

# **A New Petroleum Fiscal Regime for Timor-Leste and the JPDA: Proposals for Public Consultation**

Presentation to Timor-Leste Public

August

Timor Sea Office

# Purpose of this Presentation

- Describe financial aspects of the recommended new Tax Regime for petroleum projects
- A “Tax regime” is:
  - A set of rules setting out how economic benefits from a project are shared between the state and investors
- Explain the reasoning behind the recommendations
- This presentation is part of the process of consultation with civil society in Timor-Leste and with petroleum investors
- Your feedback is sought and it will be considered
- Results of the consultation will be brought back to the Council of Ministers for decision on the new terms and the necessary legislative proposals
- Intention is to have new legislation in place by end of 2004

# Starting point – Timor Leste owns all petroleum resources

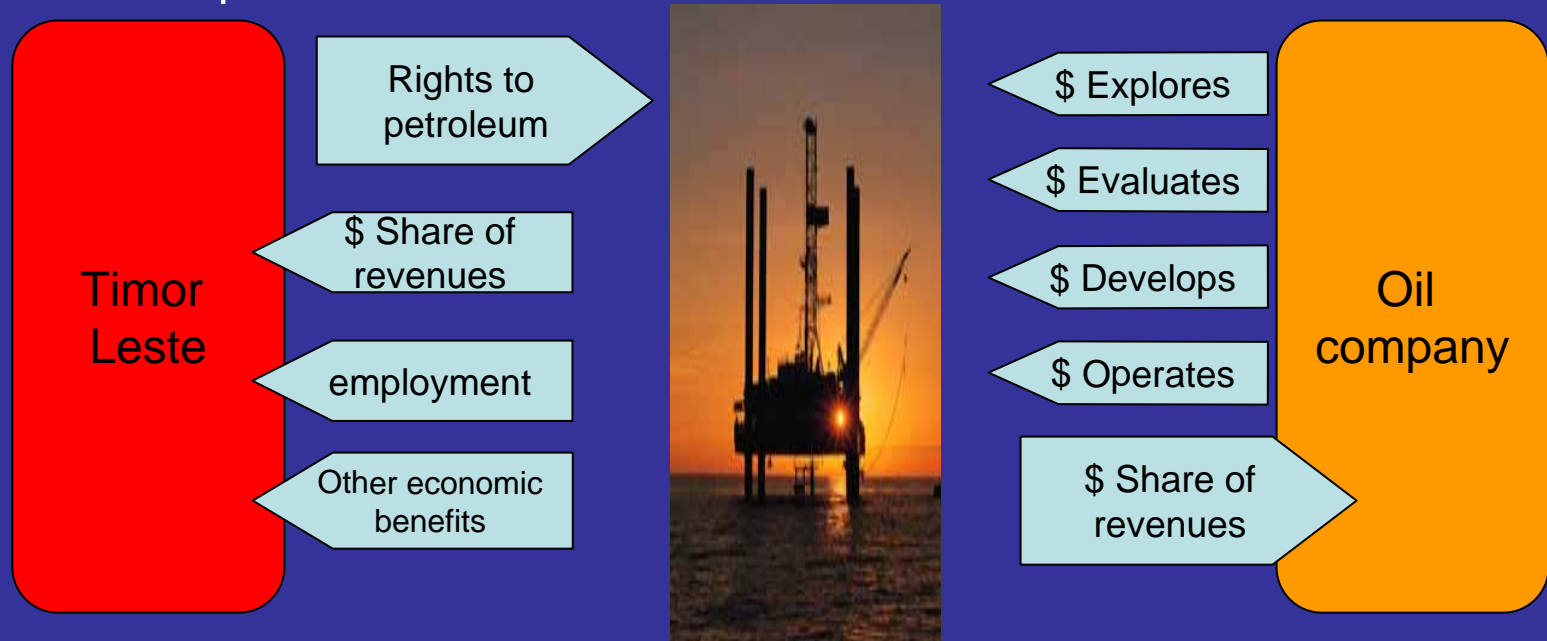
- Within Timor-Leste's borders Petroleum (oil and gas) resources under the ground or under the sea belong to the state
- Section 139 of the constitution says  
“Resources of the soil, the subsoil, the territorial waters, the continental shelf and the exclusive economic zone, which are essential to the economy, shall be owned by the state and shall be used in as fair and equitable manner in accordance with national interests”

# How do petroleum projects get developed?

- First – find them!
  - Exploration
- Then, evaluate deposits and design the project
  - Is there a technically viable way to exploit the deposit?
  - If so, is it commercially viable?
  - Is it big enough?
  - Is there a secure market for gas?
- Then, develop the project
  - Drilling Platforms, processing and loading facilities, pipelines, Liquefied Natural Gas plants etc.
- Then, operate the project efficiently and safely
- Then, close down and clean up
- Then, find the next one!

# Why does Timor-Leste need oil companies to do this?

- Exploration is difficult, risky and expensive
  - Statistic on exploration success rate?
- Development is technically demanding and very expensive
  - Especially for offshore deposits. Bayu Undan will cost around \$3.5 billion to develop
- Specialised skills are required to do this and manage the operation
- The government does not have either the money or the expertise
- Oil companies do



# What attracts oil companies to invest?

- Geological potential
- Political stability
- A proper legal framework
- Infrastructure. Roads, ports, power, human resources
- A tax regime that means they will get a reasonable share of the benefits from a project and will earn an acceptable rate of return

*The tax regime is just one consideration, and not necessarily the most important*

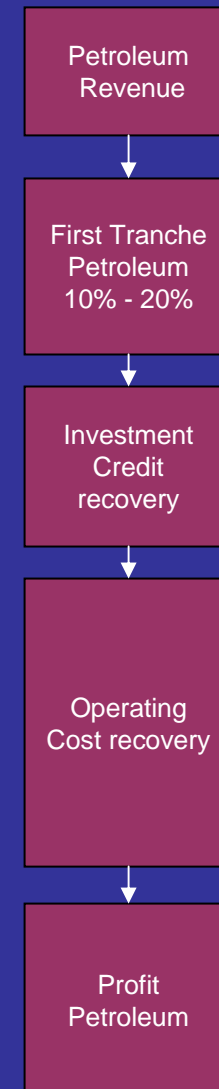
# History of tax regimes in Timor-Leste

- In Timor-Leste territory outside the joint area (the “Treaty Area”):
  - currently the general Timor-Leste tax regime applies. [UNTAET Regulation 2000/18]
  - A proper legal framework and special fiscal regime is required to manage the industry and make sure Timor-Leste receives proper share of benefits from a petroleum project
- In part of the Timor Sea between Timor-Leste and Australia
  - Timor Sea Treaty established “Joint Petroleum Development Area”
  - Right to tax a project shared between Timor-Leste 90% and Australia 10%
  - Production Sharing Contract between contractor and Designated Authority
    - Oil companies called “contractors”
  - Contractor pays tax on income earned in JPDA
  - Timor-Leste tax regime in JPDA largely inherited from Indonesia [explain]
- The Treaty fixed terms for existing projects (“Annex F”)
  - Bayu Undan, EKKN, Jahal & Kuda Tasi and Sunrise

# Existing PSC structure

PSC sets out how project production (revenues) are shared

- First 10% is called “First Tranche Petroleum”
  - Shared between contractor and Designated Authority.
- Then, contractor recovers costs
  - 127% Investment credits for certain costs
  - Exploration costs
  - Capital costs
  - Operating costs
- Any revenue left after all costs recovered is called “Profit Petroleum”
  - Shared between DA and contractor
- DA shares are then shared 90% to Timor-Leste 10% to Australia
- Contractor pays income tax on income from PSC



# Existing Timor-Leste Income Tax

Tax calculation for contractor:

- Revenues from PSC
  - + Contractor share of FTP
  - + Investment credits recovered
  - + Operating costs recovered
  - + Contractor share of profit petroleum
- Costs
  - Exploration and “non-capital costs” deducted (“depreciated”) over time based on liquids production)
  - Capital costs: deducted over time at 10% declining balance rate with remaining balance written off at end of useful life <sup>(1)</sup>
- Revenues minus costs = Taxable income
- Tax paid is 30% income tax plus 15% Branch Profits Tax (= 40.5%)<sup>(2)</sup>

(1) Legislation is not at all clear

(2)  $30\% + (1-30\%) \times 15\% = 40.5\%$

# Existing Annex F PSC & Income Tax: Problems

## PSC

- High rate of FTP (“royalty”) after 5 years imposes significant burden not related to profitability
- Separate accounting for oil and gas creates complexity and is open to interpretation
- Investment credit mechanism provides a significant economic benefit to contractor irrespective of project profitability and ignores the time value of money
- Investment credit application is open to interpretation – potential for dispute
- Oil production sharing by production volume ignores costs and prices

## Income Tax

- Depreciation provisions complex
- Branch Profits Tax rate makes total company income tax rate too high
- Withholding taxes complex

# The Bayu Undan deal

- Bayu Undan PSC and Timor-Leste tax arrangements were partly re-negotiated with ConocoPhillips
- The reason was to secure development of the full gas project (condensate + LPG + Gas)
- Key issue for Timor-Leste was to maximise share of gas revenues (sold as Liquefied Natural Gas or LNG) taxed in the “upstream” part of the project in the JPDA.
  - The “downstream” (pipeline and LNG plant) are taxed by 100% by Australia
- Some tax and production sharing changes were agreed by Timor-Leste to make this work, but careful analysis was done to make sure that full gas project resulted in more benefits to Timor-Leste than the “liquids only” (no gas) project
  - Basically: Slightly lower state share % X higher revenues = higher revenues to Timor-Leste
- Bayu Undan deal has been reviewed by a range of international experts and found to be a good deal for Timor-Leste



# Bayu Undan

## Sharing of project revenues

**“UPSTREAM”**  
Production facilities  
in JPDA  
\$2.2bn capital

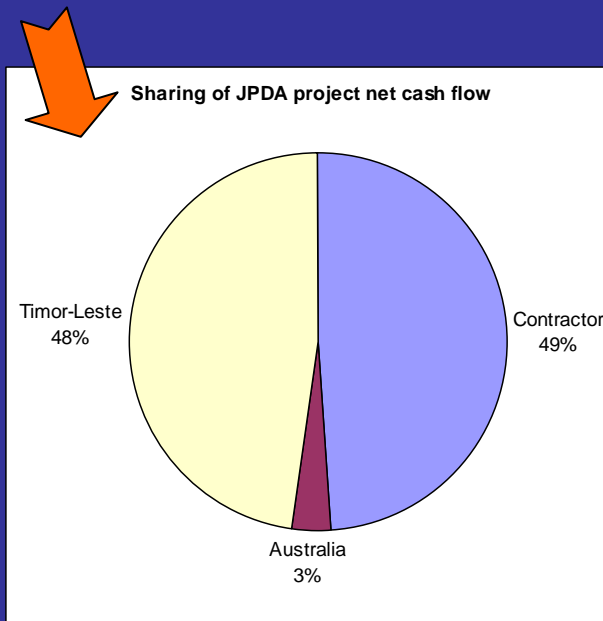
- 100% of condensate and liquids revenue
- Receives 100% of LNG revenue minus fixed Pipe and LNG charge
- Taxed 90% Timor-Leste; 10% Australia

**“DOWNSTREAM”**

Pipeline \$0.4bn

Liquefied  
Natural  
Gas plant  
\$1.2bn

- 0% of condensate and LPG revenue
- Receives fixed amount of LNG revenue to give modest 8% return on capital cost
- Taxed 100% by Australia



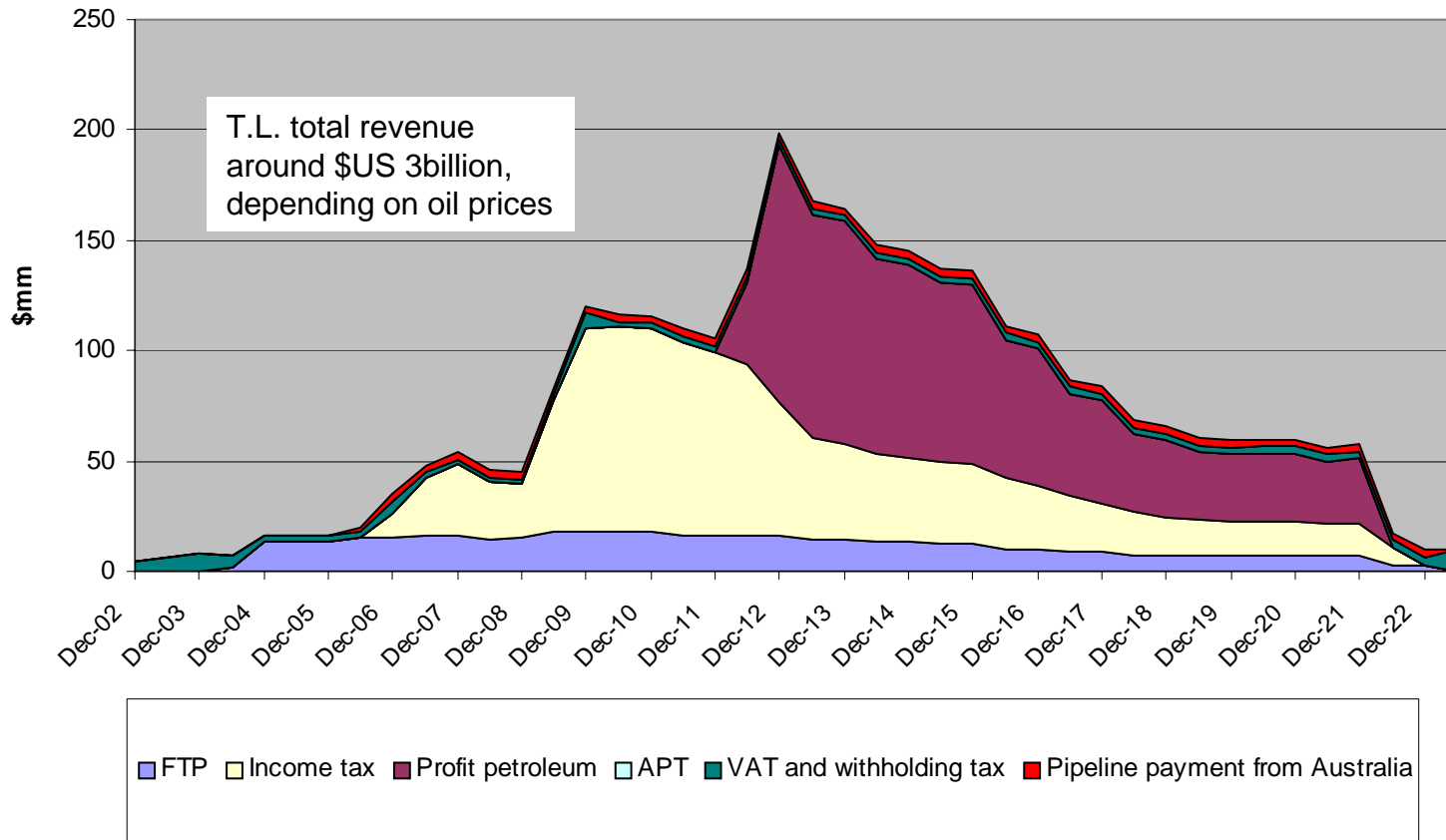
Pie shows

- Approximate sharing of Upstream JPDA project net cash flows over total life
- Net cash flows = Revenues, less all costs
- Assumes oil prices used for T.L budget 2004/5
- If oil prices change, so will share of cashflows

# Bayu Undan

## Timor-Leste revenues over project life

Timor-Leste revenues over time  
Bayu Undan project as included in budget 2004-5



# Changes made for Bayu Undan regime

In return for maximising upstream share of gas revenues, Timor-Leste negotiated:

## PSC changes to Annex F PSC

- LNG revenue sharing arrangements. 8% Rate of return for the pipeline and LNG plant after 15 years
- FTP limited to 10%. No longer increasing to 20% after 5 years.
- Gas profit share: DA 40% instead of 50% (no change in oil share)
- Contractor allowed an additional cost recoverable amount as a provision for decommissioning over last 15 years of production.

## Timor-Leste tax changes to inherited tax law

- Branch Profits Withholding tax abolished (but see APT). Tax rate therefore 30%
- Depreciation simplified and made quicker - 5 years straight line
- “Additional Profits Tax” (APT). Contractor pays 22.5% tax when rate of return earned exceeds 16.5%
- Reduction in withholding tax

# Where to now?

- Timor-Leste must now establish a general regime to apply to any new projects in the JPDA and in areas of Timor-Leste sole jurisdiction
- Profitability of oil projects is subject to great uncertainty
  - Oil prices; Geology; Costs
- Because the true profitability of a project cannot be known in advance, designing a tax regime means striking a balance :
  - Not too severe that it discourages exploration or stops projects being developed in the first place; but
  - The state gets a reasonable share of projects that do go ahead

# International Petroleum Regime Trends

- PSC framework is common, especially in SE Asia region
- Focus on “progressive” mechanisms – where state share is directly related to project profitability or contractor return
- Reduction in gross royalties or production payments
  - Not related to profitability - discourage development of marginal projects
- Simplification and transparency
- Ensure taxes paid will qualify for foreign tax credit in contractor’s home country (therefore combine PSC with income tax on contractor’s share)
- Convergence of income tax rates towards 30%
  - *But, regimes can only be compared taking into account all tax elements together*

# Principles used in new regime design

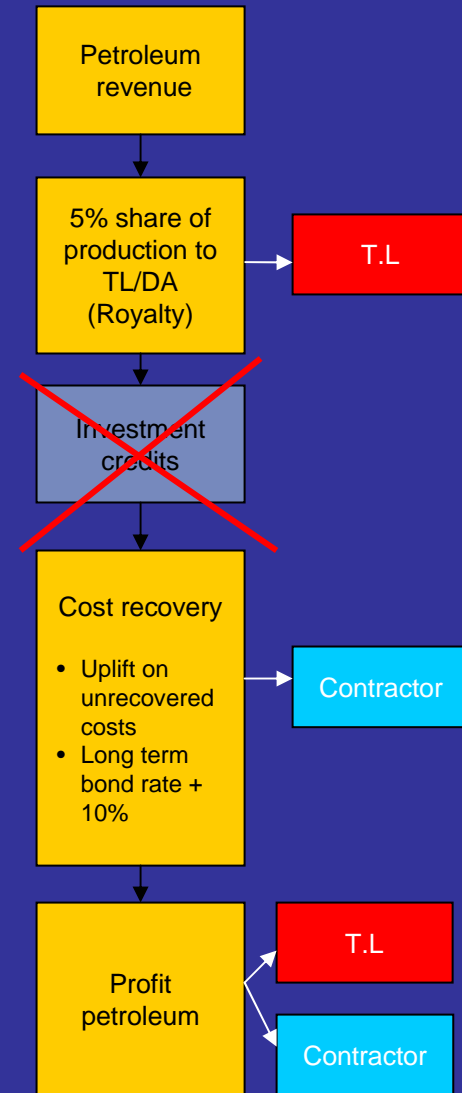
- Attempt to align taxation regime for Timor-Leste and JPDA as closely as possible – make life easier once boundary issues resolved
- Use familiar instruments and mechanisms, for administration and investor-friendliness
- Base new terms on those successful in encouraging gas development at Bayu Undan
- Take note of taxation levels in neighbouring countries but develop Timor-Leste regime with geology of Timor-Leste in mind
- Regime to be generally applicable - Limit negotiation on project by project basis
- Design a tax regime that assist small or marginal projects but also ensures that Timor-Leste gets its fair share if there is a very rich petroleum field

# New Regime – Key Elements

- Retains PSC and income tax framework, but reformed
- Same terms for Timor-Leste and JPDA
- No separate cost accounting for oil and gas
- Uses Bayu-Undan framework – a proven regime for a major gas project
- Encourages smaller field development, such as are likely to be found onshore
- Includes profit-related production sharing and income tax to capture share of high profits (e.g., in a major oil discovery)
- Simplifies Timor-Leste petroleum tax regime

# New Regime – PSC

- First 5% of production (effectively a royalty) to Timor-Leste/DA. Not shared with contractor
- Cost recovery
  - All costs are recovered by contractor from all revenues remaining after first 5%
  - Balance of unrecovered costs carried forward annually plus “uplift” (interest) of long term bond rate + 10% (=15.0%)
  - Uplift replaces Investment Credit
  - Profit oil only after contractor has recovered costs plus a reasonable return
- Profit petroleum share flat 50%. No distinction between oil and gas
- Contractor allowed to recover some decommissioning costs during project life



# New Regime – Income Tax

- Eliminate Branch Profits Tax. Basic tax rate therefore 30% unless APT becomes payable
- Simplify depreciation provisions.
  - Development costs 10 years straight-line (means equal annual amounts)
  - Exploration costs 5 years straight-line
- Depreciation based on production allowed for short-life projects
  - Straight-line depreciation may penalise these
- Additional Profits Tax (APT) same as Bayu Undan
  - Additional 22.5% tax where contractor has earned 16.5% return
  - Does not discourage investment in marginal or modestly profitable fields
  - Captures an increased share of benefits for Timor-Leste from profitable fields
- Simplified withholding tax provisions - 5% flat rate

# Let's recap

We have explained

- What a fiscal regime is, and why Timor-Leste needs a specific one for petroleum
- The history of the existing JPDA regime and changes made to it for Bayu Undan
- The recommended new regime and our reasoning

Will now explain economic analysis we did to ensure that the new regime is comparable and competitive with regional regimes

# Economic Analysis: How to Compare Tax Regimes

- Simply comparing income tax rates is not enough.
  - 30% income tax rate must be better than 40%? Not necessarily...
- Sharing of benefits depends on the combined effect of all fiscal mechanisms

## Obvious “headline” parameters

- Royalty rates
- Profit oil/gas shares
- Income tax rates
- Additional Profits Tax rate

## Less obvious

- Different terms for gas and oil
- Limits on % of revenues contractor can use to recover costs
- “Uplifts” or “Investment allowances” that allow contractors to recover > 100% of costs
- Mechanisms that change profit oil shares based on:
  - Production rates; rates of return; contractor revenues in ratio to costs; cumulative production
- Depreciation rates
  - Affects timing of payment of tax, but not total tax paid
- State equity participation in project.
  - “Carried” by contractors or not? On what terms?
- Domestic supply requirements: effectively an extra royalty

# Economic Analysis: How to Compare Tax Regimes

So to compare, we measure:

- The total amount of state share secured by the regime.
- The timing of when the state receives its share and the effect this has on contractor rate of return.
  - The more the state's share comes at the start (like with royalties), the more the regime will deter marginal projects
  - A project will only be developed if the contractor is confident of achieving reasonable rate of return – generally 15% or more
- Also must consider whether the regime works over a range of different project types and profitability? – is it flexible
- We must treat comparisons with great caution; these do not take account of geological, infrastructure or political differences.

# Economic Analysis Approach

- Comparison of recommended “New” regime with Bayu Undan regime, Annex F regime and selected regional regimes.
- Regional regimes
  - Australia: Income tax + Petroleum Resource Rent Tax (PRRT)
    - Note PRRT does not apply to Australian share of JPDA petroleum
  - Indonesia: (Model PSC + Tax)
  - Papua New Guinea: (Royalty + income tax)
  - Malaysia: (Model PSC + tax)
- Comparisons for three types of project
  - Large integrated oil and gas project. Similar to Bayu Undan
  - Small, short life field. Similar to Jahal & Kuda Tasi
  - Large, 500 million barrel oil field.

# A Caution on International Comparisons

- Regimes selected for comparison are those applying in the Timor Sea and surrounding regions
- Timor is competing against these for exploration investment.
- However a country's fiscal regime is only one factor and not necessarily the most important
  - Geological potential, political stability, access to infrastructure
  - PNG has recently drastically reduced taxes, but it is not likely that their problems caused by fiscal regime
- Comparisons are difficult; for example
  - Indonesia and Malaysia tend to negotiate on a case by case basis. No “standard” regime for comparison. It is not clear how model terms compare to those agreed for real projects. Strategy is to start high and then negotiate down.
  - Arrangements for sharing of project revenues between upstream and downstream have a big impact on state shares in integrated oil and gas projects like Bayu Undan. Not addressed in this analysis
- Comparisons should therefore be considered as a guide only

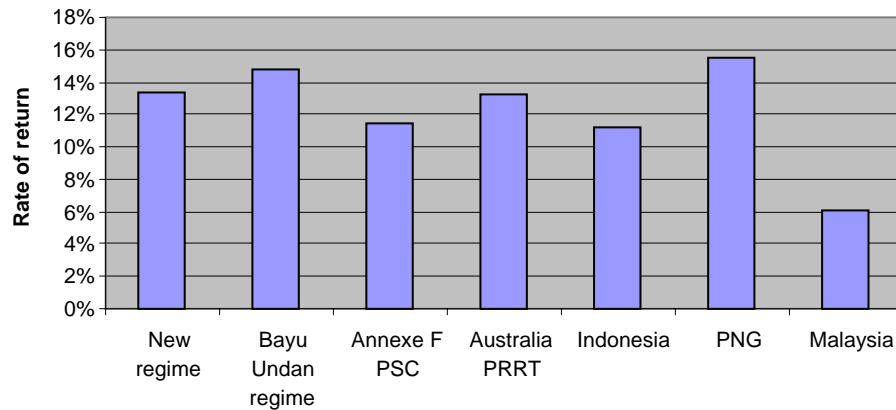
# Findings

- State share under New regime is slightly higher than Bayu Undan, as intended, and lower than inherited JPDA terms (“Annex F” + inherited income tax).
- New regime is broadly competitive with regional regimes.
  - State share lower than Indonesia and Malaysia. However, comparisons are difficult because of case by case negotiation in those countries
  - Consistent with Australia
  - Higher than PNG
- New regime operates effectively over three different types and sizes of project examples used
  - Highly progressive mechanisms and modest royalty mean recommended regime not likely to deter marginal or short-life projects
  - Highly progressive mechanisms secure increased state share in highly profitable projects
  - Depreciation choice provides practical flexibility for short-life projects

# Economic Analysis Results

## Integrated Oil and Gas Project

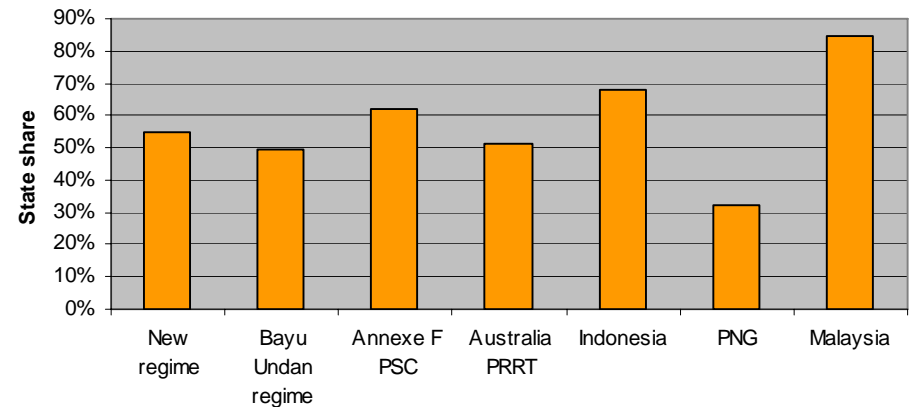
Comparative contractor returns after tax  
Integrated Oil and Gas Project



- Comparisons are especially difficult for this type of project because it includes downstream activities

- Relatively marginal project – similar to Bayu Undan
- Rate of return before tax 20%
- Analysis assumes upstream share of gas revenues similar to Bayu Undan.

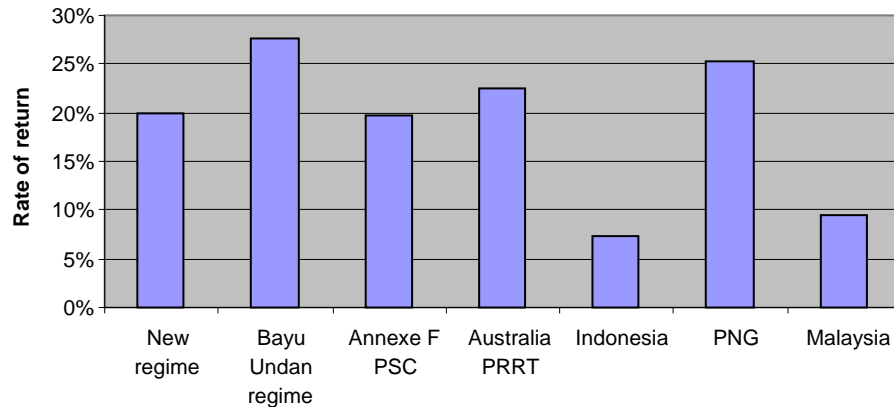
Comparative state share of project net cash flow  
Integrated Oil and Gas Project



# Economic analysis results

## Small Oil Field

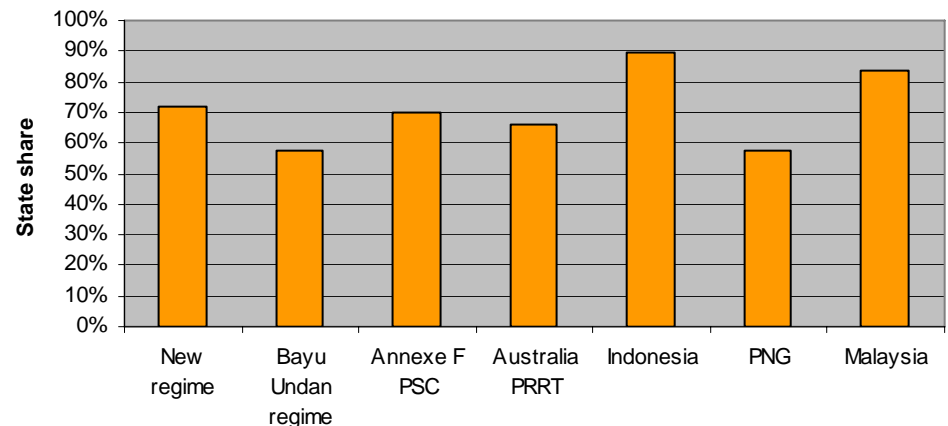
Comparative contractor returns after tax  
Small oil field



- Indonesia and Malaysia regime too severe and inflexible and would prevent project going ahead
- New regime captures reasonable share of benefits, but allows contractor reasonable return

- Relatively profitable project – similar to Jahal Kuda Tasi but with much lower exploration costs
- Rate of return before tax 56%
- Project qualifies for units of production depreciation under new T.L regime

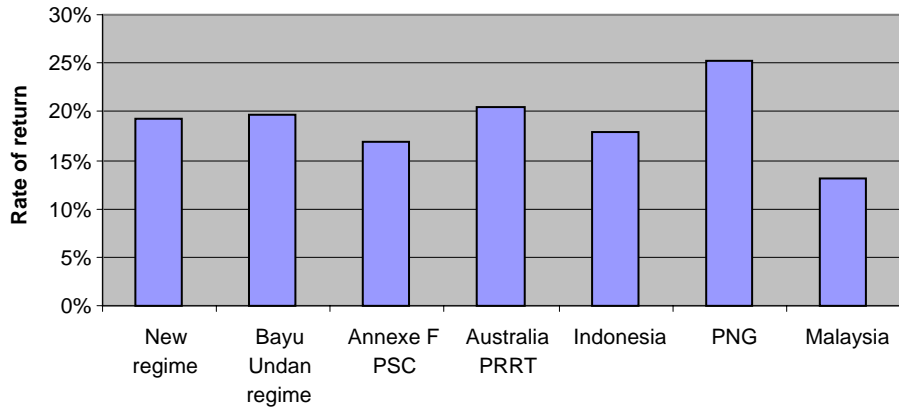
Comparative state share of project net cash flow  
Small oil field



# Economic analysis results

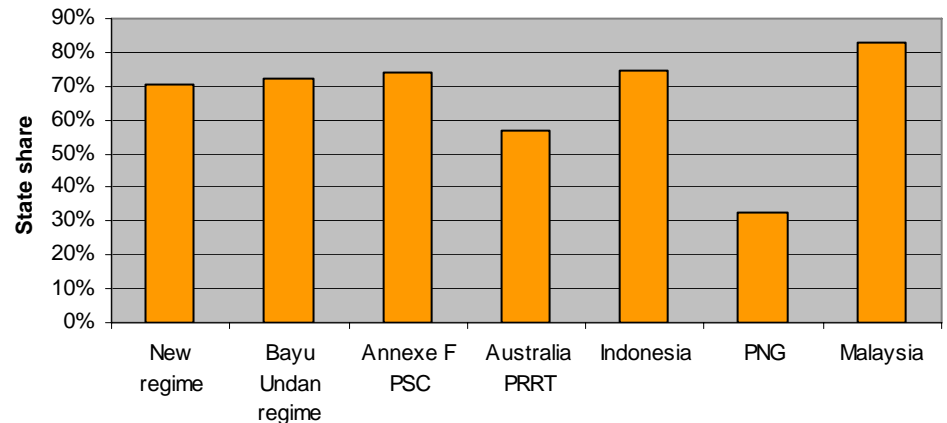
## Large oil field

**Comparative contractor returns after tax**  
Large, profitable oil project



- Progressive mechanisms mean New regime state share is relatively higher in this profitable project
- Australia and PNG regimes less progressive therefore relative state share drops

**Comparative state share of project net cash flow**  
Large, Profitable oil project



- Relatively profitable oil only project
- Rate of return before tax 31%

# Conclusions

- Designing a new fiscal regime is a difficult balance
- These proposals –
  - Build on what is familiar
  - Are reasonable in regional comparison
  - Are benchmarked to Bayu Undan
  - Offer investors good, but not excessive returns
  - Offer Timor-Leste a take that is fair
- If the state share was made higher:
  - Risk of deterring marginal projects
  - More likely to require negotiation for each project

# Consultation with Petroleum Industry

- Process
  - Documentation available on internet
  - Written submissions sought
  - Individual meetings to be held
- Petroleum industry will probably ask for:
  - Lower royalty
  - Lower profit gas share for the DA / State
  - Higher uplift for cost recovery (or re-instatement of investment credit)
  - No APT
  - Lower withholding taxes
  - Fiscal stability provision

# Process from here

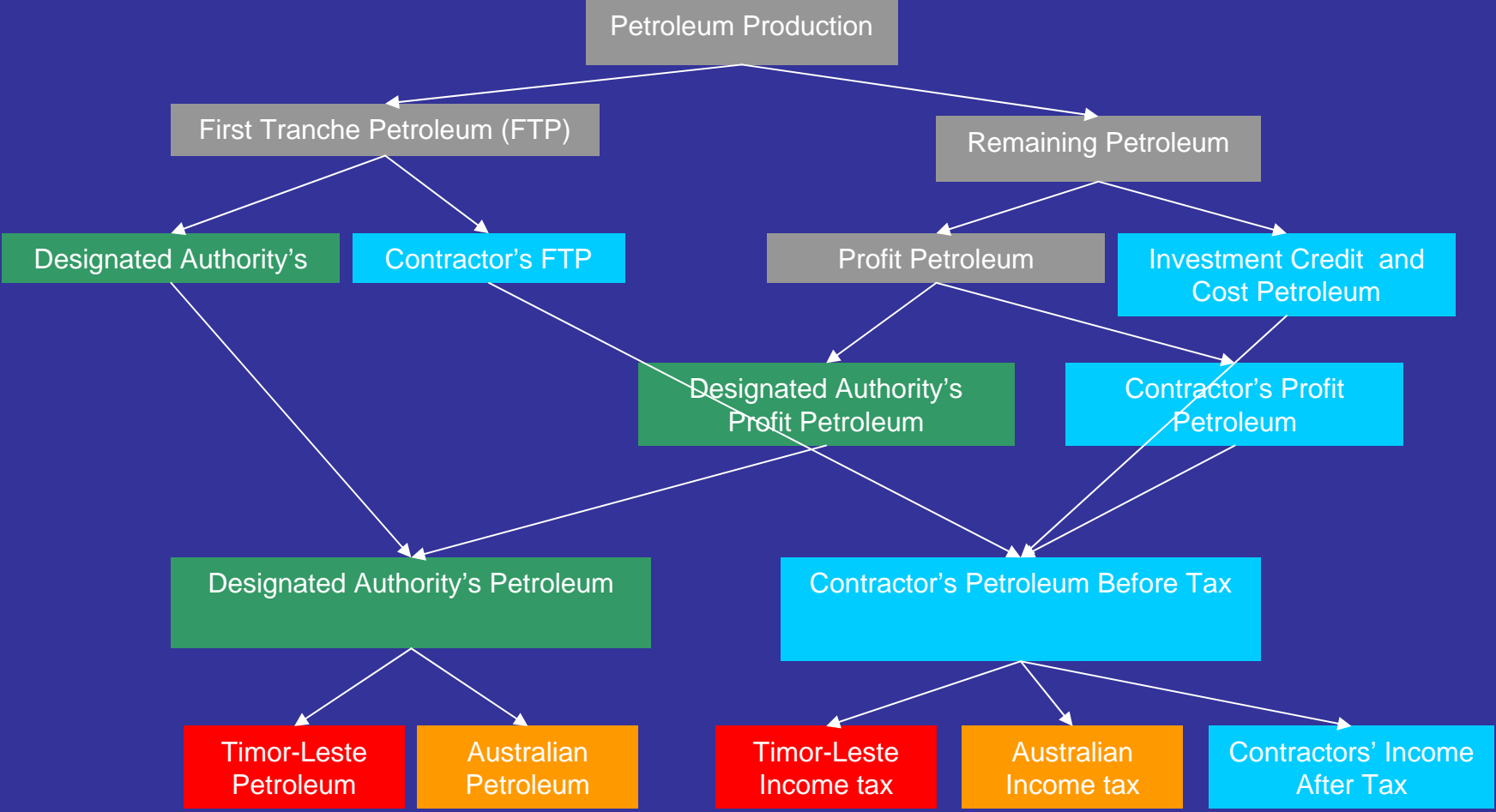
## (in main presentation as wrap-up?)

- Public consultation and what will be done with feedback
- Oil industry consultation
- Redrafting
- Presentation to COM
- Presentation to Parliament
  
- Add timing

- SLIDES FROM HERE ARE FOR BACKGROUND/QUESTIONS AND NOT INTENDED FOR MAIN PRESENTATION

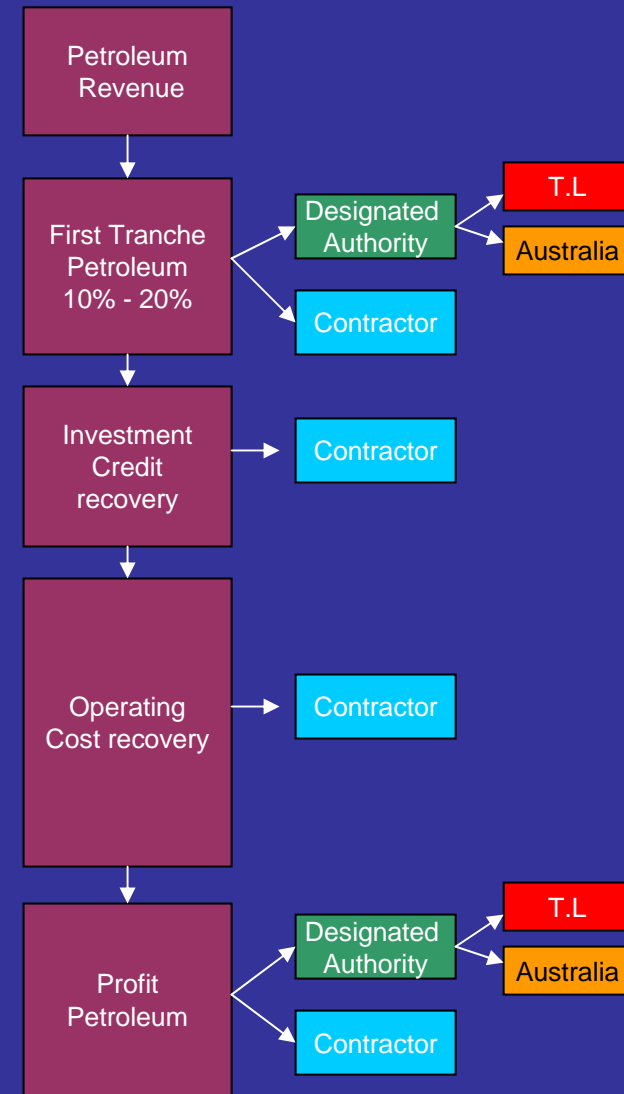
# How the existing “Annex F” PSC Works

TIMOR-LESTE: THE CURRENT FISCAL REGIME IN THE JPDA



# Annex F PSC structure for JPDA project

1. First 10% revenue is First Tranche Petroleum (FTP)
  - Increases to 20% after 5 years
  - Shared between contractor and Designated Authority (DA) on same basis as profit petroleum
2. Then, Contractor recovers “Investment Credits” from revenues remaining after FTP deducted
  - 127% of qualifying costs
3. Then, Contractor recovers “Operating Costs” (1) from revenues remaining after FTP & Investment Credit deducted
  - Exploration costs + capital costs depreciated over 5 years + non-capital costs
4. Then, revenues left (if any), are “Profit Petroleum”
  - Shared between DA and contractor
  - Oil: varies with daily production rate (DA share 50% up to 70%)
  - Gas: 50%
5. Separate calculations for oil and gas
6. Contractor then subject to income tax on its share of revenues under PSC



(1) PSC uses the term “Operating Costs”. However this includes all contractor costs: exploration + capital + non capital + current period operating/running costs

# Comparative regimes

## AUSTRALIA Income tax + PRRT

### Income tax

- Income Tax rate 30%
- Depreciation straight line over project life
- Exploration immediately deductible
- No abandonment provision

### Production Resource Rental Tax

- Tax deductible PRRT of 40% paid on positive cashflows earned after uplift
- Annual uplift for exploration - long term bond rate (5%) + 15%
- Annual uplift for other costs - long term bond rate (5%) + 5%
- Exploration concession in 2004. Extra 50% allowance for exploration costs for PRRT purposes. For specific frontier areas only.

## MALAYSIA Model PSC + Income tax <sup>(1)</sup>

### Production sharing contract

- Separate gas and oil accounting, but identical cost recovery and profit sharing terms
- 10% royalty to state
- Contractor recovers costs from 70% of revenues, reducing once ratio of revenues to costs exceeds 1
- Excess cost recovery revenue shared with state. Contractor share 80% reducing to 40% based on ratio of revenues to costs and also whether cumulative production exceeds 30mmbbl
- Profit oil share 80% to 30% if cumulative production less than 30mmbbl. 40% to 10% if > 30mmbbl.
- Excess profits payment of 70% of profit oil difference between actual oil price and base price escalated at 4%.

### Income tax

- Income tax rate 38%
- Depreciation 28% first year, 8% per year for remainder of 10 years

(1) There is a high likelihood that these terms would be modified, and made less severe, through negotiation with contractors

# Comparative regimes (continued)

## INDONESIA PSC + Income tax <sup>(1)</sup>

### Production sharing Contract

- Separate Gas and oil accounting
- State share oil 37.5%
- State share gas 28.57%
- FTP 15% shared between state and contractor
- Costs recovered from 100% of revenues after FTP
- Intangible costs and exploration recoverable immediately
- Development costs depreciated 25% reducing balance with remainder in year 5
- Investment credit varies from contract to contract
- Domestic supply commitment. (25% x 62.5%) of revenues sold to state at 25% of prevailing price

### Income tax

- 44% (30% + 20% withholding tax, less severe under tax treaties)
- Costs deducted same basis as for cost recovery

(1) There is a high likelihood that these terms would be modified, and made less severe, through negotiation with contractors

## PAPUA NEW GUINEA Income tax + royalty

### Royalty

- 2% development levy (tax deductible)
- 2% royalty (tax credit)

### Income tax

- 30% (previously 45% oil, 30% gas)
- Depreciation 10 years straight line
- APT abolished 2003.
- Previously APT 20% after 15% return; then 25% after 20% return