poor Disclosure By Europe's Chemicals, Oil & Gas, And Metals & Mining Companies Gives Limited Insight Into Decommissioning And Environmental Provisions

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In today's environmentally conscious world, the pressure on companies to meet global standards is paramount. To this end, environmental and decommissioning provisions add up to sizable future obligations for the chemicals, oil & gas, and metals & mining industries. Yet, poor disclosure is making understanding the basis and reasons for changes in such provisions guesswork.

Clearer reporting of decommissioning and environmental provisions would provide greater guidance for analysis. Standard & Poor's Ratings Services calls for standard industry terminology to be used throughout disclosure, maturity profiles for operating and closed sites split by geography or other meaningful industry categories, and disclosure of the discount rates applied.

Environmental provisions are generally unconnected to current business operations and involve a cleanup of contaminated sites connected with past activities of acquired companies or due to the toughing of environmental legislation. Decommissioning provisions are connected to current operations and will require substantial funding for the dismantling and removal of production facilities and returning production sites back to an agreed environmental standard.

Companies are setting aside provisions for those future cash outflows. The size of such provisions tends to be based on management judgment rather than third-party appraisals. This contrasts with pension provisions, where third parties provide significant input as to obligations for future payments.

Standard & Poor's typically sees high provisions for decommissioning in the metals & mining and oil & gas industries, while chemical companies tend to have mainly environmental provisions.

Standard & Poor's treats decommissioning provisions as additions to debt. For the companies we reviewed they represent a substantial part of the overall future debt burden for metals & mining and oil & gas companies. These provisions equate to about 40% of a company's reported debt. Indeed, decommissioning provisions represent a significant part of the financial risk of these companies, because the majority of cash flows occur at the end of the project's life. In contrast, we do not adjust for environmental provisions, however, the cash costs will be funded from ongoing business operations. Chemical companies, on the other hand, tend to have no decommissioning, but instead face environmental provisions. Here, environmental provisions typically represent less than 10% of the companies reported debt.

Current disclosure makes comparative assessment difficult as the details on timing and nature of the decommissioning and environmental provisions is opaque.

Specific to the companies analyzed (see tables below) is their high cyclicality and therefore volatility of cash flows. So although decommissioning cash flows do not represent material cash outflows now, as companies are currently benefiting from the strong upward business cycle of recent years, they will have to ensure they have sufficient funds to deal with future decommissioning payment obligations even in a weak business environment.

Of the three industries, oil & gas companies show the highest obligations for decommissioning and environmental liabilities, equivalent to 50% of the companies reported debt obligations in 2006 (chart 1). In contrast, the chemical industry shows the most modest provisions, representing about 9% of their reported financial debt and provisions are mainly environmental.

Basis For The Provision Building: The Accounting Rules

The accounting rules for such provisions under IFRS are summarized in IAS 37 as follows;

A provision is a liability of uncertain timing or amount. It should be recognized only when:

The entity has a present obligation (legal or constructive) as a result of a past event;
It is probable that an outflow of resources will be required to settle the obligation; and
A reliable estimate can be made of the obligation.

IAS 37 paragraph 19 breaks this down into more detail for our purposes, specifically listing information on environmental provisions and decommissioning provisions (Asset Retirement Obligations).

Provisions for environmental damage should be provided for when there is an obligating event, for example:

In connection with unlawful environmental damage; or
Where existing or new legislation requires rectification of existing environmental damage; or
When the entity publicly accepts responsibility for rectification of environmental damage.

By contrast, where an entity can avoid the future expenditure by how it acts in the future, such as by changing or improving its future method of operation, it therefore has no present obligation and no provision is made.

Decommissioning provisions relate to costs that arise where an oil installation or nuclear power station has to be dismantled at the end of its life, or a mine site capped, or land restored to a suitable standard. The standards require an entity to recognize a liability as soon as the decommissioning obligation is created, which is normally at the time facility is constructed and the damage that needs to be restored is done. The total decommissioning cost is estimated and a liability is recognized based on the percentage of the total decommissioning costs attributable to damage caused by the action to that point in time.

Under U.S. GAAP, although there is no equivalent general provisioning standard, there are a number of specific standards (FAS 143 – Accounting for Asset Retirement Obligations, SOP 96-1 Environmental Remediation Liabilities), which principally result in a similar accounting approach as for IFRS.

Disclosure Remains Hazy For Our Analysis

The disclosure styles adopted by companies are at times unclear and frequently mix up terminology. In the sample we reviewed there was a mix-up of terms used in environmental and decommissioning. For example, some are classified as environmental when they actually relate to decommissioning or asset-retirement obligations, which was mostly the case for companies in the metal & mining industry. This situation is reflective of the relatively broad discretion management has in setting the provisions within the accounting rules. This varied approach to disclosure makes it difficult for analysts to compare companies. We would like to see standard industry terminology used throughout disclosure, maturity profiles for operating and closed sites split by geography or other meaningful industry categories (for example, onshore/offshore, underground/open cast) and discount rates applied.

Chemical sector: Dominated by environmental obligations and minimal disclosure

Table 1

Chemical Sector--Disclosure Data 2006

Company	--Disclosure of accounting policy--			Quality of disclosure
	Provisions	Decommissioning	Environmental	
Akzo Nobel	Yes	P	P	Lacking detail
BASF	Yes	P	P	Lacking detail
Clariant	Yes	N.A.	Yes	Some detail
Ciba	N.A.	N.A.	Yes	Some detail
DSM	Yes	P	P	Some detail
Ineos	N.A.	N.A.	Yes	Some detail

P--Reference to decommissioning and/or environmental accounting policies included within provisions accounting policy. N.A.--Not available.

The quality of the different accounting policies and disclosure at the reviewed chemical companies varies greatly (see table 1). Accounting policies show a range from environmental provisions in a stand-alone policy to a general provisions accounting policy. However, as is the case for Akzo Nobel N.V. (A-/Stable/A-2) and BASF AG (AA-/Stable/A-1+), no detail is provided in the notes to their accounts on the nature, timing, or discount rates relating to their provisions. BASF has also come up with a unique name for decommissioning provisions, which are referred to as "recultivation" provisions.

Clariant AG's (BBB/Negative/A-3) environmental provision notes highlight the fact that all their provisions relate to environmental liabilities in connection with activities before Clariant took control of the sites.

Ciba Specialty Chemicals Inc. (Ciba; BBB/Stable/A-2) highlights details on the cleanup and remediation of past waste sites and, although expenditure is forecast for the next 30 years, it has chosen not to discount its provisions.

Royal DSM N.V. (A-/Stable/A-2), like BASF, has decommissioning provisions for oil & gas activities, although these obligations are not disclosed separately, but grouped with other items within an 'other' category in its provision notes.

Ineos Group Holdings PLC (B+/Stable/--) stands out as having the shortest time frame, with provisions for remediation expected to be used up in two to five years, although why this is the case is not explained.

Oil & gas sector: Detailed policies, but only basic provision information provided

Table 2

Oil & Gas Sector--Disclosure Data 2006

Company	--Disclosure of accounting policy--			Quality of disclosure
	Provisions	Decommissioning	Environmental	
BP	Yes	Yes	Yes	Some detail
ENI	N.A.	Yes	Yes	Some detail
Shell	Yes	P	P	Some detail
Statoil	N.A.	Yes	N.A.	Some detail

Table 2

Oil & Gas Sector--Disclosure Data 2006(cont.)				
Total	Yes	yes	N.A.	Lacking detail

P--Reference to decommissioning and/or environmental accounting policies included within provisions accounting policy. N.A.--Not available.

The oil & gas sector has the highest provisions and the most experience when it comes to reporting on decommissioning obligations, however, apart from the basic provision movements (tabular form), very little additional information is provided.

For instance, Royal Dutch Shell PLC (Shell; AA/Stable/A-1+) revised a provision recognized in 2006, which resulted in a $1.1 billion or 18.9% increase, but no additional detail as to which fields or operators was provided, making it difficult for an analyst understand the change. Likewise, Statoil ASA (AA-/Stable/A-1+), which reports under U.S. GAAP, in 2006 saw an upward revision of NOK8.3 billion or 41.8%, which was explained simply as being due to an upward revision of cost estimates related to removal complexity, rigs, marine operations, and heavy lift vessels. These are not new costs. What would be helpful to know are which fields are affected and why the previous estimates were too low. Statoil is the only company in our sample where the balance-sheet provisions figure is higher than the related note information. We assume this is due to U.S. GAAP disclosure requirements, but it would still be helpful to have information on the other provisions. Statoil does, however, make it clear that due to their possible indefinite life there are no provisions for refining and processing plants.

It is interesting to note, that Eni SpA (AA/Stable/A-1+) still refers to abandonment in its provisions note, which is not commonly referred to anymore by oil and gas companies.

BP PLC (AA+/Stable/A-1+) is the only company to specify a real discount rate, with other participants typically listing a range of nominal discount rates. They also highlight that environmental related provisions have a 10-year average life versus 30 years due to decommissioning.

Total S.A. (AA/Stable/A-1+) only provides a reconciliation of the movement in decommissioning liabilities, with no explanation of the basis for the change in the environmental liabilities, which only receive a cursory reference in the accounting policies.

Metals & mining sector: Varying terminology, but some detailed information

Table 3

Metals & Mining Sector--Disclosure Data 2006

Company	--Disclosure of accounting policy--			Quality of disclosure
	Provisions	Decommissioning	Environmental	
Anglo American	N.A.	Yes	Yes	Some detail
BHP Billiton	N.A.	Yes	N.A.	Very detailed
Norilsk Nickel	N.A.	E	Yes	Some detail
Rio Tinto	N.A.	Yes	Yes	Detailed
Xstrata	N.A.	Yes	Yes	Some detail

E--Reference to decommissioning policy included in environmental policy. N.A.--Not available.

Metals & mining companies favor rehabilitation and remediation as their catch phrase for their decommissioning provisions and generally provided the most descriptive disclosure of our sample of companies.

BHP Billiton PLC (A+/Stable/A-1) lists an accounting policy for restoration and rehabilitation. The disclosure in the notes is probably the most revealing of all companies in our sample, as it splits the provision between operating and closed sites and then details out information on the activities being undertaken at the closed sites. Moreover, they even include a potential high and low range of costs due to the uncertainty associated with the operations.

Anglo American PLC (A/Stable/A-1) has one policy encompassing restoration, rehabilitation, and environmental costs, but attempts to split the provisions out between two categories--environmental restoration and decommissioning--even though the two are clearly linked (both 30 years) as they relate the same mine sites.

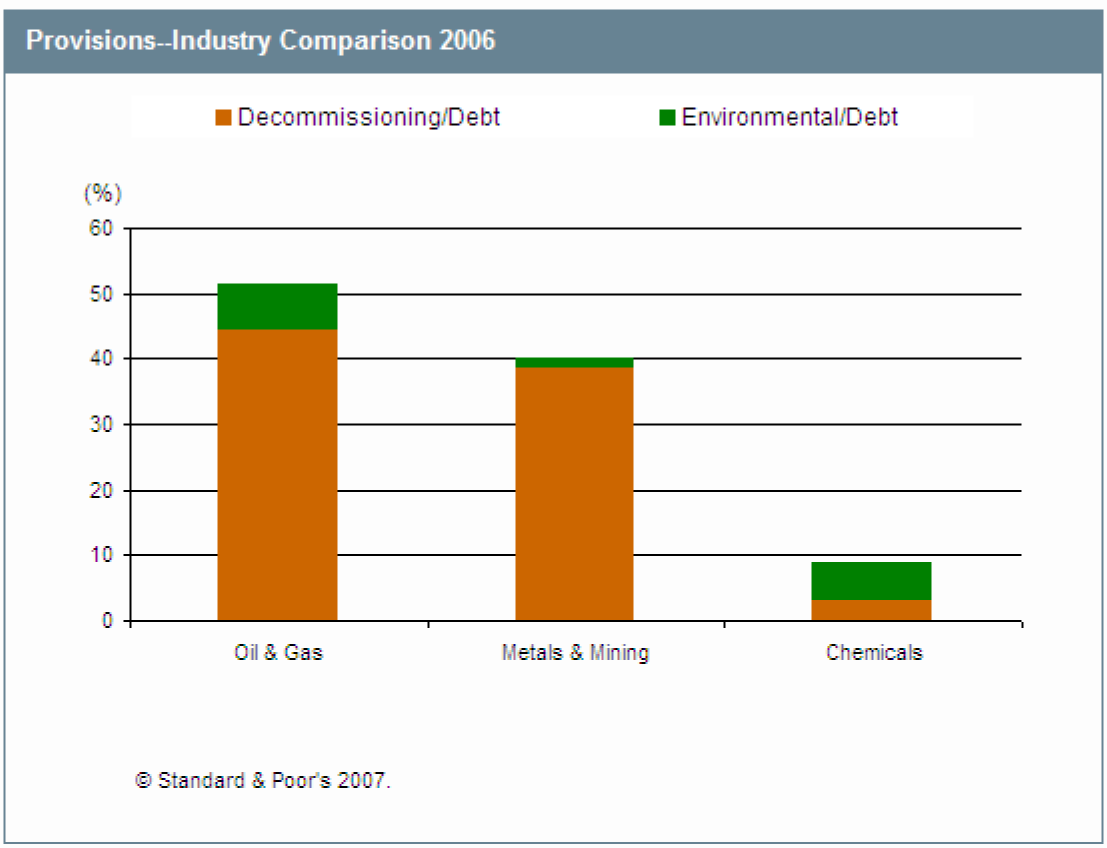
OJSC MMC Norilsk Nickel (Russia national scale rating: ruAA+/--/--; Foreign currency rating: BBB-/Stable/--) wraps its decommissioning policy under an environmental obligations accounting policy heading and, apart from the usual tabular reconciliation, provides a range of discount rates used (6.6% to 7.7%), and the maturity profile of the expenditure.

Rio Tinto PLC (A+/Watch Neg/A-1) provides some timing information, with mine closures ranging from one to 50 years with a weighted average of 14 years and the provision has been discounted at 5%.

Xstrata PLC (BBB+/Stable/A-2), like Anglo American, highlights the existence of an on balance-sheet rehabilitation fund in South Africa for its coal activities, but the remainder of its information on its actual provisions is brief.

Oil & gas companies show the highest future obligations amongst the three industries

Chart 1



Standard & Poor's has chosen a representative sample of 16 companies, reflecting key players in the industries, to illustrate the importance of the financial risk obligations, however, our only window into the future cash obligation is the provisions information provided by the company. Table 2 shows the breakdown of the provisions and the cash flow spend in 2006.

Of the three industries, oil & gas companies show the highest obligations for decommissioning and environmental liabilities, equivalent to 50% of the companies reported debt obligations in 2006 (chart 1). In contrast, the chemical industry shows the most modest provisions, representing about 9% of their reported financial debt and provisions are mainly environmental.

Differing risk profiles can be also seen in looking at the provisions in relation to sales. Oil & gas and metals & mining companies have an average of about 5% compared with the chemical industry's 2%. The same applies in terms of total assets, which show about 6% of total assets for oil & gas and metals & mining compared with about 2.5% for chemical companies.

Table 4

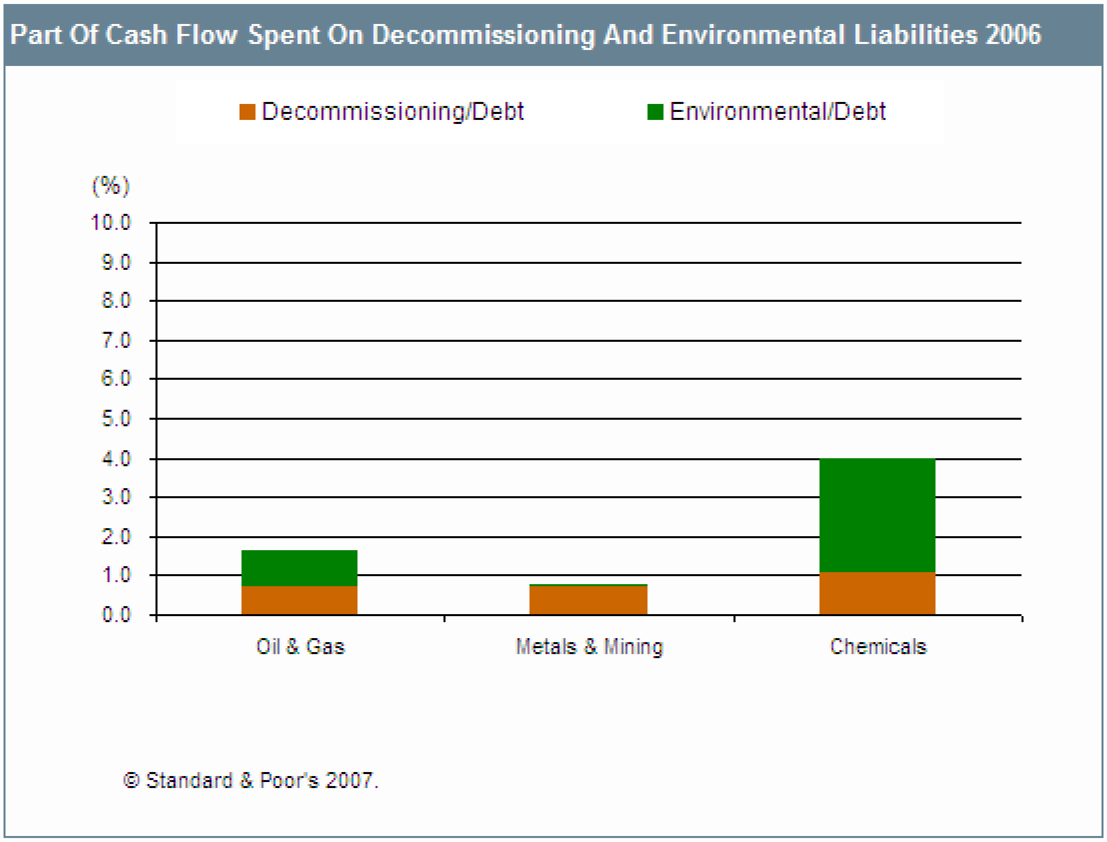
Overview Of Companies In The Industry 2006

		--Provisions--			--Cash flow--	
Company	**Currency (Mil.)**	**Decommissioning**	**Environmental**	**Total**	**Decommissioning**	**Environmental**
BP	$	8,365	2,127	10,492	179	324
ENI	€	3,724	1,905	5,629	188	430
Shell	$	8,317	967	9,284	135	275
Statoil	NOK	28,971	N.A.	28,971	182	N.A.
Total	€	3,893	574	4,467	174	N.A.
Anglo American	$	216	531	747	2	23
BHP Billiton	$	4,112	N.A.	4,112	190	N.A.
Norilisk Nickel	$	322	N.A.	322	N.A.	N.A.
Rio Tinto	$	3,359	N.A.	3,359	67	N.A.
Xstrata	$	1,080	N.A.	1,080	49	N.A.
Akzo Nobel	€	N.A.	228	228	N.A.	47
BASF	€	649	272	921	18	46
Clariant	CHF	N.A.	153	153	N.A.	13
Ciba	CHF	N.A.	411	411	N.A.	25
DSM	€	138	45	183	32	12
Ineos	€	N.A.	114	114	N.A.	14

N.A.--Not available. NOK--Norwegian krone. CHF--Swiss franc.

Cash flow use for decommissioning and environmental provisions is not a good proxy for the assessment of the potential risk profile

Chart 2



The long-term nature of these obligations plays an important role for the cash flow analysis. The timing and the amounts used are not easy to predict and may vary significantly from year to year. For example, BHP Billington provides a range that future cash flow needs for closed sites could be as much as 25% higher or 20% lower than the current estimate in the accounts. In addition, the information provided by companies about the timing and size of the individual obligations is limited. Therefore, current cash flow spending, in our view, is neither a good way of judging the importance of these provisions nor of obtaining an estimate for possible future cash outflows. In analyzing the 2006 cash flows spend at the companies reviewed, it can be seen that the amounts paid had not formed a major part of the companies' generated operating cash flows for all three sectors. Chemicals, however, at about 4% on average, show the highest portion. This mainly reflects quite significant environmental liabilities for Clariant and Ciba, which inherited substantial obligations when they were spun off.

There was only a relatively low cash flow need in 2006 for oil & gas and metals & mining companies. This partly reflects the strong cash flow generation of the companies, with both industries benefiting from the very strong phase of the current business cycle in which they currently find themselves.

Table 5

Key ratios Of European Chemicals, Oil & Gas, And Metals & Mining Companies 2006

Company	Provisions/Assets	Provisions/Sales	DP/Debt	EP/Debt	DP CF/CFO	EP CF/CFO
BP	3.9	4.8	34.8	8.9	0.6	1.2
ENI	6.5	6.4	34.5	17.6	1.1	2.5

Table 5

Key ratios Of European Chemicals, Oil & Gas, And Metals & Mining Companies 2006(cont.)						
Shell	2.9	3.9	52.7	6.1	0.4	0.9
Statoil	6.8	9.2	81.0	0.0	0.3	0.0
Total	3.4	4.2	19.4	2.9	1.1	0.0
AVERAGE	4.7	5.7	44.5	7.1	0.7	0.9
Anglo American	2.3	1.6	3.5	8.5	0.0	0.3
BHP Billiton	12.8	8.5	45.6	0.0	1.8	0.0
Norilisk Nickel	2.8	2.0	40.8	0.0	0.0	0.0
Rio Tinto	13.2	9.7	95.7	0.0	0.8	0.0
Xstrata	6.1	2.3	7.0	0.0	0.9	0.0
AVERAGE	7.4	4.8	38.5	1.7	0.7	0.1
Akzo Nobel	1.7	1.8	0.0	7.7	0.0	4.2
BASF	1.8	2.0	6.8	2.9	0.3	0.8
Clariant	1.9	2.1	0.0	7.7	0.0	4.6
Ciba	6.5	4.5	0.0	14.3	0.0	5.9
DSM	2.2	1.8	9.1	3.0	5.1	1.9
Ineos	0.4	0.8	0.0	1.3	0.0	1.2
AVERAGE	2.5	2.3	3.2	5.8	1.1	2.9

DP--Decommissioning provisions. EP--Environmental provisions. CF--Cash spent on decommissioning/environmental. CFO--Cash flow to operations.

S&P Adjusts Financial Debt For Decommissioning Provisions To Reflect The Inherent Risk Of The Businesses

Standard & Poor's has adjusted for decommissioning provisions (referred to as asset-retirement obligations published in the article titled "Standard & Poor's Encyclopaedia of Analytical Adjustments for Corporate Entities," published July 9, 2007) in the oil & gas, utilities, and metals & mining sectors for a number of years. These adjustments have not always been made due to a lack of data, which is usually down to poor disclosure by the companies concerned.

Our adjustment to debt focuses on the provision recorded by the company less any dedicated funds (such as those listed by Xstrata and Anglo American in relation to South African mines), and also factors in any future tax benefit. If the provision is discounted, we will treat the annual accretion (unwinding of the discount) as an interest cost. Typically, under IFRS, companies will also treat this as a finance cost, whereas under U.S. GAAP it will initially be treated as an operating cost. We also seek to adjust funds from operations (FFO) to represent a yearly cash cost related to the provision. This final adjustment (similar to our adjustment for pensions) takes into account the total accretions for the year, actual cash spent, and the annual increase in the provision based on normal operations.

We currently only adjust for decommissioning provisions and not environmental provisions. When a company undertakes oil and gas exploration activities or mining operations, it is generally expected that eventually decommissioning/rehabilitation of the site will be undertaken in the future. Although a majority of environmental provisions (especially for the chemical companies) relate to site cleanup, many of these liabilities were not foreseen nor of course planned, therefore they generally are over a shorter time horizon and can result in much more volatile payments.

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