

ROVUMA REVENUES AT RISK:

Inflated Exploration Costs Undermining Future Government Revenue?

Extractive sector companies regularly avoid taxes by exaggerating expenses. Through 2012, Anadarko claimed exploration costs in Mozambique of \$700 million. One year later they claimed exploration costs of \$3 billion. The Government should immediately audit exploration expenses for Anadarko and ENI. The contracts allow for an initial audit of the last three years, with provision to go further back if there has been “manifest disregard of applicable procedure, fraud or willful misconduct.”

Summary

Even under the most optimistic scenario, the first government revenues from LNG exports from the Rovuma Basin are at least five years away. But that government revenue is already at risk due to inflated exploration expenses that are not being properly monitored or audited by the Government.

This is because in the production-sharing system that governs the Rovuma Basin concessions, the split of “profit” gas between the government and the company comes only after the company has recovered its costs (“cost recovery”). The greater the expenses, the longer the government waits for its share of profit gas to grow. The experiences of other resource rich developing countries suggest that international oil companies routinely claim ineligible or inflated expenses thereby reducing the government’s share of the profits (see case studies on Timor-Leste, Indonesia, India and Alaska below).

Mozambique’s EPC contracts make clear provision for government oversight of exploration expenses. Companies must submit an Exploration (with estimated costs) for approval at the beginning of the year, and a “cost recovery statement,” listing claimed expenses, at the end of each year. However, CIP inquiries suggest that these processes are not being rigorously followed and that inflated expense claims are being accepted without careful analysis.

The risks to government revenue from inflated exploration expenses are significant. But they pale in comparison to the risks of inflated expenses during the development phase likely to begin in 2015 and involving tens of billions of dollars. As cost overruns on natural gas projects are the norm rather than the exception (often by 45% or more), the opportunities for inflating costs are exceptionally high. It is imperative that Mozambique implement stringent oversight before the development phase begins.

There is only one effective government response to the risks of inflated expenses: detailed audits. These audits are routinely conducted in other countries as the case studies below demonstrate. Emerging African producers including Kenya, Uganda and Ghana (see text boxes below) are increasingly focusing on auditing exploration and development in order to protect government revenue.

Mozambique has been slow to focus on these risks. There appears to have been only one audit conducted in Mozambique's petroleum sector – a 2010 audit funded by Norway of the Sasol Pande Temane project. There are no public details however of the findings or follow-up. No evidence has been found of government audits of either Anadarko or ENI exploration expenses.

The government must protect Rovuma revenues now by taking the following four steps:

- **Disclosure:** the Government should immediately disclose the annual cost recovery claims submitted by ENI and Anadarko from 2006 to 2013;
- **Documents:** the Government should immediately ensure that all relevant documents to support cost recovery claims are being maintained by the companies within Mozambique (often not the case – see Timor case study);
- **Audits:** the government should initiate a formal audit of ENI and Anadarko annual “cost recovery statements” for the last three years as provided for in the EPC contracts;
- **Secondary Audits:** if the first round of audits uncovers “manifest disregard of applicable procedure, fraud or willful misconduct,” secondary audits should follow back to the signing date of the contracts.

1. Government Revenue at Risk

Experiences in other resource rich countries suggest that companies routinely inflate expenses

in order to maximize profits. Timor-Leste, for example, has embarked on a comprehensive audit program that has already yielded hundreds of millions of dollars in additional government revenue and may eventually recover billions of dollars of unpaid taxes. Emerging African producers are recognizing these risks and beginning rigorous audit programs (See below: Textbox 1 on Uganda and Textbox 3 on Kenya).

One might think that tax avoidance through inflating expenses was a problem limited to smaller developing countries with weak capacity. Case studies below of Indonesia and India reveal that this is not the case. These

Textbox 1: Ugandan “Cost Recovery” Audits

Commercially viable oil was discovered in Uganda in 2006. Production estimated at 60,000 to 120,000 barrels per day is expected in 2014. The Uganda Revenue Authority, responsible for monitoring and collecting oil revenues, is concerned that poor tax administration will lead to underpayment of oil taxes.

With support from UK Aid (DFID), a capacity building program has been launched to improve “cost recovery audits,” including the provision of a long-term technical advisor. The explicit objective of the project is to disallow inflated exploration and development claims in order to reduce claims against project revenue and increase government revenue.

The DFID project is explicitly justified in economic terms, with various scenarios considered: if claimed company expenditures are reduced by just 0.5%, the DFID project would have an internal rate of return of 10%; if claimed company expenditures are reduced by over 5%, the DFID project would have an internal rate of return of 50%.

risks are inherent in the production-sharing model. In the words of Indian auditors, “it is inconceivable that the private contractor would fail to protect his financial interests, and assess every investment/ operational proposal to see whether it would result in incremental revenues for him both in terms of cost recovery and contractor’s share of profit petroleum.” The challenges are so fundamental that Indonesia rewrote their laws to try to minimize abuse while India is considering abandoning the production-sharing model entirely.

The case study on the US State of Alaska demonstrates that no jurisdiction is immune. Over a 25-year period, one dollar out of every six dollars in State revenue received from the oil industry was secured through lawsuits against companies. In one phase, the US State devoted \$217 million dollars in lawyers and accountants fees in order to recover more than \$2.7 billion. In total, lawsuits helped the state recover more than \$10 billion in revenue initially lost due to abusive practices by oil companies.

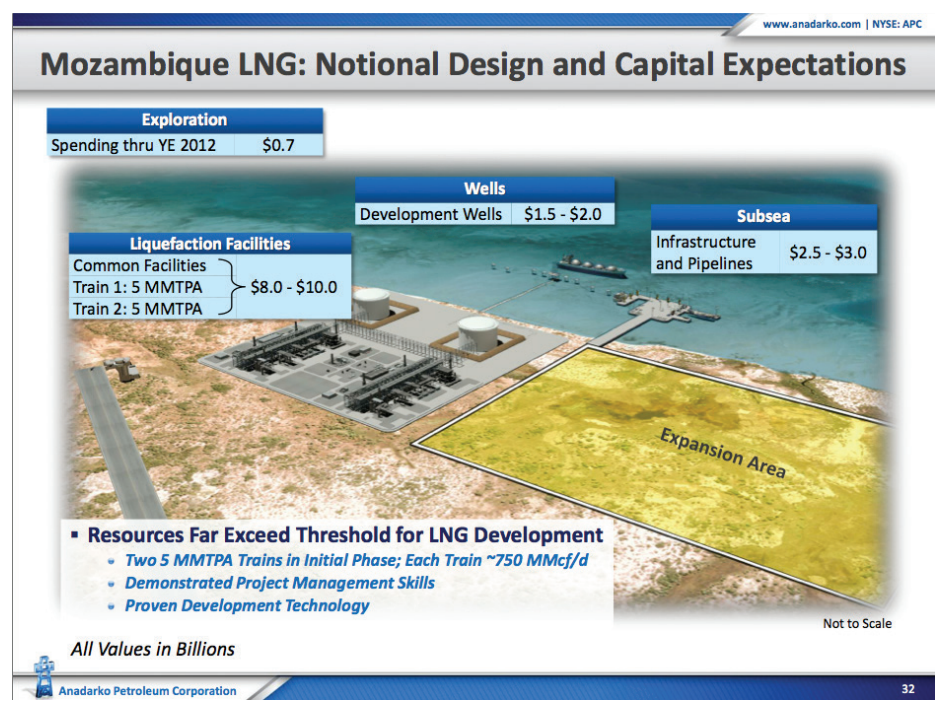
The only effective response to protect government revenue is to put in place an effective audit system. It is often mistakenly assumed that audits are important once the gas starts to flow and project revenues begin. But this is wrong. According to the IMF, “EI revenues are vulnerable to failure to audit during exploration and development phases [...] Neglect in auditing exploration and development expenses can cost the tax base dearly as a project starts to generate income.”¹

2. Is Anadarko Inflating Exploration Costs?

Inflated exploration costs represent a major risk to government revenue from Rovuma LNG. There do not appear to be any public government documents reporting on the scale of exploration expenses or the processes through which these expenses are verified. Company information is also scarce. ENI does not appear to have made any public statements on the scale of their exploration expenses in the Rovuma Basin. Anadarko has been more forthcoming, but their rapidly changing figures raise serious questions about the risks of inflated costs.

The graphic reproduced below (Figure 1) is taken from a presentation delivered on 2 October 2012 at the Johnson Rice & Co LLC Energy Conference by Anadarko Vice President for Global Exploration, Ernie Leyendecker. A similar slide was used in many Anadarko presentations to investors throughout 2012. This information was included in the materials distributed by Cove Energy in advance of the sale of their 8.5% stake to the Thai company

Figure 1: Anadarko Claims \$700 Million in Exploration Expenses through 2012



PTT. In October 2012, PTT used the same graphic as part of their “advice to investors” when reporting on the acquisition of the 8.5% stake in the concession.

The important part of the graphic is the box in the top right, labeled “Exploration,” where Anadarko claims that exploration costs through to year-end 2012 are \$700 million.

On 13 September 2013, Anadarko CEO Al Walker indicated during a visit to Tokyo, “at the end of the year the group would have invested US\$3 billion in prospecting in Area 1 of the Rovuma basin in northern Mozambique.”² The claim of \$3 billion in exploration has been repeated numerous times since September of 2013, and was confirmed by Anadarko in response to a direct question from the Centre for Public Integrity.

The increase in exploration expenses is difficult to understand. What might account for the \$2.3 billion in additional costs over that twelve-month period? There is certainly no indication of such extraordinary expenses in Anadarko’s 2013 annual report. Each year, companies listed on a US stock exchange are required by law to file an annual report with the US Securities and Exchange Commission. Strict rules exist on how these reports are to be prepared in order to protect the rights of investors. According to Anadarko’s 2013 annual report, global exploration costs for Anadarko in that year were only \$1.3 billion, and this included activity in the Gulf of Mexico, Sierra Leone, Kenya, Côte d’Ivoire and New Zealand, in addition to Mozambique.³

Despite repeated requests, Anadarko has been refused to provide CIP with a plausible answer to how exploration expenses of \$700 million at the end of 2012 increased by \$2.3 billion in only twelve months.

3. Government Fails to Provide Effective Oversight

There is no indication that the Government has audited any of the Rovuma Basin exploration expenses. In fact, there are serious questions about whether there is any significant government oversight of these expenses at all. Repeated requests for information on the processes used by Government to monitor cost recovery claims have once again gone unanswered.

Informal inquiries suggest that oversight processes provided for in the Rovuma Contracts (and analyzed below) are not being rigorously followed and that inflated expense claims are being accepted without careful analysis.

The Government should provide details on these processes. Are cost recovery statements being carefully analyzed? Are there examples of ineligible claims being rejected? Are there examples of inflated invoices from affiliated companies being revised?

It is important to recognize that the risks to Government revenue from inflated expenses have an impact beyond cost recovery. These same expenses will become deductions against gross company revenue as part of the future calculation of Corporate Income Tax (IRPC). Yet a response CIP received from the Tax Authority (AT) was that all information on the process of investment plans and cost recovery approval should be required to the Ministry of Planning and Development, once the AT assignment, according to the law, is restricted to the fiscal and customs execution.

It implies that they were not involved in the review and approval of cost recovery claims.

Actually, who makes all the decisions on this matter is the Ministry of Mineral Resources, along with the National Petroleum Institute (INP).

Textbox 2: Donor Support for Tax Audits in Mozambique

In 2010, the Norwegians provided support to the Tax Authority to conduct an audit of the Sasol Pande Temane project. There is no public information however on the outcome of this audit or follow-up measures. It appears that this is the only audit undertaken in Mozambique's petroleum sector. There is however substantial donor support for strengthening the capacity of the Tax Authority.

Norway provides support to the Tax Authority through their Oil for Development program (Norway also has a Tax for Development program).

The World Bank's Mining and Gas Technical Assistance Project (MAGTAP) includes funds to "assist Mozambique's Revenue Authority and Ministry of Finance as appropriate to develop an action plan to improve government's capacity to estimate, collect and forecast mining and gas revenues."

The IMF provides support to the Ministry of Finance on extractive sector fiscal regime design, taking into account the challenges of tax administration.

The Common Tax Fund is supported by a number of donors including Canada, Germany, Norway, Sweden and the UK. The fund supports audits, internal training, fiscal education and capacity building as well as ICT.

Reports from the Tax Authority however suggest that the technical support provided to date has had little impact on the capacity of the Tax Authority to effectively counter sophisticated company tax avoidance strategies.

4. Oversight and Audits in the Rovuma Contracts

According to the Exploration and Production Concession Contracts, there are three moments where companies and government review expenses:

1. The company is required to submit an annual Exploration Plan before the start of the year covering the current and subsequent year with details of expected costs.
2. The company is required to prepare a Cost Recovery Statement each quarter that includes the recoverable costs carried forward from the previous quarter as well as recoverable costs for the quarter in questions.
3. The company is required to submit a Final End-of-Year Statement that includes the annual Cost Recovery Statement as well as a Statement of Expenditures and Receipts.

The Rovuma contracts make provision for the Government to audit the company's accounts and records within three (3) years from the end of each calendar year.

"For purposes of auditing, the Government may examine and verify at reasonable times all charges and credits relating to the Petroleum Operations such as books of account, accounting entries, material records and any other documents, correspondence and records necessary to audit and verify the charges and credits. Furthermore the auditors shall have the right in connection with such audit to visit and inspect, subject to reasonable notification, all sites, plants, facilities, warehouses and offices of the Concessionaire serving the Petroleum Operations including visiting personnel associated with those operations." (For another country example, see Textbox 3 on Kenya⁴).

There is a clear time limit for audits. If the Government does not conduct an audit with respect to a calendar year or conducts the

audit but does not issue an audit report within the time specified [...] the Government shall be deemed not to have objected the Cost Recovery Statement. But there is one important exception. If there is evidence of “manifest disregard of applicable procedure, fraud or willful misconduct” then audits can go back as far as necessary.

Textbox 3: Kenya Calls in Cost Recovery Auditors

Interest in the petroleum sector has grown in Kenya since a series of onshore oil and offshore gas discoveries in 2012. The government has explicitly recognized that “costs incurred under the exploration stage will in future be submitted to the Government for cost recovery.” As a result, in August of 2013, the National Oil Corporation of Kenya invited firms to compete for a contract to audit selected oil and gas exploration companies.

The terms of reference call for the audit “to examine and verify all charges and credits relating to the petroleum operations such as books of account, accounting entries, material records and inventories, vouchers, payrolls, invoices and any other documents, correspondence and records necessary to audit and verify the charges and credits.”

5. How Inflated Expenses Undermine Government Revenue

Government revenue from the extractive sector are determined by four main variables: the volume of resources sold, the price at which they are sold, the costs involved in production and the rates of taxation. Of the four, the least attention is normally given to expenses. Yet the experiences in other resource-rich developing countries suggest that abuses in this area are one of the greatest sources of lost government revenue.

The main sources of Government revenue are all calculated by allowing the deduction of eligible costs. In a production sharing system, “profit oil” is allocated between the company and the government only after “cost oil” has been allocated to the company to cover expenses. Corporate income tax is assessed against gross revenues less eligible expenses. Only royalties are assessed without regard to the expenses incurred in the production of the resources. Any increase in expenses, all else being equal, result in decrease in project revenue (See Textbox 4 on Ghana⁵).

Where increased expenses are legitimate, both the company and the government suffer; the project is simply less profitable. But where ineligible or inflated expenses are included, the company generates additional profit at the government’s expense.

In some cases, expenses claimed are simply ineligible. Examples, drawn from actual cases, include companies seeking to claim:

- expenses incurred prior to the signing of the “host government agreement” contract;
- expenses for personal interests of executives, expatriate employees and families;
- expenses for the technical training of expatriates;
- a duplicate invoice for a good or service that has already been expensed;
- inclusion of expenses such as oil and gas marketing fees, or expenses related to mergers, acquisitions, or transfers in participating interests that are normally deemed ineligible according to the contract.

In other cases, the price of legitimate goods and services are intentionally inflated. This practice, known as transfer mis-pricing or mis-invoicing, is of particular concern for transactions between affiliated companies. For example, offshore drilling is contracted to

another subsidiary of the same parent firm. The invoice ultimately submitted for the work is inflated by 30% beyond what the drilling was actually worth. The 30% in this scenario is recorded as a cost to the project, but is in fact profit for the company. This “profit” is ultimately reported in a low tax jurisdiction – a process known as profit shifting. Contracts normally contain clauses requiring that all transactions between affiliated companies are based on “arms length prices,” but these are notoriously difficult to enforce.

Two additional categories of costs are a regular source of controversy. First, overseas headquarters costs are a legitimate expense but have often been used to inflate project expenses. In most contracts these costs are

Textbox 4: Ghana Expenses Reduce Government Revenue

Reports suggest that Ghana may be paying the price of a lack of oversight during the exploration and development phase of their off shore oil sector. There are five oil companies operating in the Jubilee Field with a reported US \$4.2 billion spent on exploration and development between 2007 and 2010.

Government revenue secured through royalties and payments from the National Oil Company exceeded Ministry of Finance projections in both 2011 and 2012. But overall revenues were far less than projected (almost 50% below expectations in 2011) because none of the companies paid any income tax. Concerns have been raised that the exploration and development costs may have been artificially inflated in order to reduce tax payments. The Public Interest and Accountability Committee (PIAC) has called on the government to conduct a forensic audit into the US\$4.2 billion expenditure incurred by the Jubilee Partners.

limited to a percent of overall project costs. Second, the costs of interest on the financing of projects are also a potential area for abuse. Many tax regimes put in place limits on the ratio of debt to equity (to avoid what is known as “thin capitalization”). As with transfer mispricing, affiliated companies often provide the financing. This raising the risks that interest rates are not based on arms-length “market” prices but are rather designed to minimize tax payments.

Finally, there are examples of invoices submitted for goods that were never actually acquired and for services that were never actually delivered.

Honest Mistakes or Tax Evasion?

There is no simple answer to the obvious questions of whether inappropriate claims are honest mistakes or attempts to avoid taxation. Developing and operating petroleum projects is the realm of engineers and project managers, while maximizing company revenues by minimizing tax payments is the realm of accountants and tax lawyers. Consider for example the following advertisement for a “cost recovery auditor” to work for a Canadian oil company in Chad. The first responsibility for this employee is “Managing the *maximization* of cost recovery and reimbursement by identifying variances and specific costs as stated within the companies’ Production Sharing Contracts (PSC).”⁶

Proving that mistakes in company expense claims are intentional is difficult. Companies never want to admit to purposeful fraud. Even when found guilty in court, they seek to avoid any implication of intentional wrongdoing. Who benefits from inappropriate expense claims however provides some insight into the question of intentionality. It seems almost impossible to find examples in audits of oil company books where errors worked in the favor of increasing rather than decreasing tax payments to government.

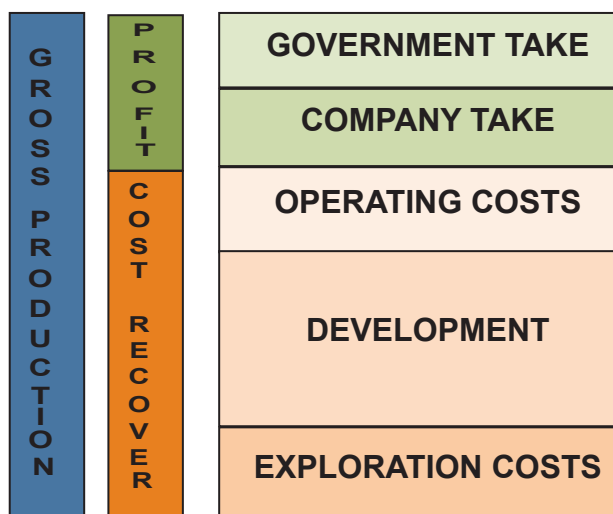
6. Cost Recovery

The cost recovery process, an integral part of production sharing agreements, creates strong incentives for companies to inflate expenses and has been the subject of controversy in many oil-rich countries (See Case Studies on Indonesia and India below).

Cost Recovery is a mechanism allowing the company to recoup their costs directly from a portion of the petroleum produced. As shown in Figure 2, three sets of costs - exploration, development and operations - are subtracted from gross production. Only after costs have been recovered is the remaining “profit gas” divided between the company and the government.⁷

1. *Exploration Costs:* Exploration costs are expenses incurred in the search for petroleum within the EPCC area. The period of exploration begins with the signing of the EPC contract (for Anadarko and ENI Concessions this is 2006) and includes the discovery of petroleum and its subsequent appraisal, up until the government approves the first Development Plan. Costs related to exploration can be recovered in the year when Commercial Production begins.

Figure 2: Elements of Cost Recovery



Examples of explorations costs, as set out in Annex C of the EPCC contracts, include: seismic surveys and studies; core hole drilling; labor, materials and services used in drilling wells; and facilities used solely in support of these purposes including access roads.

2. *Development Costs:* Often called capital costs, development costs are the money spent to build infrastructure to extract petroleum and send it to market. Putting in place the capital infrastructure represents the overwhelming majority of the costs of an LNG project.

Textbox 5: “Normal” Capital Cost Over-Runs

Initial estimates of capital costs for large petroleum projects are almost never correct.

There were massive cost over-runs in the first phase of the Sasol Pande Temane project. MIREM estimated project costs to be \$600 million; the World Bank projected \$720 million; the final price tag was \$1.2 billion.

LNG developments are particularly susceptible to ever-increasing costs. In Australia, all LNG projects have exceeded initial cost estimates by at least 40%. In Papua New Guinea, LNG costs were estimated at \$11 billion when the project was approved, \$15 billion when construction began and have now ballooned to \$19 billion. For the single Angolan LNG train, cost overruns were even worse: initial estimates were \$4 billion while final costs were estimated at \$10 billion.

Similar patterns can be expected in the Rovuma Basin. Anadarko claims that offshore development and a two-train facility can be completed for around \$15 billion. Wood MacKenzie, a leading international consultancy firm, already projects a total cost of \$25 billion. No one should be surprised if the \$25 billion figure is less than the development costs companies eventually claim.

According to the Gas Master Plan, a single LNG facility (“train”) is expected to cost \$6 billion or more. Annual operating costs on the other hand are anticipated to be less than \$90 million. And as initial capital cost projections are almost always massive under-estimates, huge capital cost overruns should be expected (See Textbox 5).

The recovery of development and production capital costs is limited to a maximum yearly rate of twenty five percent (25%) on a linear depreciation basis, in the year in which they occurred or the year in which Commercial Production commences, whichever year is later.

Examples of such costs, as set out in Annex C of the EPCC contracts, include: drilling and completing wells; the costs of field facilities such as production and treatment units, drilling platforms; petroleum storage facilities, export terminals and piers, harbors and related facilities, access roads for production activities.

3. *Operating Costs* start from the beginning of commercial production. Operating costs attributable to petroleum operations can be recovered in the full amount in the year in which they were incurred. These costs include all expenditures incurred in the petroleum operations including: operating and maintaining field facilities completed during the Development and Production Operations; and producing petroleum and gathering, storing and transporting the petroleum from the reservoir to the delivery point.

Service and Administrative Costs: Service costs are direct and indirect expenditures in support of the Petroleum Operations including warehouses, offices, vehicles, water and sewage plants, power plants, housing, community and recreational facilities and furniture, tools and equipment used in these activities. General and administrative costs are all main office, field office and general administrative costs in the Republic of Mozambique including

but not limited to supervisory, accounting and employee relations services. These costs also allow for overhead costs from outside Mozambique (normally company headquarters) to the maximum of 5% for contract costs up to \$5million, 3% for costs between \$5m and \$10m, and 1.5% for costs in excess of \$10m.

Costs Recoverable with Specific Approval and Non-Recoverable Costs

Most costs are recoverable through the normal “cost recovery statement” process, without further approval from government. But there are two important exceptions.

First, where services are provided by a company affiliated with the concessionaire, “the charges will be based on actual costs and will be competitive. The charges will be no higher than the most favorable prices charged by the Affiliated Company to third parties for comparable services under similar terms and conditions elsewhere.”

Second, and importantly, “interest, fees and related charges incurred on commercial loans raised by the Concessionaire for the Petroleum Operations” requires government approval, though this approval must not be “unreasonably withheld.”

In addition, four specific costs are explicitly identified as “non-recoverable.” These include:

- Petroleum marketing or transportation costs of Petroleum beyond the Delivery Point.
- Costs of arbitration and the independent expert under Article 30 of the EPCC.
- Petroleum Production Tax and Corporate Income Tax
- Fines and penalties imposed by any public authority in the Republic of Mozambique or elsewhere.

Case Studies: Cost Recovery, Auditing Company Books and Litigation

1. Timor-Leste Uses Tax Audits and Lawsuits to Defend Government Revenues

Timor-Leste is the most oil dependent economy in the world. In recent years, petroleum revenues have accumulated at a rate of more than \$250 million per month. The money has flowed so fast that for many years Timor-Leste devoted little effort making sure that they received what they were actually owed. The international accounting firm Ernest and Young acted as the independent auditors from 2007-2010 and, as is common practice, were paid by the companies. It is alleged that the accounting company contested few if any of the company expense claims.

In 2011, Timor Leste initiated a series of tax audits covering the years 2005-2010. In the course of undertaking the audits, tax authorities encountered a hurdle that they had not anticipated: company documents were held in Australia not Timor Leste. When auditors requested documents, they were informed that tax confidentiality laws in Australia prohibited their return. One early impact of the audit process was to require companies to keep copies of all relevant documents inside the country.

The audit process had an immediate short-term impact on revenues with a reported \$79 million being recovered in the first round. The longer-term implications could be even more significant with the government reporting that it is continuing to pursue a further 28 assessments against the oil companies that could amount to hundreds of millions, even billions, of dollars in back taxes.

Undertaking tax audits continues to be a challenge. Formal legal proceedings were required in March of 2013 before a petroleum

contractor finally agreed to provide documents on which millions of dollars in tax deductions had been based. But government tax audits continue to generate results. The Timor Ministry of Finance reported that during 2012 alone it had received more than \$400 million from “audit-related activities.”

On 10 July 2012, the Council of Minister’s confirmed that the government was “engaged in legal action against multinational oil companies ConocoPhillips and others to recover substantial monies it believes are rightfully owed the people of Timor-Leste under legal obligations stemming from production contracts.”

Government gains however come at the expense of company profits. ConocoPhillips reports that between 2010 and 2012, it “has paid, under protest, tax assessments totaling approximately \$227 million” and that it was invoking the “tax stability agreement” contained in the contract in order to pursue arbitration in Singapore.

2. Indonesia Changes Law to Avoid Cost Recovery Abuse

The Indonesian government has long believed that oil companies were inflating cost recovery expense claims in order to maximize revenue. The Government was particularly concerned in the years prior to 2010, when oil production was declining yet cost recovery claims were increasing significantly.

As a result of repeated and significant disputes following the auditing of expenses, Indonesia put in place the “Government Regulation concerning Cost Recovery and Provisions on Income Tax in Oil and Gas Activities” (Government Regulation No. 79/2010). The regulation sets out a relatively standard three

part test for costs to be treated as recoverable: they must be related to oil and gas operations within the contract area, they must be based on the arm's length principle if between affiliated companies, and they must be approved in advance by government authorities in the work program and budget.

More interestingly, the regulation explicitly excludes 22 categories of expenses that are neither cost recoverable nor tax deductible. Examples of expenses that are now explicitly labeled ineligible include:

- Expenses for personal interests of executives, expatriate employees and families;
- Incentives, pension and insurance for executives, expatriate employees and families
- Expenses incurred before the signing of the contract
- Excessive material surpluses due to mistakes in planning and/or purchases
- Tax and legal consultant fees unless directly related to oil operations
- Contractors oil and gas marketing fees
- Expenses for the technical training of expatriates
- Expenses for mergers, acquisitions, or transfers in participating interests
- Procurement of goods and services exceeding approved value by +10%

While removing some uncertainty around the eligibility of cost recovery claims, major disputes continue. A government audit of cost recovery claims between 2010 and 2012 found \$221.5 million in ineligible expenses.

3. India Considers Abolishing Cost Recovery after Audit Reveals Abuses

Cost recovery has been a major source of controversy between oil companies and the Government in India. Through the end of 2012,

India had allowed more than two-dozen oil companies to recover more than \$24.5 billion in expenses. Concerns over the scale of these expenses led the Comptroller and Auditor General (CAG) to conduct a detailed audit of the claims of three companies Reliance, Cairn and BG in order to assess whether the “revenue interests of the Government (including royalty and share of profit) were properly protected.”

The audit experience demonstrated how difficult it can be to conduct effective oversight on extractive sector companies. The request for company documents by State auditors were at first refused on the grounds that they were not relevant for the review of “accounting procedures” and would be needed only for a review of “performance” which was not provided for in the contract. Documents for most, but not all, of the companies were finally provided more than a year after the initial request only after a direct order from the Minister of Petroleum and Natural Gas. Finally, on completion of the audit, one company claimed that confidentiality provisions in the contracts prohibited the government from sharing the audit even with the Parliamentary Committee responsible for overseeing the petroleum sector.

The audit concluded that the existing fiscal regime contained incentives for companies to front-load and inflate the expenses included in their cost recovery claims. Specifically, the audit stated that “it is inconceivable that the private contractor would fail to protect his financial interests, and assess every investment/operational proposal to see whether it would result in incremental revenues for him both in terms of cost recovery and contractor’s share of profit petroleum.” The auditors also criticized the Oil Ministry for not enforcing the terms of the contracts effectively and for not catching abuses that hurt the state’s share of profit.

In the wake of the controversy, the Indian government struck a high-level panel to review existing contracts and explore “various contract

models with a view to minimize the monitoring of expenditure of the contractor without compromising, firstly, on the hydrocarbons output across time and, secondly, on the Government's take." The panel concluded that the system of cost recovery "encourages the Contractor to inflate costs, to the detriment of Government's share in profit petroleum." Its main recommendation, therefore, was that India should adopt a "new contractual system and fiscal regime based on a post-royalty-payment revenue-sharing to overcome the difficulties in managing the existing model based [...] the cost-recovery mechanism."

4. US State of Alaska Sues Oil Companies to Secure Rightful Revenues¹⁰

The American state of Alaska provides a compelling example of the technical challenges of securing the full proportion of revenues owed to the Government. According to an analysis undertaken in 2003, over the 25-year lifespan of the petroleum sector, "one dollar out of every six that Alaska received from its oil development was obtained through legal challenges to the industries original payment."

The majority (90%) of the petroleum production in Alaska since first exports in 1977 has been controlled by three companies now known by the names British Petroleum, ExxonMobil and ConocoPhillips. Over the first 25 years of production, Alaska received approximately \$70 billion in petroleum revenue from royalty payments of 12.5% of the value of the oil, and three principal taxes: corporate income tax, a petroleum production tax, and property tax.

Based on independent analyses and audits, Alaskan officials overseeing the petroleum sector claim that "industry chronically reduced the bases for calculating royalty, severance, and income tax payments by underestimating the market value of a barrel of oil at the point of sale. Overstated pipeline shipping charges (tariffs) had the same result."

In order to secure what government officials believed to be a fair share of revenues from this petroleum development, they were forced to take prolonged and intensive legal action against the companies. Between 1977 and 1994, the Alaskan Department of Law reported that it had paid contract lawyers and accounting specialists from 30 different companies a total of more than \$217 million to follow-up these legal claims. The money was well spent. Litigation resulted in additional company payments to government of \$2.7 billion.

The issues in dispute were highly technical and in some cases based on a legitimate difference of opinion in the interpretation of complex contractual language and taxation law. But in many cases the differences were based on outright deceit and fraud. By tracking the export and value of each barrel of oil being exported, Alaskan authorities demonstrated that overall revenues were deliberately minimized by misrepresenting the actual sale value of oil and by inflating the costs associated with transporting oil by pipeline and tankers.

By 2000, litigation had produced an additional \$10.6 billion in revenue including \$6.8 billion in direct payments for taxes and royalties, and an additional \$3.8 billion in increased taxes and royalties related to reassessing pipeline transportation costs. This pattern has continued with an additional \$1.7 billion in oil and gas settlements over the past decade. The figures listed above substantially underestimate the scale of abuse. Many other claims were launched against companies by the Government but were settled out-of-court and are therefore not public.

(Endnotes)

- 1 Carlo Cottarelli, Fiscal Regimes for Extractive Industries: Design and Implementation, International Monetary Fund, 2012, p. 67.
- 2 “Mozambique Natural Gas Promoted in Japan, Mining Review, 13 September 2013.
- 3 See Anadarko Petroleum Company, Annual Report Form 10-K, 28 February 2014, p. 62.
- 4 See Expression of Interest for Audit Services for Oil and Gas Exploration Companies in Kenya, Ministry of Energy and Petroleum, 5 November 2013.
- 5 See Ghana’s oil: PIAC wants forensic audit (<http://graphic.com.gh/Business-News/ghanas-oil-piac-wants-forensic-audit.html>), Oil revenues may fall short (<http://www.ghanaweb.com/GhanaHomePage/NewsArchive/artikel.php?ID=263823>); and the Public Interest and Accountability Committee (PIAC) Report on the Management of Petroleum Revenues for the Period, 1st January 2012 to 30th JUNE 2012, 15 September 2012).
- 6 Add for ‘cost recovery auditor’ placed by Griffiths Energy International in RigZone, 20 August 2013.
- 7 The Rovuma EPCCs also place a limit on the proportion of after-royalty production that can be devoted to costs in any given year. For the Anadarko concession the “cost recovery limit” is 65%, for the ENI concession it is 75%.
- 8 See Council of Minister’s Press Releases: “Timor-Leste Improves Domestic Revenue Collection for 2011,” 14 May 2011; “Timor-Leste confirms action underway to reclaim taxes,” 10 July 2012; “Making the Oil Companies Pay what they Owe,” Laò Hamutuk, 25 June 2013; Timor Government Press Release: “First tax trial delivers positive result,” 21 March 2013.
- 9 See “Performance Audit of Hydrocarbon Production Sharing Contracts,” Report No. 19 of 2011-12 for the period ended March 2011, Ministry of Petroleum and Natural Gas and Report of the Committee On the Production Sharing Contract Mechanism in Petroleum Industry, December 2012.
- 10 See Richard A. Fineberg, “Securing the

Take: Petroleum Litigation in Alaska,” in Svetlana Tsalik, Caspian Oil Windfalls: Who Will Benefit? Caspian Revenue Watch, 2003, pp. 53-69.



Good Governance, Transparency and Integrity

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