14th September 2004

Re: Document Analysis

Draft Production Sharing Contract (PSC)

I. Introduction:

Production Sharing Contract is a type/kind of Petroleum Contract typically entered into by the Host Country's nominee (maybe a Ministry or National Oil Company) and the International Oil Companies (IOCs). The concept is based on the philosophy that the Ownership of the Petroleum shall always stay with the Host Country, and that the International Oil Companies are just acting as Contractor to explore and exploit it. In exploring and exploiting this resources there is quite substantial capital risk involved and the Contrators are to take these risks. Once the petroleum is produced the Contractors, after recovering all its initial investments in the exploration and development phase, shall share the production with the Host Country in an agreed formula.

Below is the standard outline contains typical sections/articles that are covered in a Production Sharing Contract (PSC) between a Host Country (HC)/Host Government (HG) or its nominee (National Oil Company) and the International Oil Companies (IOCs):

1. Definitions

(as required).

2. Scope of Contract

A clause describing in broad terms: the relationship between Host Country (whether it is represented by a Ministry or a National State Owned Oil Company) and the Contractor, appointment of the Contractor to carry out - at sole risk - exploration, development and production on behalf of State and to supply the technical expertise and the funds required for such operations and receive reimbursement, in accordance with the terms of the PSC.

3. Term of Contract

This clause establishes a maximum duration of the PSC, and subdivides that term into exploration, development and production periods. The PSC will automatically terminate if no commercial discovery is made during the exploration period. Contractor may withdraw at any time if it is of the opinion that the results of the operation are not sufficient, provided however that all exploration work committed up to the time of withdrawal must be completed.

4. Contract Area

This clause gives a definition of the area covered by the PSC (to be progressively reduced in accordance with the relinquishment provisions).

5. Minimum Exploration Program

This clause contains a detailed description of the minimum work to be performed by the Contractor, together with an estimate of the cost in each phase of the exploration program. A possible work program might include:

Phase 1 – evaluation of existing data, study of the petroleum model, seismic acquisition, processing and interpretation of the contract area
Phase 2 – drilling of wild cat wells
Phase 3 – drilling of appraisal wells
Phase 4 – drilling of production test wells

6. Relinquishment

This standard clause presents the requirements for the Contractor to progressively reduce the size of the contract area at stated intervals during the exploration period. By the end of the exploration period only development and production areas will remain. The clause also states rules regarding the form and size of areas to be relinquished.

7. Operations Committee (optional)

This clause establishes an Operations Committee or Management Committee, on which both Host Country and the Contractor will be represented on an equal basis. The Operations Committee will be responsible (inter alia) for approval of work programs and budgets, approval of development plans, approval of development and production areas, review of any assessment of commerciality of a discovery, approval of programs for training and technology transfer, review of the Contractor's operations etc.

8. Conduct of Operations

This clause states the requirements for the Contractor to carry out operations according to the local laws and regulations and good oil industry practice and to maintain accurate records and books. The clause specifically sets out procedures for submission by Contractor of and approval by Operations Committee or Host Country's nominees of annual work programs and budgets and procedures for Contractor to make expenditures in excess of approved budgets.

9. Obligations of Host Country or its nominee (Ministry or National Oil Company owned by the State)

This clause obligates Host Country to assist the Contractor in such matters as establishing of necessary facilities in the country, obtaining supplies and equipment, securing entry permits for foreign employees, clearing equipment through customs, complying with foreign exchange regulations, dealing with government agencies, etc., and in identifying qualified local personnel for work in the Contractor's operations.

10. Commercial Discovery

This clause requires prompt economic evaluation of any deposit which the Contractor discovers and sets out a procedure by which the Contractor and Host Country can agree, within a defined, reasonable period of time, as to whether the discovery can be developed commercially. If a discovery is determined not to be commercial, the Contractor will relinquish rights to it. If a discovery is proven to be commercial, the Contractor will be required to submit a development plan for consideration to the Operations Committee. Guidelines are set forth to assess the commerciality of a discovery.

11. Financing

This clause specifies the Contractor's responsibility to provide the funds required for exploration and development, except to the extent that Host Country exercised its option to participate in development and production. An important section of the PSC explains the Contractors' entitlement to recover all exploration, development and operating costs.

12. Recoverable Cost/Cost Reimbursement and Share of Profit Petroleum

Petroleum production will be divided into the following amounts:

a) Royalty; currently in international standard ranging from 5% to 15% of gross production, payable to the State;

b) Cost Petroleum (with/without a maximum ceiling of x% of gross production) payable to the Contractor for recovery of exploration, development and operating costs. If Host Country or its nominees participates in supplying development and production expenditures, it will also share accordingly in this cost recovery;

c) Profit Petroleum; any amount remaining after (a) and (b) will be divided between Host Country and the Contractor according to an agreed formula. The amount payable to the Contractor under this formula will be considered as profit and as such will be subject to the Host Country's income tax.

13. Measurement and Pricing of Petroleum

The base for pricing the crude oil delivered to the stakeholders will be official f.o.b. prices established for term contract sales by major petroleum producing countries in international markets.

14. Taxation, Duty and Levies

This clause specifies the Contractor's liability to pay income tax, etc as well as all other taxes, fees and duties that are generally applicable in Host Country. There are no discriminatory fees, taxes and duties applicable in the Host Country. The clause also makes clear that material and equipment used in the operations are excluded from import duties and that there are no taxes and duties on the export of petroleum.

15. Domestic Supply Requirement

This clause states that in the event that petroleum available to the State from its entitlements and those of Host Country are insufficient for domestic needs, Contractor and any other third party producing oil in the country will be required to supply a volume of oil.

16. Associated Gas

Any associated natural gas and any non-associated natural gas not used in petroleum operations, belongs to Host Country.

17. Information

This clause requires the Contractor to supply timely and complete information to Host Country on all aspects of the Contractor's work. The clause also specifies that samples and original data collected by the Contractor are the property of Host Country, and provides for inspection of Contractor's facilities and records by representatives of Host Country. The Contractor will also be required to supply periodic reports describing work done to date. All information received by Host Country from the Contractor will be subject to appropriate confidentiality provisions.

18. Inspection, Safety and Environmental Protection

The Contractor will be required to conform to health and safety standards adopted by the local Host Country's Government under the authority of the Petroleum Law. Host Country and or the Government can appoint inspectors to ensure that these standards are being enforced. The Contractor will be required to conform to environmental protection standards adopted under the Petroleum Law and relevant good oil field standards and practice to ensure that no damage is done to the environment. This clause also provides for compensation in the event of damage, and for the right of Host Country to take action, at the Contractor's expense, if the Contractor fails the Law to stop pollution.

19. Accounting and Auditing

This clause contains requirements for maintaining financial records, in accordance with an agreed accounting procedure and for filing of periodic financial reports by the Contractor.

20. Title to and Control of Facilities and Equipments

This clause indicates Host Country's ultimate ownership of the petroleum produced and of all assets used in the project, except those imported temporarily for exploration and re-exported, or those leased for short periods. The Contractor will have rights to use such assets and to recover their cost, according the cost reimbursement and payment clause.

21. Local Purchasing and Procurement

The Contractor will give preference in purchasing goods and services produced or provided in the Country, provided such goods and services are comparable to imports.

22. Local Employment and Training

The Contractor will give preference to hiring Host Country's nationals, in accordance with an agreed timetable for localization, and will establish appropriate training programs.

23. Assignment

The Contractor may not assign rights under the PSC to any other parties without the consent of Host Country.

24. Force Majeure

This clause is the standard force majeure clause suspending the parties' obligations to the extent that they are unable to fulfill them because of events outside their sphere of influence.

25. Termination

This clause provides for termination of the PSC in the event of certain specified occurrences, e.g. failure to make a commercial discovery within the exploration period, serious failure by the Contractor to perform its responsibilities. The clause will also set out a procedure for termination.

26. Local Office and Notice

The Contractor will be required to establish a local office to carry out its development and production responsibilities.

27. Arbitration

This clause permits arbitration of disputes between the Contractor and Host Country (but not disputes over taxation and other State fiscal impositions, which would be resolved under the appropriate law). Arbitration will be conducted under an agreed procedure providing for an internationally appointed arbitrator.

28. Good Faith

This clause states that both parties undertake to act in good faith.

29. Effective Date

This is a formal clause specifying when the PSC will come into force (e.g., following signing and Ministerial approval).

30. Governing Law and Language

The governing law of the contract will be the law of Host Country. The contract will be executed in X Country and parties may decide to make a working text for the day to day operations in English.

II. Order of Importance:

Depending on the situation and condition of the Host Country or the Host Government the order of importance of the above sections/provisions may vary from one country to another. However, normally they can be classified into three categories:

A. Highly Critical for Host Country's Interest

This means, the provisions below **shall exist** in the PSC and **shall be emphasized** as such to really ascertaining the Host Country's interest and position:

1) Recoverable Cost/Cost Reimbursement and share of Profit Petroleum
2) Local Purchase and Procurement
3) Local Employment, Training and Transfer of Technology
4) Local Office and Notice
5) Title to and control of Facilities and Equipments
6) Domestic Supply Requirement
7) Inspection Safety and Environment Protection

B. Critical to both Host Country and International Oil Companies' interest

This means, the provisions below shall exist to serve equally the interest and position of the Host Country or its nominee, the resource Owner, and the International Oil Companies, the Contractors. These provisions shall be well defined in every PSC.

1) Definitions
2) Scope of Contract
3) Term of Contract

4) Contract Area
5) Minimum Exploration Program
6) Relinquishment
7) Operations Committee (optional)
8) Conduct of Operations
9) Obligations of Host Country or its nominee (Ministry or National Oil Company owned by the State)
10) Commercial Discovery
11) Financing
12) Measurement and Pricing of Petroleum
13) Taxation, Duty and Levies
14) Associated Gas
15) Information
16) Accounting and Auditing
17) Assignment

C. Important to both Host Country and International Oil Companies' interest

This means, the provisions below are necessary to make the contract more certain and not to be ambiguous in the case of problems or disputes arisen during the contract period, etc, as such it is an important part of every PSC.

1) Force Majeure
2) Termination
3) Arbitration
4) Good Faith
5) Effective Date
6) Governing Law and Language

III. Examining Timor-Leste Draft Production Sharing Contract

The current draft of Timor-Leste's Model Production Sharing Contract is essentially similar to the existing Production Sharing Contract Model in the JPDA, with some minor modifications.

Some Criticism and Suggestions are provided to the following Articles, Sections, and or Paragraphs. The examination is done based on the categories developed above namely, first

Highly Critical provisions:

1. Recoverable Cost/Cost Reimbursement and Share of Profit Petroleum:

In the current draft PSC this provision is provided in Article 6 and 7:

Article 6 Recoverable Costs

6.1 Generally

(a) The Contractor's accounts shall be prepared and maintained in accordance with Annex C.

(b) Only costs and expenses incurred by the Operator in carrying on Petroleum Operations, and (unless the Contractor is only one person and the Contractor and the Operator are that person) properly charged to the Contractor under an agreement made between them and consented to by the Ministry, are Recoverable Costs, but without prejudice to any other provision of this Agreement which would result in any such cost or expense not being a Recoverable Cost.

6.2 Recoverable Costs

In any Calendar Year, Recoverable Costs are, subject as further provided in Annex C, the sum of those of the following that are not ineligible costs:

(a) the sum of:

(i) Recoverable Exploration Costs;

(ii) Recoverable Appraisal Costs;

(iii) Recoverable Capital Costs; and

(iv) Recoverable Operating Costs;

(b) Decommissioning Costs Reserve, allowable in that Year;

(c) Recoverable Costs in the previous Calendar Year, to the extent in excess of the value of the Contractor's share of Petroleum under sub-paragraph 7.1(b)(i) in that previous Calendar Year; and

(d) Beginning in the Calendar Year seven (7) years prior to the Calendar Year in which Ministry approval has been given for the first Development Plan, a Quarterly amount equal to the product of the rate of Uplift and the Quarterly balance of outstanding Recoverable Costs;

less Miscellaneous Receipts and less any deductions pursuant to paragraph 7.4(a).

Article 7 Sharing Of Petroleum

7.1 Determination of Shares

In each Calendar Year, the Parties shall take and receive the following shares of every grade and quality of Petroleum as and when it is delivered at the Field Export Point:

(a) the Ministry:

(i) five (5) percent; plus

(ii) its share of any balance as mentioned in paragraph 7.1(c);

(b) the Contractor:

(i) ninety five percent (95) but not more than is equal in value to Recoverable Costs for the Calendar Year concerned; plus

(ii) its share of any balance as mentioned in paragraph 7.1(c);

(c) any Petroleum not taken by the Contractor under sub-paragraph 7.1(b)(i) shall be shared as to fifty (50) percent by the Ministry and as to fifty (50) percent by the Contractor.

ITEMS OF CONCERN:

- ✍ Provision for allowance of **Uplift** as Recoverable Items **(Paragraph 6.2d)**. The Uplift is an Income, it is not an Expenditure, packaging it under the Recoverable Cost provision, without further defining it may result, the Uplift to become a "hidden income". Moreover, it is an incentive which not always necessary to be provided. Not many countries provide such an incentive. It is comparable with Investment Credit which is normally given only to the areas of explorations that are very difficult and unattractive. Malaysia, China, India, Pakistan, and many others do not provide Uplift or Investment Credit. Only Indonesia gives Investment Credit but to the extent of 110% for gas development in areas like Lokshomawe – Aceh, where the petroleum prospectivity is very low and which without Investment Credit investor will hesitate to come. Timor-Leste's petroleum prospectivity can be considered ***very high*** and has attracted many oil companies. Therefore, this provision ***is not needed***, and least of all provided and packaged under the Recoverable Cost.
- ✍ The calculation for Profit Petroleum follows this formula:

Profit Petroleum = Gross Production of Petroleum – Recoverable Costs Petroleum

Profit Petroleum is the bulk of Income that is Taxable under Timor-Leste's Petroleum Tax Law (income tax). If Uplift is included in the Recoverable Costs provision; *first*, it will add-up to the amount of Recoverable Costs – therefore reduces the bulk of Profit Petroleum; *second*, it will not be taxable – therefore reduces Host Country's income from taxes; *third*, it will allow inefficiency in costs because Contractor make more money from this end than from Profit Petroleum and such the Contractor will tend to blow-up the cost.

- ✍ Share of **Profit Petroleum (Paragraph 7.1c).** This provision disregards the differences of exploration, development, difficulties, costs of petroleum operations in different environment such as Onshore, Offshore Shallow Water (0-200 meters), Offshore Deep Water (200-1000 meters) and Offshore Ultra Deep Water (>1000 meters). As the hardship of petroleum operations is different from one environment to another, the share of Profit Petroleum shall also vary from one environment to another. Furthermore, as the development cost of Oil and Gas is different, the share of Profit Petroleum shall also be different. It is therefore, suggested that the Share of Profit Petroleum should follow the formula presented below to reflect the different environment and petroleum component.
- ✍ Wording and paragraph arrangement. The wordings are too ambiguous and not clearly articulated.

SUGGESTIONS:

Article 9 Sharing of Petroleum [to change article 6 & 7]

[the numbering of this Article has been based on the order as set in the Palacio das Cinzas' Alternative PSC]

9.1 Cost Petroleum

(a) All expenses incurred by the Contractor in carrying out Petroleum Exploration, Appraisals, Development and Operations and Decommissioning Cost Reserve consistent with the Approved Work Programmes and Budgets are hereto considered as Cost Petroleum for the purpose of this Agreement;

(b) The Contractor is entitle to recover the Cost Petroleum

(c) The Contractor's accounts shall be prepared and maintained in accordance with Annex C;

(d) Recoverable Costs

In any Calendar Year, Recoverable Costs are, subject as further provided in Annex C, the sum of those of the following that are eligible costs:

(i) the sum of:

(aa) Recoverable Exploration Costs;

(bb) Recoverable Appraisal Costs;

(cc) Recoverable Capital Costs; and

(dd) Recoverable Operating Costs;

(ii) Decommissioning Costs Reserve, allowable in that Year;

(iii) Recoverable Costs in the previous Calendar Year, to the extent in excess of the value of the Contractor’s share of Petroleum under sub-sub-paragraph 9.2(b)(ii)(aa) in that previous Calendar Year; and

[NO UPLIFT]

less Miscellaneous Receipts and less any deductions pursuant to paragraph 9.6(a).

9.2 First Trenche Petroleum

(a) In each Calender year twenty (20) percent value or quantity of Petroleum Produced at the year concerned, prior to reimbursement of any Cost Petroleum shall be set aside and to be split between Timor-Leste (PETRONATIL) and the Contractor at the ratio 25%:75%. The First Trenche Petroleum shall be paid in cash or in kind if the PETRONATIL so elects.

(b) Determination of Share

(i) The PETRONATIL:

(aa) five (5) percent from its share of First Trenche Petroleum; plus

(bb) its share of any balance as mentioned in paragraph 9.3(b or c or d, whichever is applicable);

(ii) the Contractor:

(aa) Fifteen (15) percent from its share of First Trenche Petroleum; plus

(bb) Eighty percent (80) but not more than equal in value to Recoverable Costs for the Calendar Year concerned; plus

(cc) its share of any balance as mentioned in paragraph 9.3(b or c or d, whichever is applicable);

any Petroleum not taken by the Contractor under sub-sub-paragraph 9.2(b)(ii)(cc) shall be considered hereto as Profit Petroleum.

9.3 Profit Petroleum

(a) In each Calendar Year the remaining Petroleum available after deduction for Cost Petroleum and First Trench Petroleum shall be considered as Profit Petroleum, and shall be shared between PETRONATIL and Contractor following the formula provided in paragraph 9.3(b or c or d, whichever is applicable);

(b) In each Calendar Year, if the Development Area is in Onshore Area, the share of Profit Petroleum shall:

(i) split 40 % : 60 % between PETRONATIL and Contractor for oil production up to 20,000 barrels/day;

(ii) split 50 % : 50 % between PETRONATIL and Contractor for oil production between 20,000 to 50,000 barrels/day;

(iii) split 60 % : 40% between PETRONATIL and Contractor for oil production more than 50,000 barrels/day

(iv) for gas; split 50%: 50% between PETRONATIL and Contractor at all rate of production.

(c) In each Calendar Year, if the Development Area is in Offshore Area with water depth from 0 – 200 meters, the share of Profit Petroleum shall:

(i) split 35 % : 65 % between PETRONATIL and Contractor for oil production up to 20,000 barrels/day;

(ii) split 45 % : 55 % between PETRONATIL and Contractor for oil production between 20,000 to 50,000 barrels/day;

(iii) split 55% : 45% between PETRONATIL and Contractor for oil production more than 50,000 barrels/day

(iv) for gas; split 40% : 60% between PETRONATIL and Contractor at all rate of production.

(d) In each Calendar Year, if the Development Area is in Offshore Area with water depth from 200 – 1000 meters (Deep Water), the share of Profit Petroleum shall:

(i) split 30% : 70% between PETRONATIL and Contractor for oil production up to 20,000 barrels/day;

(ii) split 40% : 60% between PETRONATIL and Contractor for oil production between 20,000 to 50,000 barrels/day;

(iii) split 45% : 55% between PETRONATIL and Contractor for oil production more than 50,000 barrels/day

(v) for gas; split 35%: 65% between PETRONATIL and Contractor at all rate of production.

(e) In each Calendar Year, if the Development Area is in Offshore Area with water depth is more than 1000 meters (Ultra Deep Water), the share of Profit Petroleum shall:

(i) split 25% : 75% between PETRONATIL and Contractor for oil production up to 20,000 barrels/day;

(ii) split 35% : 65% between PETRONATIL and Contractor for oil production between 20,000 to 50,000 barrels/day;

(iii) split 40% : 60% between PETRONATIL and Contractor for oil production more than 50,000 barrels/day

(iv) for gas; split 30%: 70% between PETRONATIL and Contractor at all rate of production.

COMMENTS:

- With the provisions above, the Sharing of Petroleum Follow very clear and simple principle in the investment economy that is, **Profit (petroleum)** in a given year is Equal to the **Gross Income (petroleum production)** in that year Minus **Expenditures/Cost (petroleum)** in that year.
- This way, the Petroleum Taxation Law will not be difficult to elaborate it in calculating the Taxable Income.
- The profit Oil and Gas split reflect the differences in the environment where the petroleum activities are taking place. This makes more sense than having one formula for all.
- The splitting ratio follow sliding scale of the rate of production is meant to allow the Contractor produce in a reasonable Rate as to follow the need of the Timor-Leste's interest, which is not to produce a lot in very short time. In the case where the Contractor decides to produce at Higher Rate, it must compensate Timor-Leste by doing so with giving more percentage of Profit Petroleum split.
- If the Contractor decides to produce at very Low Rate, the chance is that the Petroleum may not finish yet at the time when the Contract terms finish and thus

give chance to PETRONATIL to take over the operations (by that time Petronatil should have quite good knowledge to operate a field).

Note: ***PETRONATIL*** *stands for* ***Petróleo Nacional de Timor-Leste****. This is the suggested entity to be established under the Petroleum Law (still in draft), to be vested by the law the ownership and management of the Petroleum Resources in Timor-Leste Territory, and it acts as a National Oil Company owned by the State of RDTL. This Corporate Entity to manage Timor-Leste's petroleum resources is preferable than a Ministry for reasons set later in the examining the draft of Timor-Leste Petroleum Law.*

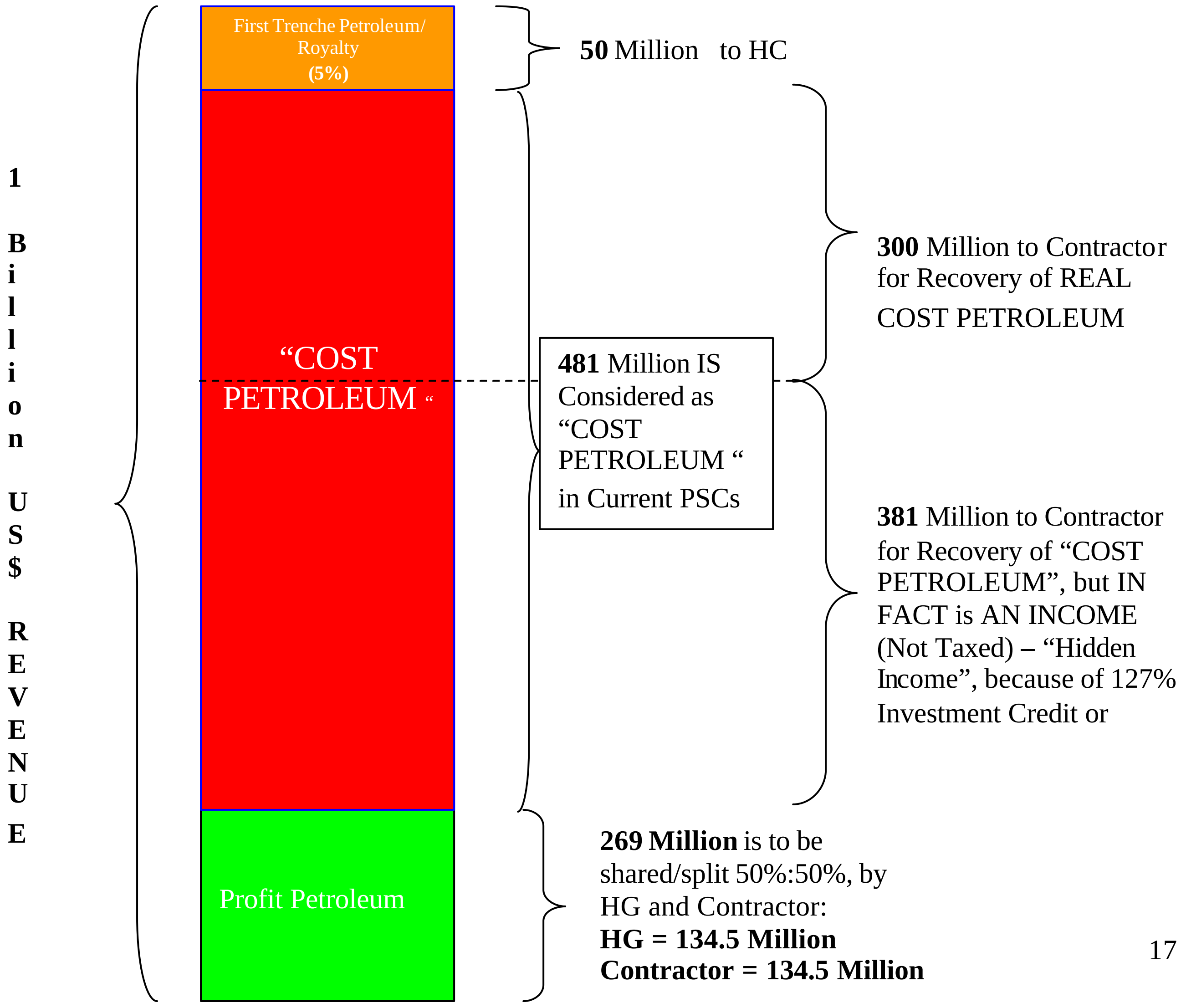
Example:

- A project of 50 Million Barrels Oil on Onshore field
- Project lifetime is **10 years,** produce 60.000 barrels of oil per day
- Using Oil Price US$ 20/barrel => Potential REVENUE is **US$1 Billion**
- The Cost of Exploration, Appraisal, Development and Operation, & Decommissioning altogether called COST PETROLEUM is **300 Million**

Abbreviation **HC** means **Host Country; Contractor means Oil Companies**

Schematic representation of eventual cash flow can be depicted as below:

1. Scenario1 : 5% FTP, 100% Recovery of Cost Petroleum + 127% Investment Credit or Uplift,and 50:50 split of Profit Petroleum between HC and Contractors.


1 Billion US$ REVENUE
First Trenche Petroleum/ Royalty (5%)
“COST PETROLEUM “
Profit Petroleum
50 Million to HC
300 Million to Contractor for Recovery of REAL COST PETROLEUM
481 Million IS Considered as “COST PETROLEUM “ in Current PSCs
381 Million to Contractor for Recovery of “COST PETROLEUM”, but IN FACT is AN INCOME (Not Taxed) – “Hidden Income”, because of 127% Investment Credit or
269 Million is to be shared/split 50%:50%, by HG and Contractor:
HG = 134.5 Million
Contractor = 134.5 Million

? HG, will then apply 30% Income Tax to Contractor Share of Profit Petroleum (30% of 134.5 Million = **40.35 Million**)

Therefore After Tax:

1. - HC's take in Profit Petroleum = HG's share of Profit Petroleum + 30% Income Tax on Contractor's take of Profit Petroleum => 134.5 Million + 40.35 Million = **174.85 Million.**

   So, percentage HC's take is **65%** (174.85 Million / 2 69 Million).

   - *The REAL Revenue/Income to HC = HC's take in Profit Petroleum + FTP => 174.85 Million + 50 Million =* ***224.85 Million.***

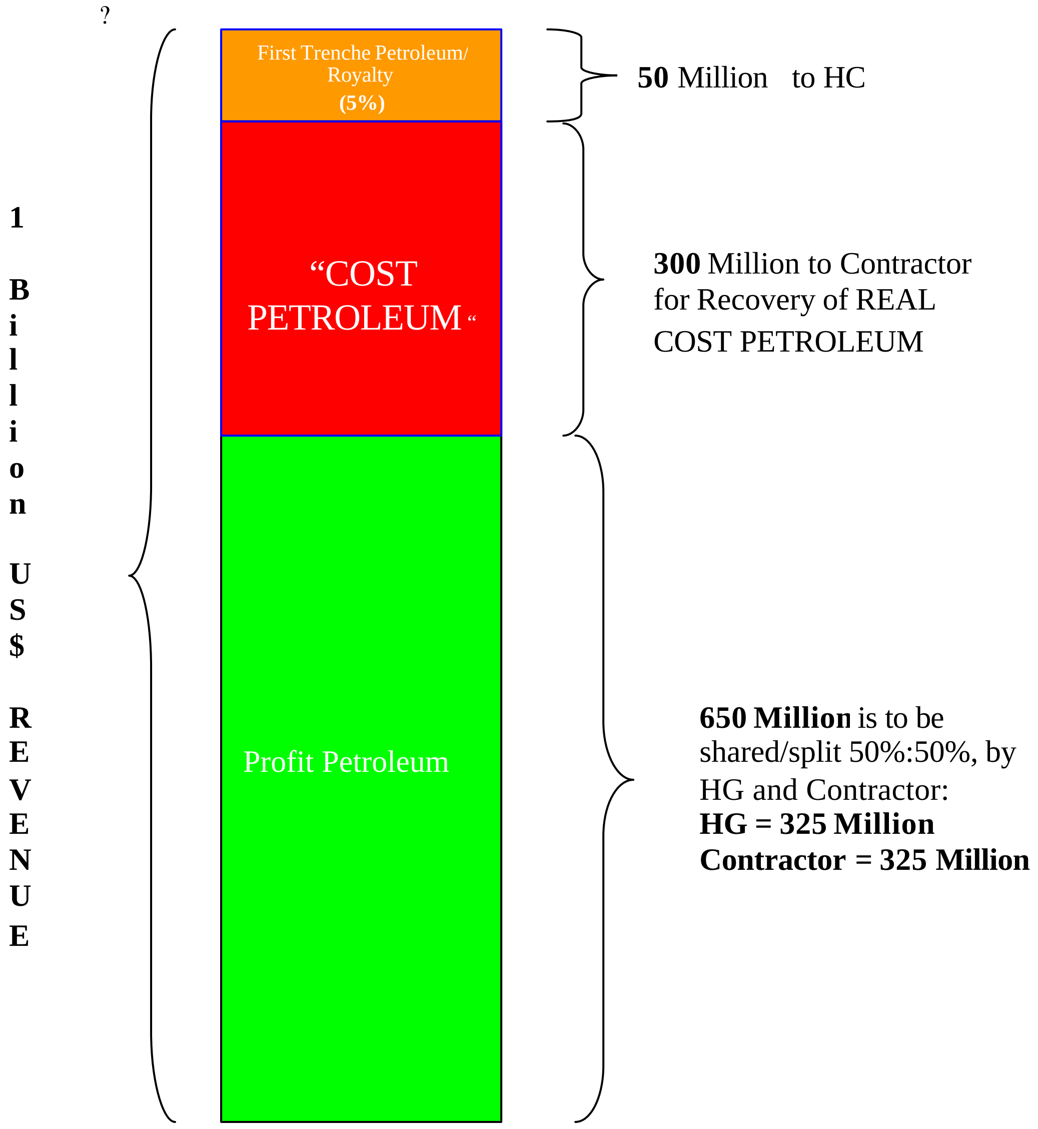
2. Contractor's take:

- The Contractor's take in Profit Petroleum = Contractor's share Profit Petroleum – 30% Income Tax on its Profit Petroleum => 134.5 Million – 40.35 Million = **94.15 Million.**

(This of course will appears Uneconomical/Unprofitable for Contractor's Investment; Investing 300 Million over 10 years and receiving only some profit of 94.14 **Million**); however

- *The REAL Contractor's Income/take= Contractor's take in Profit + Hidden Income in the "Cost Petroleum" as result of 127% Investment Credit or Uplift => 94.14 Million + 381 Million =* ***475.14 Million (more than 2 times HC's Income)***

2. Scenario2 : 5% FTP, 100% Recovery of Cost Petroleum only, Without Investment Credit or Uplift, 50:50 split of Profit Petroleum between HC and Contractors.


?
1 Billion US$ REVENUE
First Trenche Petroleum/ Royalty (5%)
"COST PETROLEUM"
Profit Petroleum

50 Million to HC

300 Million to Contractor for Recovery of REAL COST PETROLEUM

650 Million is to be shared/split 50%:50%, by HG and Contractor:
HG = 325 Million
Contractor = 325 Million

HG, will then apply 30% Income Tax to Contractor Share of Profit Petroleum (30% of 325 Million = **97.5 Million**)

Therefore After Tax:

1. Host Country's take:

- HC's take in Profit Petroleum = HG's share of Profit Petroleum + 30% Income Tax on Contractor's take of Profit Petroleum => 325 Million + 97.5 Million = **422.5 Million.**

Thus, percentage HC's take is **65%** (422.5 Million / 650 Million), same percentage of government's take in Scenario 1 **BUT more Income in this Scenario!**

- *The REAL Revenue/Income to HC = HC's take in Profit Petroleum + FTP => 422.5 Million + 50 Million = **472.5 Million**.*

3. Contractor's take:

- The Contractor's take in the Profit Petroleum = Contractor's share Profit Petroleum – 30% Income Tax on its Profit Petroleum => 325 Million – 97.5 Million = **227.5 Million.**

(This of course will appear economical/profitable for Contractor's Investment; Investing 300 Million over 10 years and receiving some profit of **227.5 Million – is a Reasonable return**);

- *The REAL Contractor's Income/take= Contractor's take in Profit =2 27.5 Million.*

2. Local Purchase and Procurement:

In the current PSC this provision is provided under the Article 5 Conduct of Work, paragraph 5.4 (a):

Article 5.4 Goods, Services, Training and Employment

> The Contractor shall comply with the proposals which accompanied its application under Article 6 of the Act for this Agreement in respect of training, employment and the acquisition of goods and services, and otherwise shall:
>
> (a) give preference to the acquisition of goods and services from persons based in Timor-Leste, provided they are offered on competitive terms and conditions;

ITEMS OF CONCERN:

- First, putting this provision under the Artcile 5 titled **Conduct of Work** obscures the importance of this provision. While, the fact is that this provision is very important for Timor-Leste's national interest that deserve a title in an Article.
- The Section 5.4 stipulated that the Contractor should comply with the proposal for the acquisition of goods and service from Timor-Leste submitted in their applications. This is too ***weak***, the reality shows there is a need for the Host Country (Timor-Leste) to facilitate, through the PSC, the establishment of good and service providers (oil field good and service supply base) in Timor-Leste. So, to achieve it there must be a stronger provisions as per suggestion below:

SUGGESTIONS:

Article 8 EMPLOYMENT, TRAINING, TRANSFER OF TECHNOLOGY, AND PURCHASE AND PROCUREMENT OF LOCAL GOODS AND SERVICES

[As it sets in the document of Palacio das Cinzas's Alternative PSC Model)
…………..

8.4 Purchase and Procurement of Local Goods and Services

(a) the Contractor shall to the maximum extent as possible require the Operator to give preference to the acquisition of goods and services from local Timor-Leste nationals, and otherwise;

(b) give preference to the acquisition of goods and services from persons based in Timor-Leste, provided they are offered on competitive terms and conditions; and

(c) within thirty (30) Days of the end of each Calendar Year, Contractor shall submit a written report to PETRONATIL describing, *inter ali*a, the number of Subcontractors of good and services purchased from Timor-Leste nationals and from persons based in Timor-Leste.

COMMENTS:

✍ This Provisions will Facilitate the establishment of Timor-Leste as the supply base, which is very important in this industry because it this part of the Petroleum Activities that will generate employment and benefits to the economy of a country (economical multiplier effect). For example, requiring the Subcontractors providing water, catering, consultancy, etc to the petroleum activities, to establish their base in Timor-Leste will, for instance, assist the local economy to grow in the following ways:

✍ First, taking the travel industry as an example, the international workers requiring travel will need to book their tickets, this will increase in the number of travel agencies in Timor-Leste and therefore more employment opportunities and more income tax to the Government. More booking and flight to Timor-Leste will also help the Airlines to intensify their operations in Timor and this will lead to further employment opportunities etc. Once a worker arrives in Dili airport he may need to take a taxi to his hotel or a house, thus generating some income to Taxi drivers; as the number of workers and flights increases it will mean more money to the taxi drivers and also an increase employment opportunities, etc. Initially this will happen as the companies' representatives begin to search for a location to establish their base in Timor-Leste. Once the base is established further employment will be generated and other economical benefits will come to Timor-Leste.

3. Local Employment, Training and Transfer of Technology:

In the current PSC this provision is provided under the Article 5 Conduct of Work, paragraph 5.4 (b):

5.4 Goods, Services, Training and Employment

The Contractor shall comply with the proposals which accompanied its application under Article 6 of the Act for this Agreement in respect of training, employment and the acquisition of goods and services, and otherwise shall:

(a) give preference to the acquisition of goods and services from persons based in Timor-Leste, provided they are offered on competitive terms and conditions; and

(b) with due regard to occupational health and safety requirements, give preference in employment in Petroleum Operations to nationals of Timor-Leste.

ITEMS OF CONCERNS:

- First, putting this provision under the Artcile 5 titled **Conduct of Work** obscures the importance of the provision for employment, training and transfer of technology. While, the fact is that this provision is very important and crucial for Timor-Leste's national interest that deserve a title in an Article.
- The Section 5.4 stipulated that the Contractor should comply with the proposal for the acquisition of goods and service from Timor-Leste submitted in their applications. This is too ***weak***, the reality shows there is a need for the Host Country (Timor-Leste) to facilitate, and establish in the PSC provisions to employ, training and transfer of technology of Timor-Leste nationals and residents, in the view of progressive replacement of expatriate once the local Timorese are qualified and experienced enough to take over the operations. So, to achieve this there must be **stronger provisions** as per suggestions below:

SUGGESTIONS:

Article 8. EMPLOYMENT, TRAINING, TRANSFER OF TECHNOLOGY, AND USE OF LOCAL GOODS AND SERVICES

[As it sets in the document of Palacio das Cinzas's Alternative PSC Model)

8.1 Employment of Timor-Leste Nationals

the Contractor shall, to the maximum extent possible, employ, and require the Operator and Subcontractors to employ, Nationals of Timor-Leste having appropriate qualifications and experience, taking into account experience required in the level and nature of the Petroleum Operations.

8.2 Training and Schooling

(a) the Contractor shall provide training and schooling for staff positions, including administrative and executive management positions. Contractor will require its Subcontractors operating in Timor-Leste to do the same. Contractor undertakes to gradually replace its expatriate staff with qualified nationals as they become available. An annual programme for employment and training of Nationals of Timor-Leste shall be established by Contractor and submitted for approval to the PETRONATIL. Such programme shall be included in the annual Work Programmes and Budgets. Within thirty (30) Days of the end of each Calendar Year, Contractor shall submit a written report to PETRONATIL describing, *inter ali*a, the number of personnel employed, their nationality and positions and the status of training programmes for nationals of Timor-Leste;

(b) the Contractor shall spend on training a minimum amount of One Hundred Thousand US Dollars (US $100,000) per Contract Year during Exploration Period and Two Hundred Thousand US Dollars (US $200,000) per Contract Year during the Development and Production phase and this commitment shall be writing in the Work Programmes and Budgets . The unspent minimum training amount during a Year, unless agreed otherwise, shall be deposited into a special account maintained for the purpose by the PETRONATIL;

(c) the amount and training provisions mentioned above are the minimum requirements, however they are biddable items. The Contractor will be assessed, in their bidding proposal among other items, their commitments to the training and staffing of Timorese nationals and the use of local content to a maximum extent as possible.

8.3 Technical Assistance and Transfer of Technology

(a) the Contractors shall separately endeavour to negotiate, in good faith, Technical Assistance Agreements with the PETRONATIL or a company nominated by PETRONATIL for this purpose setting forth the terms by which each Companies constituting the Contractor may render technical assistance;

(b) Such assistance, shall include but not limited programmes that cover both technical and management disciplines (geology, geophysics, engineering, project management, accounting, economics and legal) and shall include on-the-job training, secondment and participation in in-house seminars.

COMMENTS:

- These provisions should not be viewed as asking too much. It is normal practice and the standard provisions in PSCs of India, Pakistan, China, Malaysia, Indonesia, Vietnam, Suriname, Romania, etc.
- Although these countries have trained human resources and technologies, they still require such training, employment preferences, and transfer of technology to facilitate their nationals and national oil companies.

4. Local Office and Notice:

In the current PSC the provision Local Office is clearly mentioned but the provision for Local Notice is provided under the Article 10 Provision of Goods and services:

Items of Concern:

- ✍ No clear Article requiring the establishment of Contractor' office in Timor-Leste, which in fact very important.

Suggestions:

- ✍ There must be an establishment of Contractor' office once they sign a PSC. At least the Operator must have an office in Timor-Leste to operate from. The suggested article is as below:

Article 13 Local Office and Notice of Procurement

[As set in the Palácio das Cinzas's Alternative PSC]

13.1 Local Office

The Contactor, upon the signing of this Agreement, is required to open an operational office in the territory of Timor-Leste.

13.2 Notice of Procurement

(a) Except with the consent of the PETRONATIL, the Contractor shall draw to the attention of suppliers based in Timor-Leste, in such manner as the PETRONATIL agrees, all opportunities for the provision of goods and services for Petroleum Operations.

(b) Subject to Section 13.3, the Contractor shall, before awarding any contract for goods or services, obtain the written approval of the PETRONATIL.

(a) The Contractor shall provide the PETRONATIL, for information, with the full financial details of all contracts for goods and services, irrespective of the amount of the expenditure involved.

Comments:

- ✍ These provisions are needed to assure that the Contractor open their office in Timor-Leste as soon as they sign the PSC and thus will facilitate the communication and also provide some economical benefit to the country by renting the office space, providing staff etc.

5. Title to and control of Facilities and Equipments:

In the current PSC this provision is provided under the Article 11 Title to Equipments:

Article 11 Title to Equipment

11.1 Property

(a) Except with the consent of the Ministry, and subject to Section 11.2, all structures, facilities, installations, equipment and other property, and other works, used or to be used in Petroleum Operations, shall be and remain the property of the Contractor while so used or held for use.

(b) Paragraph 11.1(a) does not apply to property leased to the Contractor, or leased by or belonging to third parties providing services, but without prejudice to Article 10.

11.2 Retention

(a) The Ministry may, upon termination of this Agreement in respect of all or a part of the Contract Area, elect to acquire any property or other works as mentioned in paragraph 11.1(a) installed on, or used exclusively in respect of, that area, by giving the Contractor a notice to that effect.

(b) The Contractor shall have no further obligation or liability in respect of any property or other works acquired by the Ministry pursuant to paragraph 11.2(a) (but without prejudice to obligations and liabilities accrued prior thereto), and will repay, to the Ministry, all amounts included in the

Decommissioning Costs Reserve and claimed by the Contractor under Article 6 in respect of it before the acquisition, and shall claim no further such amounts in respect of it. Subject thereto, the Ministry shall pay, to the Contractor, the net salvage value of the property or other works concerned, and that value will be a Miscellaneous Receipt as mentioned in Annex C.

ITEMS OF CONCERNS:

- ✍ Too much wording but very ambiguous
- ✍ Section 11.2 means that at the end of the project or termination of this Agreement the Host Country/Ministry may elect to acquire some part or all of the equipments and works purchased and used or to use for Petroleum Operations, however, the Paragraph 11.2(b) indicate that if the Ministry/Host Country elects so it must pay the net salvage of the property.
- ✍ This is not the case in many countries such as Malaysia, China, India, Pakistan and Indonesia, where the ownership to the equipment and the works used and to be used for Petroleum Operation will lie in the Government/Host Country's nominee if it elects so, without any charge.

SUGGESTIONS:

- ✍ Use simple wording but not ambiguous provision
- ✍ The Host Country should hold the title to the equipment and facilities upon the termination of the Agreement/contract free of charge. To achieve it below is the suggested provision:

Article 14 Title to Assets

[As set in the Palácio das Cinzas's Alternative PSC]

14.1 Property

(a) Assets purchased by the Contractor for use in Petroleum Operations shall remain the property of the Contractor during the effective terms of this Agreement.

(b) Contractor shall be responsible for proper maintenance, insurance and safety of all assets acquired for Petroleum Operations and for keeping them in good repair, order and working condition at all times, and the costs thereof shall be recoverable as Cost Petroleum in accordance with Recoverable Cost provision in this Agreement.

14.2 Retention

(a) Upon the expiry or early termination of this Agreement, the PETRONATIL shall have the right to require vesting of full title and ownership in it, free of charge and encumbrances, of any or all assets, whether fixed or movable, acquired and owned by the Contractor for use in Petroleum Operations inside or outside the Contract Area, such right to be exercisable at the PETRONATIL's option.

(b) The Contractor shall have no further obligation or liability in respect of assets acquired by the PETRONATIL pursuant to paragraph 11.2(a) (but without prejudice to obligations and liabilities accrued prior thereto), and will repay, to the PETRONATIL, all amounts included in the Decommissioning Costs Reserve and claimed by the Contractor under Article 9.1 in respect of it before the acquisition, and shall claim no further such amounts in respect of it.

COMMENTS:

✍ These provisions while protecting the exclusive right to use the assets purchased for the use in the Petroleum Operations maintains the possibility for the PETRONATIL (the Host Country) to acquire the assets free of charge at the end of the production or expiry of the Agreement/Contract.

6. Domestic Supply Requirement:

In the current PSC this provision is NOT provide.

ITEMS OF CONCERNS:

✍ Very important provision but not exist in Timor-Leste PSC Model

SUGGESTIONS:

Article 10 Domestic Supply
[As set in the Palácio das Cinzas Alternative PSC]

(a) Timor-Leste, through PETRONATIL, at it's option, may require Contractor to provide the Crude Oil or Natural Gas Production from the Contract Area to meet Timor-Leste's internal requirements of Petroleum, provided, however, such requirement be notified in writing six (6) months in advance to Contractor.

(b) The price receives by the Contractor for the purpose in Article 10(a) should be no less favorable than the price of Petroleum set in the Article 11.

COMMENTS:

- Provision for Domestic Supply requirement is important to assure that, in the future, if Timor-Leste national petroleum demands increase, the Contractor has the obligation to first fulfill the national demand before it fulfills the international demand.
- This is to prevent, in the case of international crisis (because or war or other disaster) where petroleum in the open market is difficult to get, Timor-Leste will still be able to secure its domestic supply. This need may not be very real at this moment, as the domestic consumption of petroleum can still be considered relatively low, but as the economy of Timor-Leste grows the demand will increase. Thus this provision exists to anticipate those cases.
- This provision exists almost in all PSCs from other countries.

7. Participating Interest:

In the current draft PSC, this provision IS NOT provided.

ITEMS OF CONCERN:

- This provision is so important for national interest
- It is unfortunate that this provision does not exist in the current draft of PSC model

SUGGESTIONS:

- This provision can be provided as below:

Article 3 Participating Interests

[As set in the Palácio das Cinzas Alternative PSC]

3.1 Timor-Leste's Right to Participate

(a) In every Joint Venture for Exploration and Exploitation of Petroleum in Timor-Leste, PETRONATIL shall have a minimum share of **10%** ;

(b) The PETRONATIL, at its option, should take the share or assign it to its nominee;

(c) The PETRONATIL (or its nominee), shall be exempted from bearing the costs of Exploration, and such PETRONATIL (or its nominee) will not be entitle for the reimbursement of Exploration Costs (Recoverable Cost) during the exploration as provided in the Article 9, but will take and fulfill its rights and obligations as provided in Section 3.3 during the Development and Production phase.

(d) The Contractor will be assessed in its bidding proposal pursuant to the Act, the commitment to assist PETRONATIL (or its nominee) in its initial venture, to secure financial and technical capacity in fulfilling its obligations in the paragraph 3.1(c).

3.2 The initial Participating Interest of the Parties in the Exploration phase comprising the Contractor shall be as follows:

X Company ___________ :
Y Company ___________ :
Z Company ___________ :

3.3 The initial Participating Interest of the Parties in Development and Production phase comprising the Contractor shall be as follows:

X Company ___________ :
Y Company ___________ :
Z Company ___________ :
PETRONATIL ___ 10%____ :

3.4 Except as provided in this Article or elsewhere in this Agreement, the rights and obligations of the Parties comprising the Contractor shall include but not be limited to:

(a) the right to take Cost Petroleum in accordance with the provisions of Paragraph 9.2(b);

(b) the right to take its Participating Interest share of Profit Petroleum in accordance with the provisions of Paragraph 9.3(b or c or d, whichever is applicable);

(c) the right to receive its Participating Interest share of any incidental income and receipts arising from Petroleum Operations; and

(d) the obligation to contribute its Participating Interest share of costs and expenses.

COMMENTS:

- With these provisions with protect the interest of Timor-Leste to participate in any joint venture and thus allow Timor-Leste to get some value-chain of the project.
- It is fundamental that Timor-Leste should involve from the beginning in the exploration phase through carried interest. It only pay the cost during the development and production face and thus entitle to get reimbursement of these

cost under the Recoverable Cost provision, should it elects to take its minimum participating interest.

- Section 3.1(d) provides a way to get commitment of the potential Contractor to assist the financial and technical capacity of PETRONATIL, should PETRONATIL take its minimum participating interest in the Joint Venture during the Exploration and Exploitation phase.