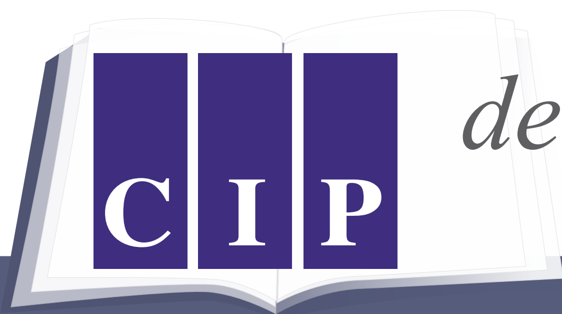

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PETROLEUM LEGISLATION

Beyond Rovuma Natural Gas Understanding the Implications of the 2014 Laws

This paper analyzes the petroleum laws that set the terms for future developments in the sector, including the Petroleum Law (21/2014 dated 18 August 2014) and the Petroleum Tax Law (27/2014 of 23 September 2014).

An important question in understanding the potential impact of these laws is their potential applicability to projects where contracts have already been signed – particularly those for the Rovuma Basin. The laws themselves are clear on this point: with only a few exceptions, these laws apply to future contracts[1] .

The two laws analyzed here set the terms the 5th Licensing Round launched in October 2014.[2]

Already one major change to existing fiscal terms has been imposed on all extractive sector projects – a capital gains tax levied at 32%. This change was brought into effect with the new corporate income tax law (IRPC) at the start of 2014 and is reasserted in the new Petroleum Tax Law.

Beyond the changes to the taxation of capital gains, it seems unlikely that the Government will use provisions of the new laws to cover developments related to Rovuma natural gas. Any renegotiation of the terms of the original 2006 Exploration and Production Concession Contracts is likely to be done within the Decree Law that will establish a "Special Regime" for Rovuma Basin LNG.

Although the two laws have been published, much still remains unclear. More details will follow in the associated petroleum regulations that were to be issued within 60 days. For the fiscal law, much of the additional detail will be contained in the new "model" Exploration and Production Concession Contract that has not yet been made public, even though the 5th Licensing Round has already been launched.

Public drafts of the two petroleum laws suggested that the changes would be relatively minor – largely an updating and consolidation of existing legislation and terms in the model Exploration and Production Concession Contract. The presumption of broad continuity on fiscal terms seems to have been confirmed. The Petroleum fiscal law 27/2014 is essentially a consolidation of existing terms from the 2007 laws, the 2008 decrees and the 4th Licensing Round model contract.

The scale of changes to the broader sector law are however much more significant than anyone expected – including the Government when they submitted the laws to Parliament in June. The final version of law 21/2014 includes significant new provisions including: the creation of a high level political body (Alta Autoridade da Indústria Extractiva) to oversee the petroleum sector; an expanded role for ENH in the marketing of

natural gas and a government commitment to guarantee ENH financing; a domestic market obligation that 25% of production must be sold within Mozambique; new requirements for foreign companies to have national partners and register on the Mozambique Stock Exchange; more emphasis on hiring Mozambicans and using national goods and services as well as expanded rights for communities.

II. The Petroleum Sector Law 21/2014

The new Petroleum sector law replaces Law No. 3 /2001. It involves changes to the mandates of key institutions as well as new provisions on transparency and oversight, maximizing benefits within Mozambique and the rights of affected communities.

Transparency and Oversight

Contract Disclosure (Article 28): CIP has long argued that full disclosure of extractive sector contracts – the overarching contract between the government and the company – is an essential part of good governance in the sector. There was no mention of contract disclosure in the initial draft law, and the addition in the new law still fails to meet emerging international standards by committing only to "publication of the main clauses." This omission is surprising given that the government has already published some petroleum contracts and that documents related from the Fifth Licensing Round indicated that "The awarded EPCCs will be made public consistent with Petroleum Law 2014 requirements."[3]

Publication of Revenue Payments (Article 50): The new law requires that petroleum companies publish their results, the amounts paid to the State, as well as the costs related to social and corporative responsibility. The government also commits to maintain an "inventory of petroleum operations revenue and publish them periodically" (Article 27). It is unfortunate the new law did not explicitly reference new EITI requirements including the publication of data on production volumes and sale prices.

Transparent Jurisdiction (Article 26): Clearly sensitive to the risks associated with foreign companies registering in secrecy jurisdictions (tax havens), the new law requires that they be established, registered and administered in "transparent jurisdictions." No further details are provided on how this provision will be interpreted or enforced.

Role of the Assembly of the Republic (Article 37): In contrast to many other resource rich developing countries, there is no specific legal framework for petroleum sector revenues. The new law simply says that it is for the Assembly of the Republic to ensure the sustainable and transparent management of revenues taking into account the present needs and those of future generations. Unfortunately, the law makes no other mention of the role of Parliament in ensuring good governance and oversight. The should also have expanded the role of Parliament to provide regular oversight of the sector, with particular emphasis on state owned enterprises such as ENH, its afiliates: CMH, CMG, ENH logistics, ENH Rovuma Basin Land.

Institutional Responsibilities

High Authority for the Extractive Industries (Article 23): The most striking institutional change introduced in the new petroleum law is the creation of a new entity directly subordinate to the Council of Ministers (Alta Autoridade da Indústria Extractiva). No further details are provided. The Petroleum law indicates only that this body will control petroleum activities. The new Mining law 20/2014 indicates that this entity will also control the mineral sector. Again no details are provided, except that it must be in operation within 12 months (Article 25). Therefore, the gap left by the legislator on the competencies and composition of AAIE may result in creating an institution merely decorative.

ENH Expanded Role (Article 24 & 36): The central role of state in the petroleum sector is reaffirmed. ENH is stated to be responsible for participating in all phases and aspects of

the sector. The scope of ENH's responsibility for marketing petroleum products is extended beyond the domestic market. To the surprise of many analysts, the call for ENH to "take the lead" in marketing is now expected to include involvement in international deals as well. In Article 4 on the "Role of the State" the law adds a guarantee of financing for ENH, presumably to assist the company in borrowing to pay its share of development costs for Rovuma LNG.

Maximizing Benefits in Mozambique

Domestic Market Obligations (Article 35): As is common in petroleum producing developing counties, a portion of production governed by future contracts is committed to the domestic market. In this case, the amount is 25%. There are obvious questions about the ability of the domestic market to absorb significant amounts of natural gas – ten years passed before the government took even 5% of Pande Temane royalty gas for use within Mozambique. Furthermore, the next paragraph indicates that the government will establish the price for this quota raising questions about whether this portion of production might be sold at below-market rates. On the other hand, the fiscal terms analyzed below would allow the government to meet most of this commitment out of their share of production.

Pre-emption rights if associated with Mozambican entity (Article 26): In the awarding of concession contracts, preference will be given to foreign companies that associate with Mozambican companies. The definition of a "Mozambican" company extends beyond the country of incorporation or registration – at least 51% of the share capital must be held or controlled by Mozambican citizens or Mozambican public or private companies. Greater participation from Mozambican enterprises should be encouraged, but in other resource rich developing countries, the requirement of a national partner has often been a mechanism for political and economic elites to extract wealth while providing no added value.

Registration on the Stock Exchange (Article 13): Under the heading of the "promotion of local entrepreneurship," the new law requires that oil and gas companies must be registered in Mozambique's Stock Exchange. No further details are provided. Industry analysts have questions whether this provision will require registration or whether a portion of company shares will be required to trade within Mozambique.

Requirement of National Partner for Service Providers (Article 41): According to the law, companies providing services to oil operations should be associated with Mozambican companies. No further details are provided. As with the pre-emption rights discussed above, creating obligations for association with Mozambican entities creates greater opportunities but also greater risks of wealth extraction by political and economic elites.

Mozambican Labor, Goods and Services (Article 12 & 41): Greater emphasis is given in the new law to promoting employment for Mozambicans as well as encouraging companies to make more use of Mozambican goods and services. Companies must ensure both employment and technical training for Mozambican nationals, including their participation in management though there is no reference to a specific quota. Companies must also give preference to local products and services where they are not more than 10% more expensive than imported equivalents.

Rights of Communities

The new sector law places additional emphasis on the rights of communities in areas surrounding petroleum exploration and production.

MOU for Compensation (Article 4): If families or communities need to be resettled from within a petroleum concession area, compensation must be paid in a fair and transparent way by the companies based on rules set out by the Council of Ministers. Specifically, the terms of the compensation must be set out in a memorandum of understanding (MOU)

between the Government, the company and the community. This MOU is a requirement for granting the right of exploration.

Resettlement (Article 42): Petroleum companies are obligated to guarantee the costs of resettlement of populations following consultations with local state organs and community authorities. The law further states that resettled populations will be guaranteed dignified, improved living conditions based on fair compensation.

Involvement of Communities (Article 11): Communities must be given "prior notice of the beginning of exploration activities" and they must be "consulted" prior to the approval of petroleum activity. Furthermore, the Government commits to creating mechanisms for involvement to ensure participation of the communities in areas of petroleum operations.

Local Development (Article 19 & 48): The existing petroleum fiscal law contained a provision that an unspecified percentage of revenues is channeled back to the development of communities in the areas surrounding the oil production (Article 11, Law 12/2007). This provision is repeated in the new petroleum law in both Articles 19 and 48.

Local Employment and Training (Article 15): Among the general obligations of companies holding the rights to explore and produce oil and gas is the need to ensure employment and technical training to national citizens with a preference for those who live in the concession area. There are however no detailed on how companies must meet this general obligation.

II. The Petroleum Tax Law No. 27/2014, from 23 of September

The objective in fiscal laws is to find the appropriate balance between encouraging investment and securing a fair share of revenue for the government. The 2006 Rovuma contracts were very generous to the companies with a 2% royalty rate, a very rear-loaded (for the government) approach to production sharing, and a reduced rate of corporate income tax in the early years. The fiscal terms were substantially tightened through changes to tax laws in 2007 and decrees in 2008 and the model contract used for the 4th Licensing Round.

Tax Law 27/2014 essentially consolidates the existing laws (2007 No. 12 and 13) and the associated Decrees of 2008, as well as substantial sections of the law on corporate income tax (IRPC) and the existing "model" Exploration and Production Concession Contract. CIP commends the Government for following international best practice and placing the terms for accessing Mozambique's petroleum in public law rather than confidential contract-by-contract negotiations. Important details on the fiscal terms however will only be clear when the associated "model contract" is published.

Royalty Rates (Article 10): In Mozambique, the petroleum royalty (terms a production tax) is levied on the fair-market value of the petroleum produced. The government has the option to take its royalty in cash or in kind (the delivery of the petroleum product itself). The royalty rates remain unchanged from the 2007 law with the oil rate set at 10% and natural gas at 6%. There is no longer any concession for deep-water natural gas which resulted in a 2% royalty for existing Rovuma Basin contracts. The new law however does offer a 50% reduction in the existing rates if "production is intended for development of the local industry".

Corporate Income Tax: (Article 15) Previous analysis of the draft petroleum fiscal law suggested that the government would establish an independent 32% income tax rate within the petroleum law thereby setting a clear rate irrespective of potential future changes to the general IRPC. However, the new fiscal law simply references the existing IRPS (personal income tax) and IRPC (corporate income tax) laws. Depreciation rates have changed under the new law. Previously, capital assets were depreciated at 20%. That same rate is now applied to "petroleum production assets" but "development expenses" are now depreciated at 25%, and "acquisition of petroleum rights) are depreciated at 10% (Article 23).

A withholding tax of 10% will be applied to services provided by non-residents.

Capital Gains Tax: (Article 29) As previous CIP analysis has documented, the application of a capital gains tax in Mozambique's extractive sector has been highly inconsistent. Changes to the IRPC passed in 2012 and effective from 2014 have clarified that there is no longer a declining rate based on the length of ownership. The IRPC now calls for a straight 32% tax on capital gains and this provision is reproduced in the new Petroleum fiscal law.

Production Sharing: Production sharing is the centerpiece of Mozambique's petroleum regime. Although it was not applied to the Sasol Pande Temane project, for all other contracts a share of petroleum production accounts for the largest portion of revenue paid to the Government. Terms that were negotiable in the past have now been established in law.

Cost Recovery (Article 31): First, there is a limit to company recovery of costs. In past contracts this rate has varied allowing a high of 90% to a low of 60% of post-royalty petroleum to be allocated to costs. The new law sets the rate at 60% (Article 31). The effect of this change is to provide additional revenue to the government in the early years of production.

Division of Profit Petroleum (Article 32): Second, the division of profit petroleum (the remaining production after the royalty and costs have been subtracted) continues to be allocated based on an assessment of the projects profitability or "r-factor." In the past, these percentages were among the most significant "negotiable" element in the EPC contract. Now it appears as though the minimum government share is set in law, with larger government shares possible through negotiation. According to Article 32 of the new law, "The profit-petroleum must be shared based on the following table." However, according to the Fifth Round Licensing Documents, the division between government and contractor above the minimum share established in law is a biddable element.[4]

Stabilization (Article 43): Investors seeks clear assurances that fiscal terms agreed at the outset remain unchanged throughout the project. Governments seek flexibility to accommodate changing circumstances. In the past, Mozambique has offered oil companies a guarantee that irrespective of changes in national law, "the EPC remains in full force."[5] Under the terms of the new fiscal law, terms are guaranteed for only the first ten years of production. Fiscal stability can be extended from year 11 through the life-time of the concession for "payment of additional 2% of Production Tax from the eleventh year of production."

State Participation: The Petroleum sector law indicates that the State is seeking to expand its participation in the oil and gas sector. The principle is not new. ENH held the rights to a 30% stake in the Pande Temane gas fields and a 10-15% stake in the Rovuma EPCCs.[6] According to documents associated with the 5th licensing round launched in October 2014, the state will hold a minimum of 10% in all future petroleum concessions.[7] The actual size of the government stake in the project is subject to company bids and therefore may be higher. The terms of state participation have also changed. ENH continues to have the right to participate after commercial

Production Sharing Splits (Article 32)

R Factor	Government Share	Concessionaire Share
Less than 1	15%	85%
Equal or higher than 1 and less than 1,5	25%	75%
Equal or higher than 1,5 and less than 2	35%	65%
Equal or higher than 2 and less than 2,5	50%	50%
Equal or higher than 2,5	60%	40%

quantities of petroleum have been discovered. Under these new terms, the company is required to pay all costs (a "full carry") with the government repaying its share once production begins. This means that the government is not required to finance development costs through borrowing as required by the Rovuma contracts.

(Endnotes)

1 Article 39 – "The entities carrying out petroleum operations under an existing petroleum contract entered into based on the herein repealed legislation shall continue to meet their tax obligations under those contracts, unless they expressly request the application of this Regime within sixty days from the date of its entry into force."

2 See, MIREM/INP, Mozambique Fifth License Round, London, 23 October 2014.

3 Iden (p. 85).

4 Mozambique, Fifth Licensing Round, Appendix C, Financial Proposal, p.3.

5 INP, Mozambique Model EPCC, 2006, Article 27(12) p. 77.

6 ENH initially held a 30% stake but transferred 5% to the International Finance Corporation in order to arrange financing.

7 "In addition the State through ENH will have a carried interest (minimum of 10% biddable) in each EPCC." Mozambique Fifth License Round, MIREM/INP, London 23 October 2014, p. 97.

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