Timor-Leste

Comments on Petroleum Legal Regime

World Bank, November 2004

The following provides comments from the Oil, Gas and Mining Division of the World Bank Group (the "Bank") on Timor-Leste's proposed petroleum legal regime. These comments are not offered from a strictly legal point of view, but rather from the perspective Bank's own experience with international practice and emerging trends in the petroleum sector. Comments focus on the Timor-Leste draft Petroleum Act, 2004, the associated draft Model Production Sharing Contract, and the draft Petroleum Taxation Act, 2004. Separate comments have not been prepared for the largely similar, parallel regime for the Joint Petroleum Development Area shared with Australia.

Overall Impression

The proposed petroleum regime is well thought out, and well prepared and presented. The consultative process conscientiously followed in approaching legislation of such importance has been exemplary and represents international best practice. The comments received during the process from a wide range of stakeholders will further enhance the quality of the documents under review.

The regime which the documents are intended to establish will be essential to the beneficial and orderly development of Timor-Leste's petroleum sector. At the same time, the drafts underscore the very considerable demands sector development will place on sector institutions and the urgent need to establish the institutional capacity to implement the new regime.

Timor-Leste Petroleum Act, 2004

Principal Observations

- The number of Ministerial approvals required under the Act is substantial, with, in many cases, considerable discretionary latitude. This has two consequences: a) it may be a cause of concern among potential investors, to the extent it creates an uncertain commercial environment; and b) it calls for considerable institutional depth in terms of skills and resources.
- The draft puts a great deal of emphasis on local content, i.e., the training and employment of Timorese and the purchase of Timorese goods and services. Investors should be asked to be responsive in both areas. That said, however, it will be important to manage local expectations. The oil industry is not labour intensive, and the skills required long term are typically of a highly technical nature. Major employment opportunities for unskilled labour are likely to be short-lived, or sporadic, e.g., in facilities construction.
- The press statements and documents announcing and conveying the drafts also rightly stressed the importance of transparency and accountability. While these themes are picked up in the draft Act, they deserve a great deal more prominence in the text, beginning with a place in the Preamble.

Detailed Comments

- *Contents.* The numbering of articles in Contents and in the text is off by one, i.e., Article 5 in Contents is Article 4 in the main text. This is due to numbering the Preamble in the Contents, but not in the text. The comments and suggestions which follow refer to the numbering in the text.
- *Preamble.* As suggested, add a reference to transparency and accountability objectives
- *Definitions.* Harmonize with Definitions in the draft Model Production Sharing Contract. Consider adding definitions for, e.g., Responsible Party (Art 14.1), Joint Operating Agreement and Lifting Agreement (Art 15), Unitisation (Art 16), Exploitation (throughout)…

- *Art 3.2. Representations*. The opportunity for stakeholders to make representations is at the Ministry's discretion. This might be strengthened to indicate that the Ministry will (rather than "may") accept representations where the expected impact of his exercise of power is significant.
- *Art 8.1. Access Authorisation*. Qualify the right to grant the access with reference to the avoidance or mitigation of adverse impacts on affected third parties.
- *Art 10.6. Ministry not Obliged to Invite Applications*. While possibilities for abuse of this provision are limited by the obligation to publish notice of the granting of any Authorisation made without invitation, and by the obligation to make the Authorisation itself available to the public (Art 26), an indication of the circumstances under which this Article might apply would be helpful.
- *Art 18. Exemption from or Variation of Conditions*. Qualify the Ministry's right to exempt an Authorised Person from compliance with and/or vary the conditions of an Authorisation by references to the circumstances under which this might occur, and by an obligation to make public the nature of and reasons for the exemption.
- *Art 19.1. Production of Petroleum*. The requirement that "as much as possible of the petroleum be produced" (Art 19.1 (a) (i)) typically conflicts with the requirement that production take place "in accordance with sound economic principles" (Art 19.1 (a) (ii)). The first objective should be qualified by the second.
- *Art 21.2. Data and Information*. Recognizing that the terms and conditions for the exercise of rights in respect of data will be elaborated on in contracts and regulations, it would nevertheless seem desirable at the level of the Act to provide more detail, e.g., to ensure that the Ministry, even where originals of data or physical samples are not retained locally, at all times has access to such originals and physical samples. Art 14.2 (b) of the Model Contract seems meant to address these concerns.
- *Art 22. Inspection and Audit.* Given its importance, Audit might be the subject of a separate Article. Books and accounts of the Authorised Person should be made available in Dili or, if elsewhere, at the Authorised Person's expense. The Model Contract requires the Contractor to have independent audits of its activities conducted, as well as making its books available for audit by the Ministry. This requirement might be usefully repeated in the Act.

- *Art 25. Publication of Details of Authorisations*. The requirement for publication of a summary of terms is important and goes beyond the practice of many other countries in favour of transparency. Some countries do, however, publish Authorisations in full, going farther than simply making them available for inspection (Art 26).
- *Art 26. Public Register*. Given the relatively minor cost that would be involved (certainly relative to the revenues from the petroleum sector), consideration should be given to increasing ease of access to the register, e.g., waiving the suggested fee. It would also seem appropriate to include in this Article reference to other data that will be made public, e.g., production and revenue data and payments to Government…
- *Art 27. Regulations*. As with the Act itself, the making of regulations should involve a process of stakeholder consultation.

Model Production Sharing Contract

Principal Observations

- The precise nature of the Model should be made clear. In particular, to what extent can it be modified, by whom and in what context?
- There are some 50 different references in the Model to Ministry approvals, consents, elections, etc., covering a very wide range of topics, often without specified criteria for the granting of such approvals, etc.. The need for this level of (discretionary) control should be examined closely. In many cases it may be appropriate. As noted above, however, in making the same observation with respect to the draft Act, the implications for institutional capacity are very serious. Uninformed decisions and/or undue delays in these areas can be extremely expensive, not only with respect to the operations directly involved, but also with respect to outside perceptions of the overall investment environment. The ability to implement these Contracts in a manner that is both timely and consistent with good international practice will be critical.

Detailed Comments

- *Definitions*. As above, ensure harmonization with the Petroleum Act and as far as possible with the draft Petroleum Taxation Act. Why does "Approved Contract" relate only to "Development Plan" approval?
- *Art 1.3 (i). Interpretation*. This includes not being unreasonably delayed within the meaning of not unreasonably withheld, which is important. In some cases, however, it may be possible and preferable to identify a specific time limit, beyond which approval, consent, etc., will be deemed to have been given.
- *Art 1.6 (a) (ii). Operator*. Under what circumstances would an Operator not also be an Authorised Person? Contractors are supposed to demonstrate financial and technical competence etc.. Does this clause contemplate assigning operatorship to a non-authorised person?
- *Art 1.6 (f). Operator*. Some reference to the criteria to be applied by the Ministry in determining non-competence on the part of the Operator should be included.
- *Art 3. Relinquishment of Blocks*. Why specify exploration terms and relinquishment percentages in the Model? It is normally sufficient to specify a structure (as is done for Work Programmes and Budgets, Art 4) and leave numbers to be announced for each licensing round, as a function of previous exploration success (or lack of it), the size and configuration of the Contract Area offered, etc..
- *Art 3.5. Gas Retention Area*. An important and well drafted provision.
- *Art 4.9. Discovery and Appraisal*. Appraisal Costs are included in Exploration Costs (Art 2.2 of the Accounting Procedure). It should be made clear, as appears to be the intent of the Model, that Appraisal activities are not, however, creditable against an Exploration Work Programme. Note that such a provision will typically encourage the Operator to defer declaration of a Discovery, putting pressure on the robustness of the definition of Discovery contained in Art 1 to prevent this.
- *Art 4.11 (d) (v). Development Plan*. It is increasingly common (and desirable) to provide, where appropriate, for social as well as environmental impact assessments and plans. Social issues arise onshore and/or offshore where onshore facilities are involved or livelihood activities such as fishing are affected . The same comment

applies to Conduct of Work, Art 5.1 (b), and Health, Safety and Environment, Art 5.3.

- *Art 4.11 (d) (vii). Development Plan*. Comments above regarding local content apply here and to Art 5.4, Goods, Services, Training and Employment. Timor-Leste's aspirations in these areas are properly high-lighted, but care should be taken to manage expectations and ensure that the cost and efficiency of petroleum operations are not adversely impacted. See also comment on Art 10, below.
- *Art 4.14. Decommissioning*. At least part of this Article seems better suited to the Accounting Procedure than to the main text of the Contract.
- *Art 6.2. Recoverable Costs*. The reason for use of the double negative "not ineligible costs" is not clear.
- *Art 7. Sharing of Production*. Under the provisions of Art 6, the Accounting Procedure and this Art 7 the Ministry's production share (excluding its 5% off-the-top allocation) to drop to zero again (and later return to a positive number after major rehabilitation or secondary recovery investments). This is appropriate given the overall intent of the fiscal regime, but care should probably taken to prepare outside observers for this possibility, remote as it might appear to be.
- *Art 10.1 Goods and Services*. In general this Article provides for comprehensive approvals by the Minister (except for contracts below a specified ceiling) and for massive documentation (the number of contracts involved in any reasonably sized development operation will be very large). The potential positive contribution of such demanding provisions in terms of cost control and local content needs to be carefully weighed versus their possible adverse impact on cost and efficiency and the burden of administration. Requirements for government approval of bidder lists and contract awards have often been used in other petroleum producing countries to unduly bias procurement in the direction of high cost local or otherwise favoured suppliers.
- *Art 12.1. Third Party Access*. It would seem reasonable to place some limits on this requirement to (negotiate) TPA, e.g., referring to avoidance of interruption to Contractor's operations, compensation for additional costs, etc..
- *Art 14.2. Records*. The reference in Art 14.2 (c) should be to Art 14.2 (b), not Art 13.2 (b). [Note: there are several references to Art 13 in

this Article which are actually meant to refer to Art 14. See, e.g., Arts 14.5. 14.6 and 14.7]. The requirement (Art 14.2 (d)) of Ministry consent for Contractor retention of copies of data submitted to the Ministry beyond what is needed for the conduct of Petroleum Operations seems unusually severe, as does the same requirement with respect to data use (Art 14.5 (b)).

- *Art 14.6. Confidentiality*. Consideration should be given to the exemption of Contractor financial data such as payments to government from the time limits on disclosure by the Ministry of data and information. Presumably Art 14.5 (a) gives the Ministry the right to at least disclose such data at an aggregated or consolidated sector level (all contractors) without any waiting period.
- *Art 16. Audit*. The requirement of an independent annual audit of the Contractor's books and accounts should be made mandatory, as should the annual Ministry audit. Art 16.5 should refer to Art 16, not 15.
- *Art 17.2 (a). Insurance*. Incorrect reference to Art 16.1.
- *Art 19. Assignment and Change in Control*. Harmonize with Art 15 of the Act.
- *Art 20.3. Applicable Law*. For construction purposes, given the very limited relevance of the laws of Timor-Leste to, and experience with, petroleum sector operations, it would be desirable to reference some other legal regime. Laws of the United Kingdom or the State of Texas are often referenced.
- *Accounting Procedure*. Very thorough treatment of the subject. *Art 2.9 (c). General and Administration Costs.* Art 9 of the draft Timor-Leste Petroleum Taxation Act is very clear on how these will be treated. Art 2.9 (c) of the draft Contract says they will be determined through a detailed study. While accounting under the Contact and the Taxation Act may differ (e.g., with respect to interest costs and depreciation…), this seems one area where they can/should be harmonized.

Timor-Leste Petroleum Taxation Act, 2004

Highlights

- Much of the draft Taxation Act is very difficult to read or understand, making it less than transparent to many/most stakeholders. It appears to work as intended, based on the results of economic simulations which combine the provisions of the Act with the fiscal provisions of the Model Contract, but it is not at all easy to distill from the draft the essential features of the fiscal regime.
- A significant improvement in clarity will occur when, as reportedly intended, the provisions of the UNTAET Regulation 2000/18 are written into the Taxation Act rather than simply cross-referenced, as in the current draft.
- The fiscal regime will remain complex, however, with three accounting procedures (for the Model Contract, the corporate tax and the Supplemental Petroleum Tax), a corporate tax, and two fiscal mechanisms intended to capture excess profits (the Production Share and the SPT). This points once again to the critical importance , especially in this area, of adequate institutional capacity and, in addition, to the need for taxpayer/stakeholder education.

Detailed Comments

- *Art 2. Definitions*. Harmonize with the draft Act and Model Contract. One element of confusion relates to the relationship among definitions of "Petroleum Contract" (draft Act), "Agreement" (Model Contract), "Approved Contract" (Model Contract and draft Taxation Act), and "Petroleum Agreement" (Taxation Act), all of which seem to overlap and to come under the broader definition of "Authorisation" (Act).
- *Art 6. Rate of Tax.* If 30% is the generally applicable corporate tax rate, it may be preferable to state that the rate of corporate tax applicable to Contractors will be the generally applicable corporate tax rate, rather than specifying a particular percentage, which may change in the event of a change in general tax legislation.
- *Art 7. Interest Deduction*. Without access to the UNTAET Regulation, it is not clear what this Article allows. An allowance for reasonable interest cost deduction in calculating the corporate tax is required if that tax is to qualify for a foreign tax credit in, e.g., the United States.

- *Art 10. Decommissioning Expenditure*. The intent of Art 10.3 and the formula it contains is not clear, and in the preparation of these comments, proved impossible to understand.
- *Art 11.5. Depreciation*. Given their importance to the calculation of depreciation, consideration might be given to including "commercial production" and "first production" in Definitions. [Note: Commercial Production" is defined in the draft Model Contract, although the definition there does not appear to be consistent with what is intended in this Article]. It would not be unreasonable to qualify the discretion of the Ministry in determining the rate of production to be treated as commercial production with some reference to the criteria to be applied in making that determination.
- *Art 12. Small Field Depreciation*. The option to apply unit of production (UOP) rules for depreciation in situations where small reserves may mean incomplete depreciation under normal straight line depreciation methods is interesting. Presumably if this incentive proves overly generous, it will be compensated for by the Supplemental Petroleum Tax. The Article should perhaps address the situation where reserves turn out to be greater than estimated at the time the UOP option was approved.
- *Art 16.4. Installments of Tax*. The treatment of underpayment and overpayment of installments is not symmetrical. In the case of the former, the underpayment is added to the first installment due after it has been identified. In the case of the latter, there is no provision for credit against the next installment due, except at the end of the year, should calculations at that time that show a cumulative overpayment for the year.
- *Part 6. Arts 17 through 24. Supplemental Petroleum Tax*. Before turning to the specifics of the SPT as drafted, a few comments on the proposed overall fiscal package are in order. With one exception, the proposed package is fairly conventional and consistent with good practice, comprising three basic elements, each with their own special purpose: a) a royalty – the 5% off-the-top production share going to the Ministry (Model Contract Art 7.1) is effectively a royalty, providing the government with early and dependable income regardless of underlying project profitability; b) a corporate profits tax of general application (the 30% tax specified in Art 6 of the Taxation Act), providing for non-discriminatory treatment of the petroleum sector under normal circumstances of profitability and assisting

Contractors in obtaining tax credits in their home countries for taxes paid to Timor-Leste; and c) and additional payments which apply only after the Contractor has recovered his costs and earned a specified return (the 50% production share payable pre-tax after the Contractor has recovered costs uplifted by 30-year LIBOR plus 10% in the case of the Model Contract, and the 22.5% tax payable after the Contractor has earned a 16.5% post-tax return in the case of the SPT). It is the last element which departs from conventional practice, and can be expected to impose additional demands on administrative capacity. Typically, petroleum fiscal systems incorporate only one additional payments mechanism. Under production sharing, it is built into the rate of production sharing which escalates in the government's favour as the Contractor's return escalates, measured with accuracy as a rate of return or, more commonly, but less accurately, as a rate of production. Where the rate of return "trigger" is applied, the escalation can be structured as a function of pre-tax, or post-tax, return. The SPT approach is typically associated with a straight tax and royalty system, i.e., not with production sharing. The advantage of limiting the additional payment mechanism to one lies in greater transparency and simplification of the burden of administration. The proposed approach may have been influenced by similar arrangements already in place for the Bayu-Undan field development. Whichever approach is adopted, it will be important for both transparency and accountability to issue a companion text to the Taxation Act, explaining the underlying philosophy of the fiscal package, and setting out in simple terms the function of each of its elements and their methods of calculation.

- Turning now to the specifics of the SPT…. The SPT is a critical component of the fiscal package for petroleum , yet, as presented, it will not be easily understood by those without considerable prior experience in petroleum taxation design and practice. Hence the importance of the explanatory text mentioned above.
- *Art 17.2. Imposition of the SPT*. This Article and the formula it contains presumably perform two functions – clarification of the payment due and (by grossing up the payment with a view to allowing its subsequent deduction for tax purposes) satisfaction of the criteria applied in international oil company home countries to determine whether or not a foreign tax is creditable against home tax obligations. It should be made clear (here, or in Art 19) that where "A" is not positive, no SPT is payable.

- *Art 18. Accumulated Net Receipts*. A minor point, but perhaps important for ready understanding of the provisions of the Act – the letters A, B, etc., are used in formulae in several provisions of the Act, but with different meanings in each case…this can be confusing to the reader. The function pre-tax interest expense term [-(I x (1-r))] in Art 18.1 is not at all clear. Why is it there?
- *Art 21.1 (a). Deductible Expenditure.* Why is interest a deductible expenditure for SPT purposes? This provision appears to allow the Contractor to "double dip" before payment of the SPT – interest costs are explicitly recovered, and then implicitly recovered again through the 16.5% effective uplift that applies before application of the SPT. While allowance for deduction of interest is important in the case of the corporate tax – for foreign tax credit reasons – the same reasons do not apply to supplemental taxes.
- *Art 25. Regulations*. The comment made with respect to Art 27 of the draft Act applies here as well. The preparation of Regulations should involve stakeholder consultations.