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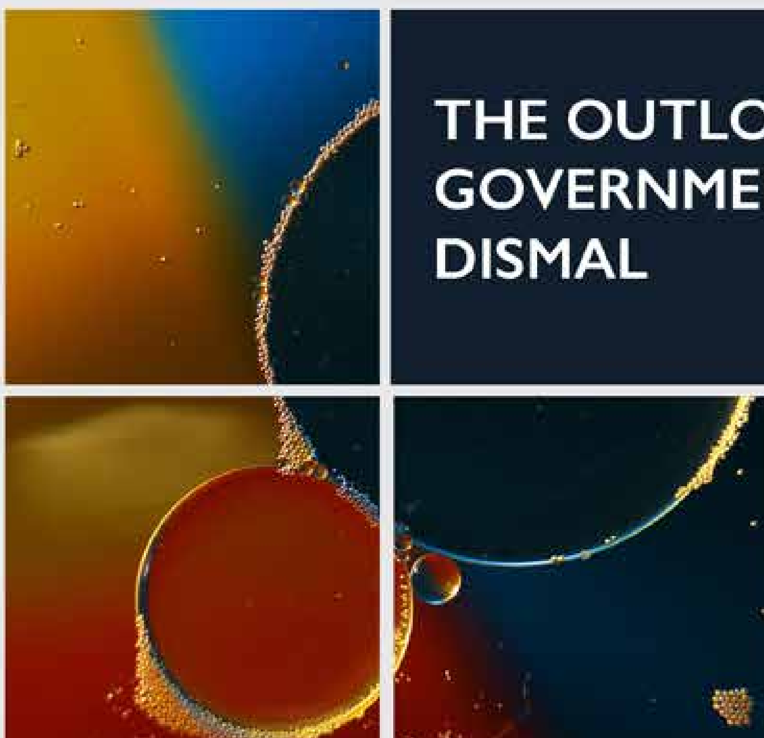
THE OUTLOOK FOR GOVERNMENT TAKE IS DISMAL



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Title: Sasol's Development Plan Under the PSA Is Problematic

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Adriano Nuvunga e Inocência Mapisse

Maputo, August 2017

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Executive Summary

In its edition of August 23, 2017, the newspaper "O Pals" indicates on the cover that "Sasol announces new discoveries of oil and gas in Inhambane". These are discoveries made under the Production Sharing Agreement (PSA) signed in October 2000 between the Government, ENH and Sasol Petroleum Mozambique Lda (SPM), whose objective was to explore, evaluate, develop and produce in the areas adjacent to the PPA.

In the context of the PSA, Sasol notified the Government in February 2013 of the "commercial viability" of the findings and on February 25, 2015 submitted for the Government's approval the Development Plan for the production of light oil and natural gas at from the deposits at Inhassoro and Temane. It is within the framework of this Development Plan that Sasol announced to the public the "discoveries" made. An evaluation of this Development Plan raises serious concerns, all related to the economic viability of the PSA, from the point of view of gains for the State:

• While the recovery factor for gas -- proposed at 70% -- is acceptable, the proposed recovery factor of 22% for light oil is well below the world average of 40%, considering the levels of technological development achieved in the industry;

• Both the capital and proposed operating costs of Stage 1 are acceptable, but given it is financing from within the Sasol Group, and taking into account the experience under the PPA -- that had a capital increase of 60% -- the conditions are created for both the capital and operating costs to become inflated, diluting the potential revenue for the Mozambican Government;

• The expansion of the central processing facility (CPF) provided for in the PSA is assigned a realistic cost, which reinforces CIP's argument that the cost of US$ 400 million for the first expansion, in the context of the PPA, had been vastly exaggerated;

• Even before considering the aspects mentioned above, the Development Plan presented by Sasol was already problematic as regards the economic component, because it did not present positive results, since investment expenses are higher than expected revenues;

• The PSA does not provide for production sharing. This stems from the fact that -- despite this being 2017, with clear petroleum tax laws with respect to the sources of revenue for the Government – it was insisted to mold the PSA according to a law of 36 years ago, i.e., Law 3/81 of 3 October (the Law on Activities in the Oil Sector) and the Decree of the Council of Ministers (CM) n° 14/82 of 3 December. Because of this, the Mozambican Government, in this day and age, signs a PSA without production sharing.

• What apparently makes Sasol continue with the PSA, even if it generates losses, is the possibility that its structure will allow it to be the instrument for the extension of the lucrative PPA, without negotiation, when the contract expires in 2029.

Introduction

In its issue of August 23, 2017, the newspaper "O Pals" indicates on the cover that "Sasol announces new discoveries of oil and gas in Inhambane". These are discoveries made under the Production Sharing Agreement (PSA) signed in October 2000 between the Government, ENH and Sasol Petroleum Mozambique Lda (SPM), whose objective was to explore, evaluate, develop and produce in the areas adjacent to the PPA.

The PPA is the project for the exploitation natural gas at Pande and Temane, in the southern Province of Inhambane, by the South African multinational Sasol that is the result of an agreement with the Mozambican Government signed in 2000 in the form of a Petroleum Production Agreement (PPA), under Law 3/81 of 3 October[1].

In the context of the PSA, Sasol notified the Government in February 2013 of the "commercial viability" of the findings and on February 25, 2015 submitted for the Government's approval the Development Plan for the production of light oil and natural gas at from the deposits at Inhassoro and Temane.

It is within the framework of this Development Plan that Sasol announced to the public the "discoveries" made. CIP has had access to the Development Plan and this report addresses this Plan. The evaluation of this Development Plan raises serious concerns, all related to the economic viability of the PSA, from the point of view of gains for the Government.

Development of the Inhassoro and Temane Fields

The PSA designates SPM as the contractor entrusted by ENH to carry out petroleum activities and specifies the area defined in the PSA contract for those petroleum operations to be carried out. The PSA also defines the rights and obligations of SPM as the contractor, which include the obligation to pay all costs incurred in the performance of petroleum operations and the right to remuneration through a right to quantities of oil, as specified.

The PSA reservoirs comprise the Inhassoro and Temane fields, with oil reservoirs in Inhassoro and natural gas in Temane, both within the Mozambique Basin.

Sasol proposed the development of these reservoirs in two stages, covering the areas of production development of Temane and of Inhassoro, through an integrated project of oil and gas production. The reservoirs that have been declared commercially viable are:

Stage 1

- Inhassoro G6, consisting of an oil rim with a gas cap;
- Inhassoro G10, a sheet of sub-saturated oil;
- Temane G8, an accumulation of non-associated natural gas; and
- Accumulations of non-associated natural gas G11, G11A, G12 and G12A of Temane-East.

The Development Plan does not include the development of Stage 2, which is dependent on the development results of Stage 1, requiring the development and approval of a new Development Plan. The Development Plan for Inhassoro aims at a period of development and production of 25 years from the date of approval of the Development Plan.

1 Law n° 3/81 of 3 October regulated petroleum operations in Mozambique.

The Development Plan of Temane aims at a period of development and production of 30 years from the date of approval of the Development Plan.
The Inhassoro reservoirs contain oil and gas from capping. First, light oil will be produced, using gas as reservoir energy. After the depletion of light oil, gas will be produced.
According to Sasol, the reservoirs contain the following amounts:

Total Expected Recuperation of the Reservoir	Low	Best Estimate	High
Gas (BSCF)			
Temane G8 & G10	187	300	569
Temane G11	51	69	86
Inhassoro G10	0	11	21
Light Oil (MMSTB)			
Inhassoro G6	10	30	58
Inhassoro G10	0	25	47

The table above shows the possible and recoverable quantities in the reservoirs. It is noted that for gas a total of 380 BSCF (billion standard cubic feet) ~ 0.38 Tcf (trillion cubic feet) can be recovered for the best estimate, which means that the recovery factor for gas is 70% for the different reservoirs.

For light oil, there has been a recovery of about 70 MMSTB (million stock barrels), resulting in a recovery factor of about 14% and 22% for the two reservoirs of Inhassoro, respectively. Taking into account the new technologies used in the oil industry, on the one hand, and the experiences of similar reservoirs, on the other hand, a recovery factor in the order of 40% would be expected. Therefore, CIP feels that 22% is a recovery factor that is too low.

Commercial, Financial and Economic Issues

Commercial Issues

In the context of the present project, several commercial agreements are foreseen, including sales agreements for oil, natural gas, condensate and GPL. As a matter of principle, such agreements should be established in order to activate the implementation and production operations of Stage 1 of the development project under the PSA.

Commercial Agreements

I. Development and production of oil:

• Operating and Maintenance Agreements between the SPT and PSA contracting party regarding the operation and maintenance of the liquid processing facility (LPF) and of wells and facilities in the development and production areas (DPAs) in Inhassoro under the PSA;

• A Services Agreement in which the PSA contracting party receives services (certain utilities and systems for process control, monitoring and safeguards) from the PPA contracting party;

• An Agreement for the Allocation, Measurement and Lifting of oil production once the LPF is operational;

• An Initial Production Processing Agreement in which the PSA contracting party pays a production-based fee to the PPA contracting party for the use of PPA flow lines and facilities;

• A Gas Lending and Replacement Agreement for the short-term processing of the Inhassoro gas from the PSA prior to the Gas Processing Agreement (GPA) coming into force. A GPA for the processing of the Inhassoro gas from the PSA once the liquid processing facility (LPF) is operational.

II. Gas Development and production:

• An Operation and Maintenance Agreement between the SPT and PSA contracting party regarding the operation and maintenance of wells and facilities of the Temane DPA;

• A Gas Processing Agreement between the PPA contracting party and the PSA contracting party;

• An Agreement for the allocation and measurement of natural gas from the production development areas between the PPA contracting party and the PSA contracting party;

• The award of contracts to execute an Agreement for the Sale of Gas between the PSA contracting party and the gas purchaser.

A production of 15,000 bbl / d of light oil is expected according to the Inhassoro Development Plan, which could increase to 17,000 bbl / d with the addition of the condensate produced in the central gas processing facility (CPF) under the PPA.

Financial Issues

Funding for the development of Stage 1 of the PSA will be supported by loans from the shareholders of Sasol Petroleum Mozambique Ltd (SPM). SASOL Petroleum International (SPI) will finance shareholder loans through a combination of surplus liquidity from the Sasol group and existing facilities.

While the use of funds from the same business group to finance projects is beneficial, among other things, because it makes capital available as quickly as possible for project development, this modality is problematic because it tends to: inflate the amount of capital required for investment, raise the cost of capital through high interest rates and tends - from past experience - to require a capital increase that often results from a lack of proper project preparation and of management efficiency that would be required under other financing modalities, for example, Project Finance[2].

In other situations, the use of funds from the same group to finance projects allowed the parent company or subsidiary to divert part of the capital assigned to the project in question to other projects with a higher degree of risk but to record the expenditure for the project for which the amount was initially mobilized. This is a real risk which the Mozambican authorities should be prepared to deal with.

2 Project Finance - is a form of financial structuring of projects, used for the development of large investment projects, where the cash flow generated by the project is the main source of payment for the interest and amortization of capital from third parties.

Economic Issues

Inhassoro's light oil production envisages capital costs of US$ 863 million and operating costs of US$ 1,337 million, totaling US$ 2.2 billion. Tax revenues for the Government from this project are estimated at US$ 1,731 million on account of taxes (IRPC) collected during the life of the project.

The project for gas production at Temane envisages capital costs of US$ 321 million and operating costs of approximately US$ 1,069 million, totaling US$ 1.39 billion. According to the Development Plan, this project provides fiscal revenues in the order of US$ 656 million over the life of the project, which could allow the Government to raise an average of US$ 26.24 million annually.

In addition, the Contracted part is to deliver to the Government, in cash or in kind, an amount corresponding to 5% of the natural gas produced and sold in Temane and an amount corresponding to 8% of the light oil produced and sold in Inhassoro, corresponding to 1,200 bbl / d.

This economic analysis refers only to the development of Stage 1 of Temane and Inhassoro. The Development Plan proposes the approval of Stage 1 only, and subsequent stages will be subject to a new Development Plan and respective economic feasibility analysis.

For both projects, the proposed capital and operational costs are within what CIP has seen in similar projects, but the experience with the PPA, with an increase of 60% in capital, suggests a need for caution. An increase of 25% is within what is seen in the outside world, but an increase of over 60% seems rather abnormal. CIP is worried that this scenario may be repeated with the PSA, greatly compromising the possibilities for the Mozambican Government to realize meaningful revenues under this project.

The Development Plan does not disclose the hypotheses for the revenue projections by Sasol that are the basis for the calculation of the revenues for the Mozambican Government. This has to be disclosed transparently in order to be able to use the existing formula, ceteris paribus, to calculate the revenues accruing to the Government. The Development Plan is also not transparent as regards the basis for the revenue projections of the Mozambican Government, although it indicates that these will only come from the Tax on Petroleum Production and from the Income Tax on Companies (IRPC). This makes it clear that, like the PPA, the PSA does not provide for production sharing.

As its name indicates (production sharing) it was expected that the PSA would contain an unambiguous clause regarding the sharing of production, as was already envisaged in Law 3/81 of 3 October. Furthermore, the Development Plan is approved now in the context of Tax Law no. 27/2014 of 23 September, applicable to oil contracts, that establishes unequivocally as sources of revenue for the Government the following: (i) Tax on oil production (royalty) - 10% for crude oil and 6% for natural gas; (ii) Income tax on companies (IRPC) - 32% after all deductions have been made; and (iii) production sharing based on the R factor.

How can a Development Plan be approved in 2017 without updating the fiscal aspects of a contract (for production sharing) that is governed by the 36 years- old Law 3/81 of October 3?

All things considered, the Development Plan itself indicates that the project does not only have a number of uncertainties but also generates losses. It does not present positive earnings, as the investment expenditures are higher than the expected revenues, since, for an overall investment of the two stages in the order of US$ 3.5 billion, the expected revenues in the order of US$ 2.3 billion are smaller, reflecting a deficit or loss of US$ 1.2 billion. This means that the project shows economically unattractive figures because the amount of investments is greater than the amount of revenues.

Project for the Expansion of the Natural Gas Central Processing Facility (CPF)

Sasol Petroleum Mozambique Ltd (SPM), contracting party under the PSA, has requested from Sasol Petroleum Temane, Ltd (SPT), contracting party under the PPA, a gas processing service for the Temane and Inhassoro DPAs, including associated gas from the proposed liquid processing facility (LPF) of the PSA. SPM has also requested that the monitoring and control of all PSA installations and wells occur in the central processing facility (CPF) and that certain public utility services be provided to the LPF from the CPF.

This will require the expansion of the CPF by building an additional gas processing module (the fifth module), increasing current production capacity from 183 mGJ / year to 243 mGJ / year, about 33%, equivalent to 60 mGJ / year. This will be CPF's second expansion after it expanded its production capacity from 120 mGJ / year to 183 mGJ / year, approved in 2009.

Economic and Financial Aspects

The economic assessment of this expansion project was carried out by taking account of the fact that the construction and commissioning of the additional gas processing facilities of the central processing facility (CPF) will be executed as part of the development of Stage 1 of the PSA.

Additional gas processing facilities will be financed, owned and operated in full by the PPA contracting party, Sasol Petroleum Temane, Ltd (SPT). The PPA contracting party will recover the capital expenses by charging a processing fee to the PSA contracting party, Sasol Petroleum Mozambique, Lda (SPM). This fee will be calculated to recover not only capital expenditures but also a proportionate share of the cost of production and maintenance of the facilities.

Capital costs are estimated at US$ 150.7 million and operating costs at US$ 76.7 million, based on market-based estimates in 2014.
Based on the assumptions of the PPA and assuming the additional production and costs mentioned above, the economic benefits of the project are positive at a discount rate of 10%, with a return of 16.4% on the contractor's side. Government earnings at the same discount rate will be US$ 29.9 million resulting from the collection of taxes.

The first expansion of the Central Processing Facility (CPF), whose proposal was approved in 2009, was budgeted at US 400 million, aimed at increasing production capacity by 50%, from 120 mGJ / year at the time to 183 mGJ / year, an effective increase of just 63 mGJ / year.
Today, about 13 years after the CPF began operating, a further expansion of the CPF - a module, the fifth - costs US$ 150.7 million, about 38% of the amount spent on the first expansion, which aims at guaranteeing an increase in the production capacity of the current 183 mGJ / year to 243 mGJ / year, that is, an increase of 60 mGJ.

Therefore, in 2009, the capacity increase of the CPF by 63 mGJ / year was US 400 million. In 2017, the capacity increase of the CPF by 60 mGJ / year costs US$ 150.7 million. These figures reinforce CIP's argument that the cost of US 400 million for the first expansion in the context of the PPA was vastly exaggerated for the purpose for which it was intended and, in practice, the purpose has not yet been achieved, given the current production volume (180 mGJ in 2016).

Considering all the critical aspects of the present PSA Development Plan, and the fact that Sasol is moving forward with the PSA even in the face of many uncertainties, suggests that the incentive may be to create a situation where the boundaries between the PPA and PSA are not discerned clearly, and, in this way, have the PSA prolong the lucrative PPA without renegotiation when the contract ends in 2029, since, when the existing contract ends, the whole project (the gas fields, CPF and gas pipeline) revert to the Mozambican Government.

Use of the PSA resources

Light oil

The initial strategy for the use of oil produced in the area of the PSA is to export to international markets. However, this strategy may be altered depending on the quantities of product derivatives (gasoline, diesel, naphtha) that can be obtained by distillation.
An analysis of samples indicates that the fractional distillation of light oil will give a higher yield with 73% of naphtha and 27% of average distillate, which means that the use of the light oil in the domestic market to obtain gasoline and diesel may be limited.
In the case of obtaining gasoline from naphtha, which has a low octane index that would indicate that it should be exported, and in the case of distillates to produce diesel, a change in the sulphur content specification of diesel would be required from 500 ppm to 830 ppm.

Natural Gas

With respect to gas, aside from the export activities, which is the essence of the project, the PSA contracting party commits to ensure the supply of gas to the projects mentioned below, to be developed in the country:

• MOPETCO - Project for the Production of Fertilizer and Ammonia;
• Mozambique Gas to Power, in association with EDM and Sasol New Energy - Power Plant.
What is not known about this allocation is the quantity to be allocated and in what context it will occur: whether as part of agreements with the Government regarding the quota allocated to the domestic market, or whether as part of agreements between Sasol and these two companies.

Condensate

The condensate to be produced from the Temane production development areas (PSA) will be mixed with the condensate from the PPA, and possibly the PSA contracting party and ENH will sell the product jointly.

Socioeconomic Impact

With respect to local content, Sasol identified the development of the local supplier as a key element for the achievement of local content requirement in the hydrocarbon industry in Mozambique. Sasol's commitment to local content will be achieved through the identification, development, growth and sustainability of Mozambican suppliers, particularly SMEs. The project provides for the creation of business opportunities and technical development, financial support solutions, as well as linked business networks, to allow greater participation of SMEs in the value chain of the hydrocarbon industry of Mozambique, thereby contributing to the socio-economic development of the country.
Regarding training of labor for the construction of the project, Sasol intends to train more than 400 workers in various areas of specialization. The objective of this initiative is to replace foreign workers

with Mozambicans graduates from this training program, which is being developed in coordination with INEFP, PIREPE, the Ministry of Education and Human Development, the Ministry of Labor, Employment and Social Security and private institutions. Sasol is planning to hire between 2,000 and 3,000 semi-skilled workers for the construction phase.

However, the local content program of SASOL is similar to other programs of this type whose implementation has failed. This can be demonstrated with Sasol's current gas exploration project: after 13 years its socio-economic impact is nearly invisible. Suffice to look at the construction of the Nyamacunda complex to house Sasol's senior staff, with an investment of more than US$ 30 million, which was awarded to SMH Construction in South Africa despite the fact that there are many Mozambican construction companies with a license to execute similar projects.

The factors that determined the failure of the local content program of Sasol's pioneering project are structural and still exist, so that the tendency of this program not to be effective is real and is due to several issues, of which the following stand out:

a) Although the contracting of goods and services by the oil industry, as stipulated under the Petroleum Law, should benefit local companies, there are no mechanisms that guarantee the effective fulfillment of this norm (particularly the stipulation of Item d) of Article 41). For this reason, the use of local content is seen as optional - depending on the goodwill of the operating enterprise. This situation, coupled with the low competitiveness of Mozambican small and medium enterprises (SMEs) (in terms of size, price, quality and capacity to satisfy demand) when compared to South African companies, puts local SMEs always at a disadvantage in the supply of goods and services;

b) The business segment that is able to provide goods and services to large projects is formed by a specific part of society, which are the political and economic elites of Maputo that obtain privileged information for the sector, to the detriment of other segments. In this case, when talking about the use of local content, the essence of "local" is distorted. "Local" should refer to the host community of the project. It is this community that suffers the negative impact of project implementation and, consequently, it is this community that should benefit from the advantages of local content. In reality, the few opportunities that arise are taken over by the Maputo elites, and this cannot be called use of local content.

Thus, the inclusive development that is sought is nullified. The social inequality issues remain that local content policies are intended to prevent or resolve.

Liquefied Petroleum Gas (LPG) Project

The establishment of an LPG (cooking gas) production unit in Mozambique, which is produced from the propane and butane fractions from gas and oil, was a commitment made by the PPA contracting party to the Government of Mozambique in 2007, following the approval of the expansion of the natural gas venture (CPF) from 120 mGJ / year to 183 mGJ / year under the PPA. Following a request made by the PPA contracting party to INP, the latter recommended that the commitment for the production of this LPG be transferred to the PSA, which received a favorable opinion.

Around 25,000 tons of LPG per year are currently being imported into Mozambique at a high cost. This is far below market needs, which is exacerbated by limited storage capacity. The PSA is intended to replace some or all of these imports by LPG produced locally by the PSA liquid processing facility (LPF), up to a maximum of 20,000 tons / year of LPG. This is a major effort to reduce dependence on imports, but it will not replace imports, as imports of 25,000 tons per year correspond to 1 kg per capita per year, which is clearly lower than the real needs of the Mozambican market (15 kg of LPG per capita[3] .

Conclusions

An assessment of the Development Plan, which comprises light oil from the Inhassoro fields and natural gas from the Temane fields, owned 100% by SPM, shows a promising outlook. However, considering the terms of the agreement and the experience with the PPA, CIP feels that conditions are created for a déjà vu that, just like under the PPA, it is the Sasol group who benefits and leaves the Mozambican Government without any meaningful revenue. Consider the following issues:

• While the recovery factor for gas - estimated at 70% - is acceptable, the proposed recovery factor for light oil of 22% is well below the world average of 40%, considering the levels of technological development attained in this industry;

• Both the capital and proposed operating costs of Stage 1 are acceptable, but in a situation where the financing is within the same group, and taking into account the experience of the PPA that had a capital increase of around 60%, CIP fears that the investment indicated could possibly increase without justification during the development of the project, as a strategy for minimizing the revenues to be paid to the Mozambican Government;

• The CPF expansion cost envisaged in the PSA is realistic, reinforcing CIP's argument that the cost of US$ 400 million for the first expansion in the context of the PPA was highly exaggerated but could actually end up being a fictitious expenditure, since the capacity needed to make the production under the PSA feasible may already be covered by the underutilized capacity under the PPA;

• Even before considering the above situation, the economic component of the Development Plan presented by Sasol was already problematic, as it did not generate positive results, since investment was higher than expected revenues;

• The PSA does not provide for Production Sharing. This derives from the fact that, despite this being 2017 with clear petroleum tax laws, the PSA is consistent with a Law that is over 36 years old - Law 3/81 of October 3 (Law on Petroleum Activity) and Decree No. 14/82 of December 3, establishing the tax framework for exploration, development and oil production;

• The PSA Development Plan claims a considerable socio-economic impact, most prominently on the local content component. With the exception of the Liquefied Petroleum Gas (LPG) project, CIP has reservations about the projected results. First, the fact that opportunities for local content under the PPA have benefited South African companies and only marginally Mozambican companies. Secondly, the few Mozambican companies that benefited from these opportunities are based in Maputo and almost all of them are linked to the country's political-economic elite. Third, the lack of a legal instrument that makes it mandatory to use local companies for the supply of goods and services, leaving the implementation of local content as something optional - depending on the goodwill of the operator. And, finally, excessive tax incentives for projects, which makes it cheaper to import equipment and materials, with generous exemptions from customs duties and VAT, rather than acquire them locally.

• Thus, as in the PPA, the idea of socioeconomic development linked to the PSA seems more a formality in the presentation of the project than a commitment for a real contribution to the socio-economic development of the country.

3 According to Peter Mulder, 2007, Energy Perspectives in Mozambique, Ministry of Planning and Development, Republic of Mozambique.

• Finally, considering that the PPA ends in 2029 and the entire project (i.e., gas fields, CPF and gas pipeline) will revert to the Government, and despite all the concerns related to the PSA, mainly that of generating losses, and other uncertainties related to it, and that even so Sasol is moving forward, even though important aspects still need clarification, suggests, ceteris paribus, that the PSA is fundamentally an instrument to prolong the lucrative PPA without renegotiating the contract in 2029.
In this way, it can be seen that both the PPA and PSA are structured so that the South African multinational Sasol receives the benefit and the Mozambican Government is being milked.

Recommendations

The conclusions of this report revolve around the quality of governance in the relationship between the Mozambican Government and the multinational Sasol. What is clear is that the latter uses all possible strategies to maximize its gains while sterilizing the gains of the Mozambican Government. This is normal, but the present case is seriously problematic and cries out for the following urgent actions:

• Upward revision of the recovery factor for light oil from the current 22% to 40%;
• Control of the cost of investments to be carried out, as well as of the operating costs;
• Review of the factors causing uncertainty to ensure the economic viability of the project, so that revenues are higher than expenditures;
• Revision of the contract to ensure that the production sharing clause is included, in line with the Petroleum Law in force, Law 21/2014 of 18 August;
• Setting of the sales price for gas in line with the international prices, in order to avoid transfer pricing; and
• Disclosure of the hypotheses for Sasol´s revenue projections for the sake of transparency

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