Commercial Value From Sustainable Local Benefits in the Extractive Industries: Local Content

Michael Hackenbruch, Director, Advisory Services
Jessica Davis Pluess, Associate, Advisory Services

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About This Report

This report was written by Michael Hackenbruch, Director, Advisory Services, and Jessica Davis Pluess, Associate, Advisory Services, with support from Farid Baddache, Tim Buchanan, Pablo Fuentes, Chris Nolan, and Michael Oxman. It is part of a series of briefing notes BSR is publishing in 2011 on emerging trends and practical solutions in delivering sustainable local benefits and commercial value. For comments or questions please contact Michael Hackenbruch (mhackenbruch@bsr.org) or Jessica Davis Pluess (jdavispluess@bsr.org.)

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Defining Local Content

The term "local content" typically refers to the added value brought to a host country through the procurement of goods and services and local workforce development. Some companies expand this definition to include strategic community investments.

The definition of "local" can vary by region and industry. A narrow understanding of "local" is frequently used in mining operations where the majority of employment and procurement is done in country. In this case, "local" tends to refer to the immediate vicinity of an operation. This also applies to the oil and gas industry; but as operations tend to be larger and more capital intensive in the oil and gas industry, "local" content often refers to any in-country expenditure. In these cases, the terms "local" and "national" content are used interchangeably, especially in regulatory or contractual provisions.

Determining what qualifies as "local" content with respect to procurement has been debated extensively over the years. In some cases, it equates to a locally owned business with local capital invested, while in others it is any business that maintains a permanent operational presence within a given area.

Introduction

Delivering local benefits in the communities where extractives companies operate is no longer a choice. It is a commercial necessity—and one that is increasingly mandated by law. In the new competitive landscape of waning supply and increasing demand for energy and mineral resources, companies in the extractive industries face rising expectations to do more than simply mitigate negative impacts, serve as sources of tax/royalty revenue, and act as good neighbors.

Today, business success depends upon the ability of companies to develop local talent, build a competitive local supplier base, and deliver lasting socio-economic benefits to the areas where they operate. The growing number of reported cases of project interruptions due to non-technical risks—including stakeholder pressures, socio-economic conditions and national politics—is a testament to this. Analysis by Environmental Resources Management of delays associated with a sample of 190 of the world's largest oil and gas projects (as ranked by Goldman Sachs) found that 73 percent of project delays were due to "above-ground" or non-technical risk, including stakeholder resistance, compared to 21 percent due to technical risk.

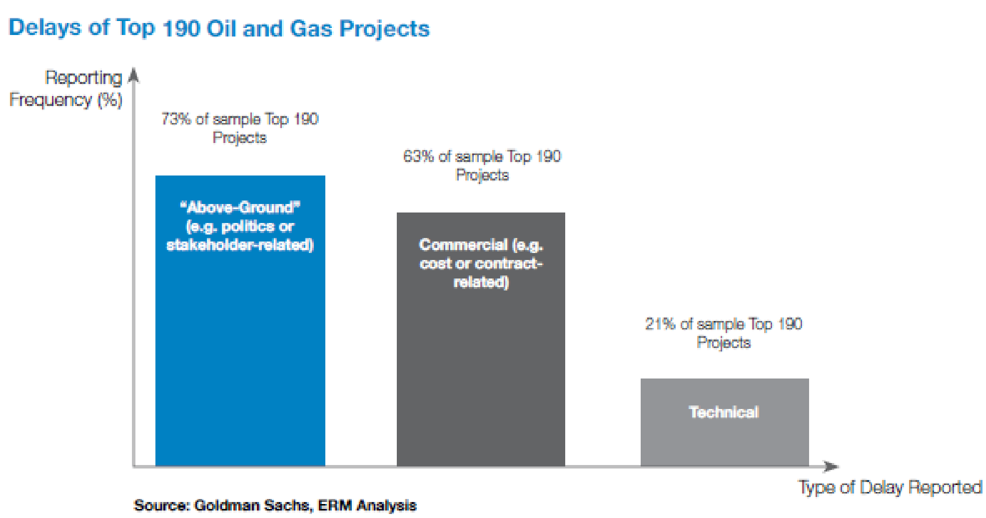


Figure 1: Delays as a result of non-technical risk[1]

The number of large mining corporations from developing economies is increasing, with 40 percent of the top mining companies now domiciled in the BRIC countries (Brazil, Russia, India and China).

Source: "The New Politics of Natural Resources," ERM

Some companies have responded to non-technical risks through isolated investments in community development. Increasingly, however, companies are finding that they can drive more sustainable and commercial value with integrated investment approaches to community engagement by leveraging company resources (from the asset to corporate level), third-party expertise, civil society and multi-lateral partnerships, and proactively developing local capabilities with strategic planning.

Although increasingly required by law in the oil and gas industry, local content represents the most strategic contribution a company can make to securing its social license to operate and leaving a positive legacy in countries. If designed and implemented effectively, local content offers an opportunity for companies and governments to unlock mutual benefit from resource extraction by focusing on companies' core competencies and supporting long-term economic growth prospects. It is particularly relevant to large-scale projects in the mining and oil and gas industries, yet the drivers, approaches, and tools for implementation can vary between these industries.

This paper offers insights into the key trends driving higher expectations of extractives companies, highlights some of the challenges and opportunities for companies in building local content approaches that drive commercial value, and provides recommendations based on BSR's 15 years of experience working with companies in the extractive industries.

A New Competitive Landscape

As the demand for scarce resources grows, companies are operating in areas that have yet to see widespread benefits from oil and mineral extraction, and have experienced what many perceive to be significant negative environmental and social impacts. In response, both communities and governments are seeking ways to capture more value from their resource wealth, leading to a more competitive landscape and higher expectations on international companies.

Greater risks in accessing scarce resources

With current economic growth projections, it is unlikely that the world's appetite for natural resources will decline significantly in the next 20 to 30 years. Accessing new sources of supply to meet these demands has become much more difficult and expensive due to both physical and geo-political constraints. While shale and oil sands in the United States and Canada still offer sizable reserves, it is expected that in the next 20 years 90 percent of oil reserves will come from frontier countries and developing economies, compared to 60 percent just three decades ago. Higher political, social and environmental risks in many of these countries, combined with more sophisticated technical demands of exploring oil in more remote regions and deeper reservoirs have contributed to what analysts estimate is a three-fold increase in the cost of discovering each new barrel of oil and gas over the last decade.[2]

While the location of mineral resources is more dispersed than oil and gas, some of the largest deposits of aluminum, copper, nickel, iron ore, gold, silver, and platinum are found in Russia, China, and developing economies in Africa, South America, and the Asia Pacific region, where secure access to resources and social and political risks remain key concerns for the industry. A cyanide use ban in the Argentinean provinces of Chubut and Rio Negro, production blockage at the Yanacocha mine in Peru, and attacks on the North Mara mine in Tanzania are all recent examples of the growing importance of non-technical risks to mining operations.

88% of the world's oil and natural gas reserves are under the control of state-owned national oil companies.

Source: US EIA, Independent Statistics and Analysis

Shifts in bargaining power for control of natural resources

In many of the countries where natural resources are located, activities related to their extraction and production represent a significant contribution to the national economy. Mining accounts for 5 percent of Ghana's GDP and minerals account for about 37 percent of total exports, of which gold is the most important, accounting for over 90 percent of the total mineral exports. Oil exports represent 70 percent of overall exports and 24 percent of the GDP in Kazakhstan.[3] In economies that are highly dependent on the extraction of resources, controlling these resources yields incredible bargaining power for national governments and increasingly puts international companies on the defensive.

In the oil and gas industry, governments are positioning National Oil Companies (NOCs) to expand beyond managing licenses to operate actively in exploration and production and securing hydrocarbon reserves abroad. Long gone are the days when integrated oil companies like ExxonMobil, BP, RoyalDutchShell and Chevron dominated the industry in market capitalization. The top 15 companies in the industry today also include: PetroChina, Petrobras (Brazil), Eni (Italy), and Gazprom (Russia), all of which are state-owned to a greater or lesser extent.[4]

The repositioning of NOCs in the industry is changing the rules of the game as the heavy involvement of the state means these companies are not only shouldering the economic and social development goals of the country (including the NOC's own capacity to build local content), but also functioning as commercial entities. One result of this situation is that there is increased pressure on international companies from NOCs to deliver more local benefits and develop local talent to support the overall government agenda, as well as to help build the NOC's own long-term commercial capabilities.

At the same time that they maintain control of resources at home, NOCs increasingly represent their respective state interests in securing access to resources beyond their boundaries. This is accomplished by leveraging their political backing and diplomatic ties, and linking concessions to financing facilities and infrastructure investments to support local economic growth. Chinese companies in particular are tying large government-to-government loans and massive infrastructure investments with oil and gas agreements. Like their international counterparts, many NOCs face challenges in delivering benefits to communities in jurisdictions well beyond their traditional domains.

For the mining sector, the scenario is slightly different, but there are numerous cases of mining companies receiving "home" state backing in overseas markets. Chinese mining companies, both state-owned and smaller collectives, are investing abroad in places like Peru, Zambia, Papua New Guinea, and Cameroon through specific mining leases, major processing facilities such as smelters, joint ventures with local companies, and acquisitions of shares in overseas mining companies with a range of assets.[5]

Communities seek to reap more economic benefits from resource extraction

While companies face increasing competition in accessing resources, there are also more demands from stakeholders, particularly communities, to remedy the legacy of missed opportunities in translating resource wealth into widespread benefits for communities. Mismanaged revenues by governments and entrenched corruption, combined with inefficiencies and poorly designed development projects, have limited opportunities for communities to reap direct local economic benefit of large-scale projects and have left many communities living in poverty and amidst political instability. This has contributed to rising tensions among communities, resource companies, and governments.

This is an important driver for rising expectations of companies, particularly in the mining industry, in which there are increasingly vocal communities backed by international NGOs, which have elevated community concerns to a global level and engaged media and end users in demands for more local benefits from resource extraction.

Codifying regulations around the delivery of local benefits

In response to these community demands and a desire to expand local industry, governments have raised demands for local hiring, local procurement, and local beneficiation. In some cases, governments have unilaterally declared that existing energy and extractives' concession agreements must be renegotiated in a manner that resorts to "resource nationalization."

In the oil and gas sector, a number of governments have established stringent requirements on local content—either through legal frameworks or contractual terms, which range from simply requiring companies to give preferential treatment to local suppliers to sophisticated local content policies that include provisions on local capability building through knowledge transfer, joint ventures, and preferential pricing to local firms, among others.

Local Content Requirements: Oil and Gas Industry[6]

Indonesia	Until 2009, there was little regulation around the use of local/national labor and/or goods and services in the oil industry in Indonesia. However, at the end of 2009, the Indonesian regulatory agency for oil and gas, BPMIGAS, imposed stringent requirements for local content in exploration and production activities. These requirements were included under the Ministry of Industry's "Technical Guidance of Usage of Local Production" Regulation 49. The regulation requires foreign bidders for energy services contracts to use a minimum of 35 percent domestic content in their operations. Foreign energy services companies that cannot document their compliance are subject to substantial fines.
Brazil	Prior to 2002 there was no minimum local content requirement in Brazil. However, through the various bid rounds, local content rules have become more tangible and specific to different fields according to on/offshore and the depth of water involved. The primary objective of the Brazilian local content policy is to "maximize goods and services national industry content, within competitive and sustainable basis, in the implantation of oil and gas projects in Brazil and abroad." Petrobras' strategic investment plan calls for 65 percent of equipment and services to be sourced from domestic suppliers.
Kazakhstan	In 2007 amendments to the country's energy and mining legislation reflected a change in government attitude toward local content from an informal expectation to a legal requirement that included definitions, monitoring procedures, and quality standards. In late 2009, the rules on local content became much more stringent through the "Law of the Republic of Kazakhstan No. 223-IV," which established minimum requirements for Kazakhstan content when concluding subsoil usage contracts. When transitioning from exploration to extraction, the competent state authority is entitled to unilaterally set requirements for Kazakhstan content with regard to goods, works, and services. If the contractor rejects these requirements, it loses its preferential right to the extraction contract. The law, which came into effect in January 2010, set a target for the level of product procurement from Kazakhstan suppliers at 50 percent by 2012, and for services—up to 90%.

While resource nationalization is nothing new in the mining industry, international mining companies are becoming increasingly attractive targets for additional taxation, contract renegotiations, and mandatory investments in social development projects. Most recently, the new president of Guinea, Alpha Condé, announced that he would revisit an existing mining contract with Rio Tinto, as well as other agreements signed by his predecessors. [7] Similar disputes over potential control of resources are occurring in South Africa, among other countries. Indonesia has also introduced requirements for mining companies to give preference to local subcontractors and service companies, and process and smelt ore domestically.[8]

Commercial Value and Sustainable Local Benefits

External pressure is mounting for companies to take on more responsibilities for economic growth and social progress of host countries, but most companies are not equipped to fulfill such mandates. In the race to secure resources, companies are seeking to satisfy immediate expectations at the peril of inefficiencies and high costs, while governments aim to capture wealth generated by resources, but often without a long-term and holistic vision.

While companies have always sourced goods and services locally and supported local employment, the traditional mindset has focused on meeting short-term cost pressures by hiring personnel and procuring the majority of goods and services from outside communities through established supply chains, rather than building up local skills and industry. This can no longer be the case in a world of increasing demands for local content.

There are a number of obstacles to establishing programs that deliver long-term value to both companies and communities through local content. These challenges stem from both the external context companies are operating in and the internal organizational structures and processes necessary to execute strategies that deliver local benefits.

Some of the obstacles to designing and deploying local content programs include[9]:

- Internal inconsistencies in view of strategies and focus across the project life cycle, and insufficient internal and external design and execution capacities and capabilities
- Shortage of adequate or appropriate industrial skills in local community to meet company needs
- Pre-requisite of ensuring access to basic services and infrastructure by communities, particularly in remote areas
- Weak enforcement of social and environmental standards among local businesses
- Complex procedures and costs for small- to medium-sized local businesses associated with procurement prequalification requirements
- Local content requirements that exceed local industry growth potential and contribute to unintended negative consequences in economic and social development
- Insufficient coordination with internal and external stakeholders, and the absence of transitioning and exit strategies

If executed effectively, local content programs offer an opportunity for companies to meet business needs for more efficient supply chains while maximizing development benefits by helping local companies grow and become competitive, as well as raising household incomes, all of which have a number of multiplier effects. Below are some of the potential outcomes that can be achieved through local content.

Commercial Value Outcomes

- Reliability of supply and cost efficiencies through local sourcing and close proximity to supplier structures
- Social license to operate and improved relationships with host communities
- Greater value of community investment resources
- Strategic relations with host governments and government authorities

Sustainable Local Benefit Outcomes

- Long-term employment opportunities by building transferable skill sets in local communities
- Growth of competitive and commercially sustainable businesses—potential for additional supplier/customer relationships
- Multiplier effect through sustainable economic growth and spending in communities

Recommendations for Optimizing Commercial Value Through Local Content

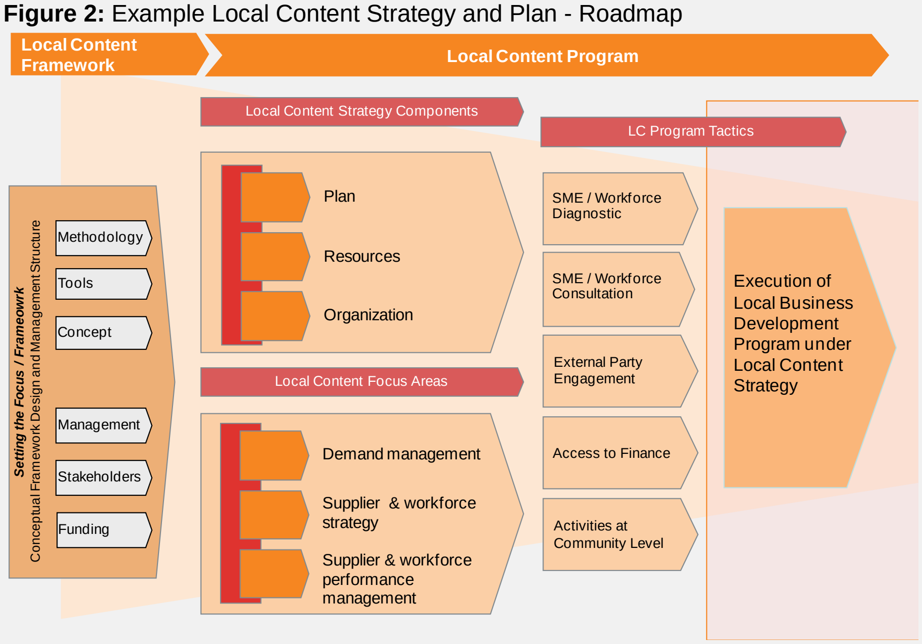
Through BSR's experience working with companies in Asia, Africa, and Latin America, we have gained a unique perspective on the internal and external ingredients needed to deliver local benefits effectively through local content—from design through implementation. While we assert that local content programs are essential to success in today and tomorrow's energy and mineral markets, they are part of a larger requirement to manage non-technical risks and stakeholder expectations. Below are 10 recommendations for successfully delivering local benefits and commercial value through local content.

Summary of Recommendations

1) Make local content a core part of business planning and strategy
2) Consider local content within overall fiscal/commercial negotiating terms
3) Break the silos and align internal incentives
4) Partner with key contractors to share risks
5) Align community investment with local content goals
6) Drive supplier competitiveness through capacity development
7) Accept a higher level of complexity in the supply chain
8) Take a life-cycle approach to enhancing employment opportunities
9) Leverage partnerships with peers and other institutions to scale impact
10) Invest in internal capacity building at corporate and site levels

1) Make local content a core part of business planning and strategy.
Local content is not optional nor can it be an afterthought. The traditional mindset of addressing local concerns has placed local content as a sidebar, leading to lost value and weak on-the-ground implementation. The importance of local/national economic contributions in commercial negotiations, combined with the rise of government and community expectations, reinforces the need to make local content programs a centerpiece of business planning and strategy. Building a systematic plan for local content at the outset of a project is critical in identifying and maximizing the opportunities to drive value through local content.

Figure 2: Example Local Content Strategy and Plan - Roadmap



2) Consider local content within overall fiscal/commercial negotiating terms.
Governments are using a variety of levers in negotiations with companies, primarily in the oil and gas sector, in attempts to maximize gains from resource extraction. This can include local content and may also include fiscal terms negotiated as part of Production Sharing Agreements, corporate social responsibility (CSR) expenditures, maximum expatriate levels, beneficiation, and other related requirements. It is critical that companies include the value of investments in local content programs, such as local capacity building, as part of negotiations on fiscal terms or short-term oriented local content targets.

3) Break the silos and align internal incentives.
Developing the right project and process management systems internally for local content is key to ensuring that local content programs benefit from the intended technical and operational improvement objectives. Local content programs have often been rigid, stand-alone projects that are isolated in specific disciplines or departments, such as CSR, HSE, or procurement. The lack of a holistic strategy on local content for many companies has led to inefficiencies and lost opportunities for both commercial and community gain.

Effective local benefit programs require companies to break the silo approach to business units and build cross-functional teams to optimize efficiencies and leverage strengths within companies. These cross-functional teams may be most effective in promoting collaboration if they are built around strategic goals or themes (i.e. capacity building, supporting local infrastructure, etc.) rather than business unit goals.

Case Study: ExxonMobil

ExxonMobil has been pursuing national content for many years, but it has always varied by country depending on local laws, country infrastructure, and supplier base. However, over the last few years the company decided to build a global strategy for national content with guidelines and standards that could be deployed at every operation. ExxonMobil's approach is unique in the way it integrates community investment into its overall strategy for pursuing national content. These include investments in health, education, and infrastructure.

The three pillars to any ExxonMobil National Content Plan are:

- Workforce Development
- Strategic Community Investments
- Supplier Development

Source: ExxonMobil national content strategy, http://www.exxonmobil.com/Corporate/Files/news_pub_nc.pdf

4) Partner with key contractors to share risks.

Local content is increasingly becoming a critical issue for service providers and Engineering, Procurement and Construction (EPC) contractors as operators define the national/local content terms and push down the responsibility to meet these terms to suppliers. Companies should engage contractors and service providers to align and leverage their respective local content strategies into processes and delivery. If discussed at the outset of collaboration, operators and contractors can identify opportunities for risk sharing and consider ways to re-work contracts and invest resources in local procurement development to help maximize long-term local content value.

5) Align community investment with local content goals.

Community investment in basic infrastructure and services in countries remains an important part of any oil and gas and mining companies' social performance strategy. However, approaches to community investment have largely been focused on risk mitigation and social license to operate rather than optimizing long-term economic opportunities for the company and communities. In contrast, companies are finding that the most successful and sustainable social investment strategies are those that support core business objectives and leverage key strengths of the company, as well as align with country/community development goals. Leveraging community investments in capacity building, local enterprise and business development, education, health, and other services that support local content reduce inefficiencies and ensure that value is not lost in one-off projects with little long-term benefit prospects. Examples include access to finance instruments for the supply chain, business development services, and vocational training programs for skills needed by the industry.

6) Drive supplier competitiveness through capacity development.

One of the biggest barriers to engaging local suppliers in large-scale mining or energy projects is a shortage of skills. Since energy and mining projects usually involve large capital expenditures, technical complexity, and uncertain commercial returns, shifting the sourcing of goods and services from global to local providers has the potential to increase project costs, delay schedules, and negatively affect commercial value. In countries such as Chad, which have little business foundation to support the oil and gas industry, a lack of skilled labor, along with major gaps in government services and supporting infrastructure, companies have had to bear the majority of the costs and risks associated with programs aimed at building local capacity and engaging local suppliers in industry value chains. The mining industry has also been battling project delays and higher project costs due to a shortage in qualified mining staff and scarce technical and artisanal skills.

BSR believes there are three key ingredients to an effective supplier development strategy. First, companies should understand their offering potential and existing supply capabilities within the country along different spend categories. BSR encourages companies to carry out strategic sourcing assessments, as well as assessments of local supplier skills and institutional settings, to see how these correspond to company procurement needs. Second, we encourage companies to engage in capacity building for potential suppliers through programs targeted at upgrading capabilities to meet company needs for reliable and skilled suppliers, as well as help local firms compete in local and national markets. Lastly, to drive competitiveness companies should promote accountability. This means measuring the success of supplier development programs using the same business metrics around quality, consistency, and efficiency with local suppliers that a company would use for any other suppliers.

7) Accept a higher level of complexity in the supply chain.

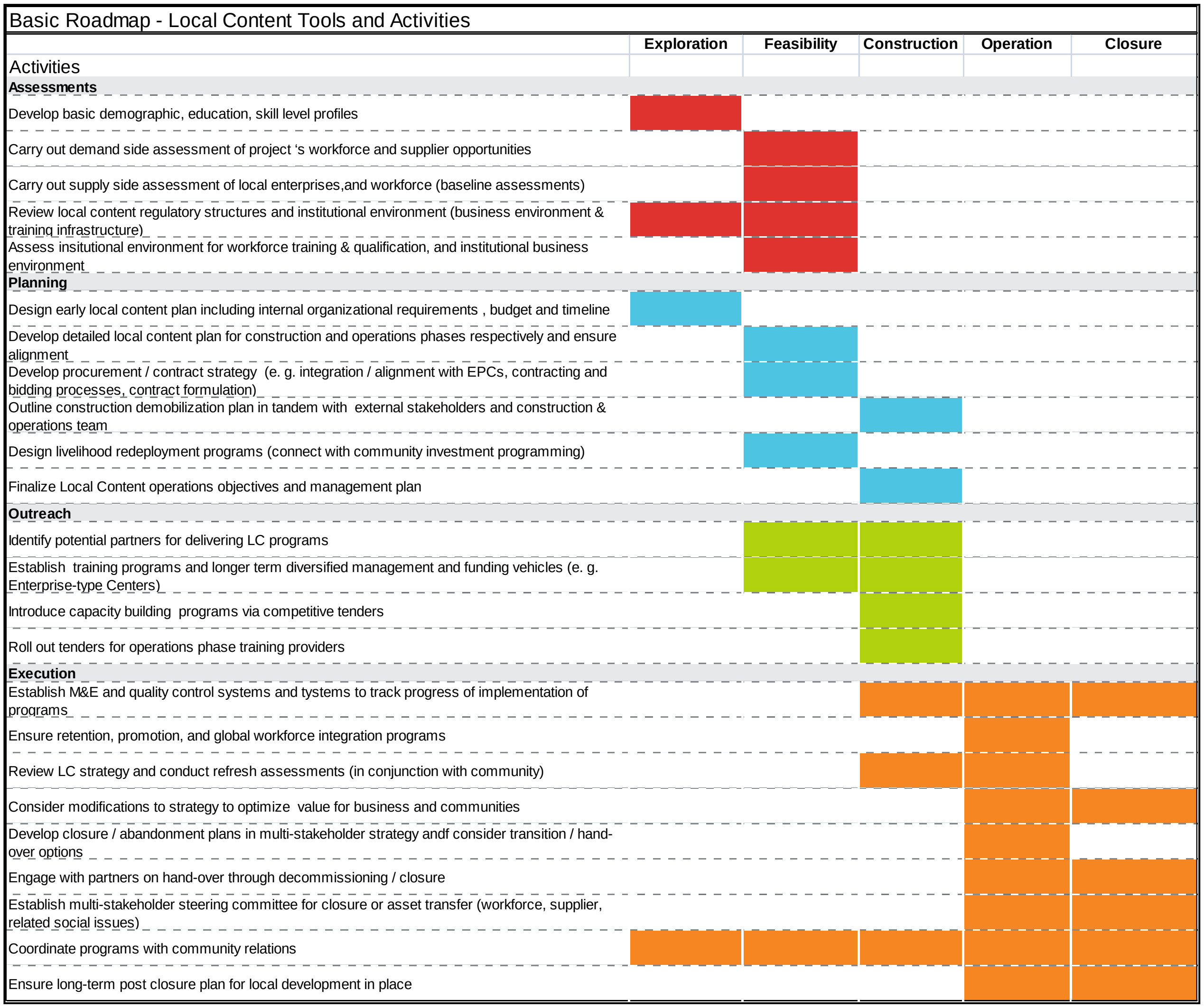
Maximizing the commercial value of local content requires a willingness to innovate procurement policies, strategies, processes, and contractual arrangements, and create a different level of complexity in the supply chain. In cases where local supplier capacity exists, reviewing supplier contracting arrangements, breaking down work packages by unbundling contracts, easing payment terms, and creating a favorable subcontracting environment can help expand opportunities to engage local suppliers. This, however, implies higher risk exposure and cost, requiring careful management. In some cases, instead of unbundling contracts, companies may find it more beneficial—from both a risk and competitive advantage perspective—to develop a procurement strategy that incentivizes international contractors to engage local suppliers in a way that supports skill upgrading and enhanced competitiveness. It should be noted that strategies may not be replicable in every country and may actually require adjustments to the tendering processes in countries.

8) Take a life-cycle approach to enhancing employment opportunities.

The greatest opportunity for large-scale employment in the oil, gas, and mining industries is in the construction phase. In the oil and gas industry, the rest of the project life cycle remains highly capital intensive with demands for only a small number of higher skilled workers. While the mining industry offers more lower skilled employment opportunities throughout the life of a project, both industries provide limited long-term employment opportunities. By developing a local content plan at the very early stages of resource evaluation and implementing programs prior to construction, companies can support sustainable workforce development.

In the oil and gas industry, companies have started to explore programs for post-construction demobilization planning, which includes retraining people so they can participate in other projects and sectors. Similarly, mining companies are undertaking mine closure planning. This has been most successful when it is developed jointly with host governments, engages NGO partners, and is included as part of initial business planning. Figure 3 (next page) captures some of the potential activities throughout the life cycle to optimize local content for sustainable benefits through effective planning.

Figure 3: Enhancing local content through life-cycle planning



9) Leverage partnerships with peers and other institutions to scale impact.
Partnering with other extractives companies offers the potential for investments in local content to have much greater and sustainable impact. This is particularly the case for capacity building in which an individual supplier or contractor has more incentive to raise its standards if it has the potential to service more than one company. In many cases, without the critical mass and potential sustainability that a group of companies can provide, many local content programs will not be sustainable. This also applies to working with NGOs, government, and other institutions that can help scale up programs and ensure there are long-term benefits beyond the life of a project/operation.

10) Invest in internal capacity building at corporate and site levels.
Investing in internal systems and people is critical to maximizing the commercial value of local content programs. This includes designing tools and modules to help resources at project level support implementation, such as a "toolbox" with field-based guidance on processes and practices. Adding internal capacity building programs to build local content awareness and implementation skills will also help staff anticipate change and adapt strategies to different local contexts.

Conclusion

Local content plans and programs are an increasingly important part of business strategy in the extractive industries. To be effective, these programs require early systematic planning and coordination with internal and external partners, and consistent application throughout the project phases. With the right tools, these programs can generate value for the business as well as contribute to long-term economic growth prospects in host countries.

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