CIP
CENTRO DE INTEGRIDADE PÚBLICA
Anticorrupção - Transparência - Integridade

EXTRACTIVE INDUSTRY

Issue N ° 6 - September 2019 - Distribution free of charge

Transfer Prices in the Extractive Sector as a Scheme for the Illicit Outflow of Capital

- Risks for the Coral South FLNG Project of Area 4 of the Rovuma Basin, Led by ENI

1. Context

As a result of the 2nd tender launched in 2005, in December 2006 the Mozambican Government signed with Eni East Africa S.p.A, an engineering, procurement, construction and commissioning (EPCC) contract for the offshore area 4 of the Rovuma basin block[1]. The EPCC was signed for a period of 30 years from the date of approval of the Development Plan[2], under Petroleum Law No. 3/2001, of 21 February, in force at the time, and under Decree No. 24/2004, of 20 August.

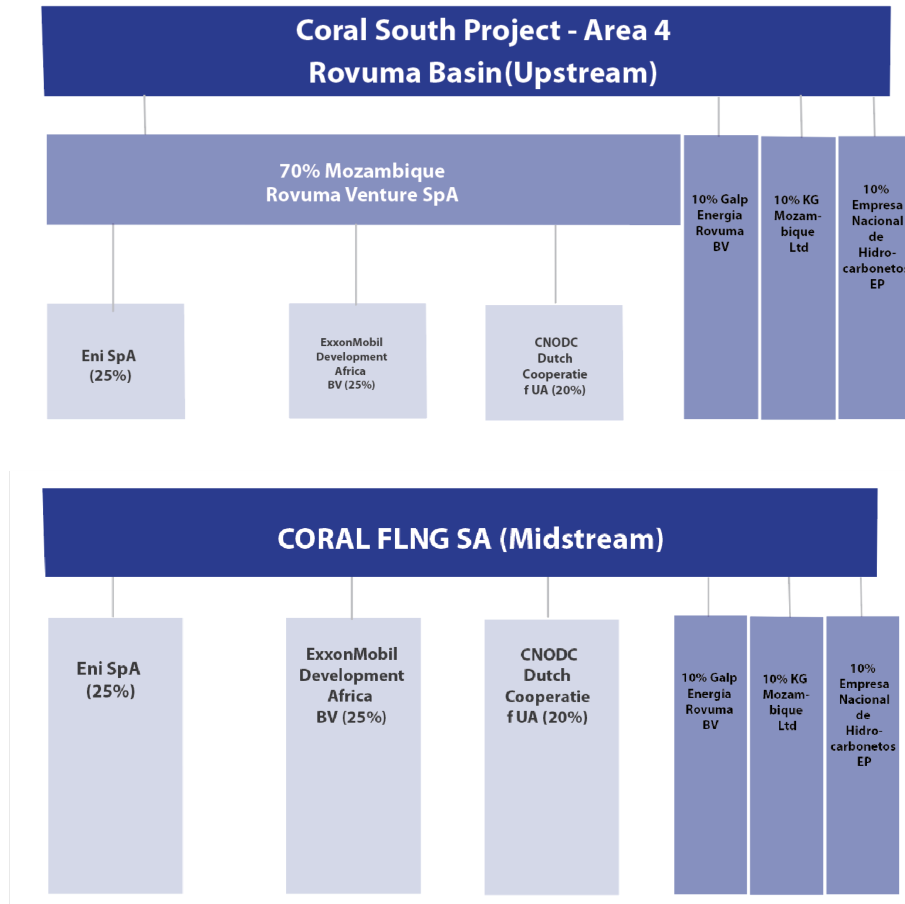
The primary rights of area 4 were granted to Eni in 2006, with a 90% of participation, and to the National Hydrocarbon Company (*Empresa Nacional de Hidrocarbonetos*, ENH), with a 10% participation. In the following years, ENI ceded part of its participation to four companies: (1) in April 2007, Galp Energy acquired a 10% stake in the project; (2) in 2008 the Korean Gas Corporation (KOGAS) also acquired a 10% stake; (3) the China National Petroleum Corporation (CNPC) acquired a 20% stake in 2013; and (4) in March 2016, Exxon Mobil acquired a share of 25% in area 4 for US$ 2.8 billion. This transaction was completed when Exxon Mobil secured a 35.7% stake in Eni East Africa.

After the acquisition by Exxon Mobil, Eni East Africa was renamed Mozambique Rovuma Venture (MRV). MRV is a company registered in San Donato, Italy.

Below is the current shareholder structure of the South Coral project, including upstream and midstream operators.

[1] http://www.inp.gov.mz/pt/Politicas-Regime-Legal/Contratos-de-Pesquisa-Producao-de-Hidrocarbonetos/Area-4-Bacia-do-Rovuma
[2] The development plan for the South Coral Field was approved in December 2016.

Figure 1: Shareholder Structure of the South Coral Project– Area 4



Source: Prepared by the author

In order to carry out its activities, in relation to an investment of about USD 7 billion dollars, Eni and its partners, using the argument of the great distance between the Coral South field and the Mozambican coast, proposed the development of the Coral gas field by mounting a floating liquefied natural gas (FLNG) platform with a capacity of some 3,370,000 tons per year, powered by 6 subsea wells, which was approved by the Mozambican Government in 2016 upon the approval of the Development Plan of the project.

However, according to the EPCC contract (signed in 2006), initially the production of liquefied natural gas (LNG) was not foreseen. This resulted in certain actions taken to accommodate the LNG portion, including the adoption of an out-of-the-ordinary commercial structure.

The structure adopted by the consortium with a view to accommodate LNG production presents risks of abusive transfer prices, one of the techniques widely used by extractive sector companies to illicitly transfer financial resources from the country where the project is located to the company headquarters outside Mozambique.

In view of the above arguments, the present text intends to present and specifically discuss the potential risk of abusive transfer prices to the Coral FLNG project, and to show how this can lead to an illicit outflow of capital from Mozambique.

2. Analysis of the Risk of Abusive Transfer Prices to the Coral FLNG project

The capture of potential revenues and the risks associated with them depend, among other factors, on the tax conditions that will be applied to the project, cost estimates for development and production, and details of the commercial structure that will be adopted by the oil and financing companies.

It is the last two elements that this text intends to address.

2.1. Commercial Structure of the Project as a Critical Element

The risk that abusive transfer pricing will occur stems from the commercial structure set up by the Coral South FLNG project consortium.

In the 2006 EPCC contract, natural gas production was foreseen but there was no mention of Liquefied Natural Gas (LNG) production. Therefore, as in other countries, LNG production was bound to be under a contract different from the original (Box 1).

Box 1: Examples of LNG Production in some Countries

Malaysia – MLNG Dua

This project includes the natural gas and LNG production components. Upstream Shell and Petronas Carigali produce gas through a production sharing agreement and sell to the midstream operator (plant operator MLNG Dua), a joint venture between Petronas, Shell, Mitsubishi and the Sarawak Government under a sale of gas.

Trinidad and Tobago – Atlantic Project (Train 1)

In the case of this project, the upstream consists of BP and Repsol. These companies are not part of the midstream (liquefaction phase), i.e. they do not have a stake in the liquefaction part and are therefore subject to the payment of a toll fee to ensure the transformation of the gas to a liquid state. The fact that these are different companies operating at different stages ensures that there are no transfer prices or toll rate inflation.

From the above cases it is clear that, although upstream companies may be shareholders, at the midstream level a different entity operates that should be duly licensed by the Government other than through the agreement signed with the gas exploitation company, which is not the case for the Coral South FLNG project in Mozambique.

However, what actually happened is that, in light of Decree-Law 2/2014 of 2 December, which establishes the special legal and contractual regime for Rovuma LNG projects, the LNG production component of the South Coral project was included as part of the EPCC contract signed in 2016.

Under those circumstances, the upstream partners decided to create a separate company that owns, and operates, the vessel used in the liquefaction process, FLNG. The company, a Special Purpose Vehicle (SPV) under Decree-Law 2014, is registered in Mozambique as Coral FLNG SA.

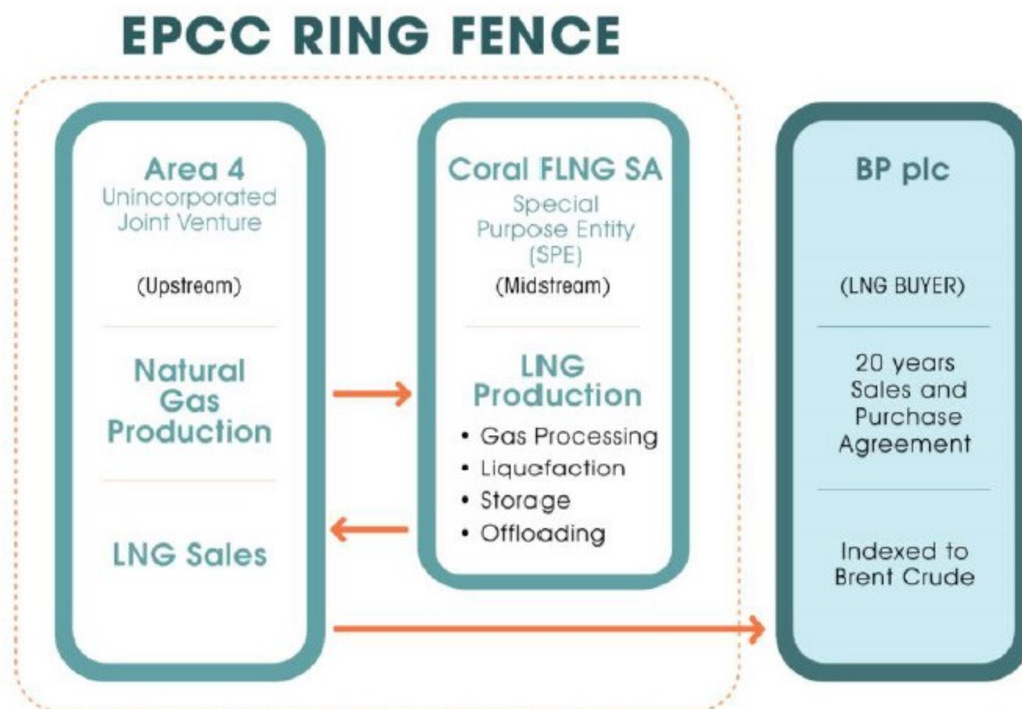
The same upstream partners participate in the entire structure created for liquefaction, on the same terms, which presupposes that the partners are also responsible for the midstream.

However, the business structure adopted by the project partners is, as a minimum, complex and unusual, randomly bringing together characteristics of an integrated and unintegrated business structure (see Box 2 regarding commercial structures).

According to Eni's 2018 Annual Report, the commercial structure foresees three phases:

i) Natural gas production by upstream partners; ii) Midstream gas liquefaction by the assembled platform (these are the same partners); and iii) LNG trading by upstream partners through Mozambique Rovuma Venture to BP under a 20-year long-term contract - with an additional 10-year option (see image below).

Figure 2: Commercial Structure of the Coral South FLNG Project



Source: Hubert, D. 2018. Government Revenue from Coral FLNG. R4DEV

With the same partners in both phases, it would make sense that both the upstream and midstream projects would be considered in the same EPCC ring fence, i.e. an integrated structure, as it was actually considered.

However, the structure foresees the charging of a toll fee to be paid to the midstream operator, ***although the same partners are operating in both phases****. This gives rise to abusive transfer prices, since they are the same partners, which can lead to cost inflation and, consequently, a reduction in the tax base.*

Box 2: Commercial Structure of LNG Projects

Integrated Commercial Structure

The integrated model involves a single entity or group that has upstream and midstream assets, with a single financial package that spans both. The advantage of this model is its simplicity. An entity holds all assets, avoiding complicating issues.

Upstream participants may, for convenience, establish a separate SPV[3] with respect to FLNG that they own. This entity may also act as a borrower and seller of LNG, but the structure remains economically integrated. The SPV can pass on the costs to its upstream shareholders (where the funding extends to the upstream capex[4]).

Trader Structure

Under this structure, the natural gas producer is a different entity from the plant owner of the LNG project. The liquefaction company buys natural gas upstream from the enterprise of the exploitation project, under a purchase and sale agreement. The profits of the LNG project derive from the amount by which LNG sales revenues are higher than the cost of production, because the owners of the upstream and liquefaction projects are different entities.

Commercial toll fee structure

Under this type of structure, the owner of natural gas is a different entity from the owner of the gas liquefaction facility (LNG). The LNG project company provides liquefaction services under one or more liquefaction toll fee contracts. In this case the risks (of abusive transfer prices) are minimized because it is a transaction between different companies.

Because the functions of the company of the LNG project do not include a commodity trader function, the company does not face commercial risks of goods, such as those related to supply, demand and the price of natural gas and LNG.

2.1.1 Transfer Pricing Regime Mozambique

Decree No. 70/2017 of 6 December, approving the transfer pricing Regime (*Regime dos Preços de Transferência*, "RPT"), was published in December 2017, entering into force on 1 January 2018.

The issue of transfer prices is raised in the corporate income tax code (*Código do Imposto sobre o Rendimento das Pessoas Colectivas*, CIRPC), approved by Law No. 34/2007, of 31 December. Although the CIRPC assigns jurisdiction to the Tax Administration to make adjustments in order to determine taxable profit, the procedures to be observed in determining the corrections regarding transfer prices were not detailed, which is a serious omission in the legislation.

Decree No. 70/2017 of 6 December provides details on the RPT, including the methods to be used for the determination of transfer pricing, which are aimed to assist in an abusive transfer pricing situation, namely: (1) method of comparable market prices, (2) method of the resale price, (3) method of cost plus, (4) method of profit splitting; and (5) method of the net margin of the operation.

---

[3] Also known as Special Purpose Entity (SPE).
[4] Capital expenditures.

Although the country has this important instrument, the RPT, mentioned above, gives rise to three aspects that constitute risks of abusive transfer prices:

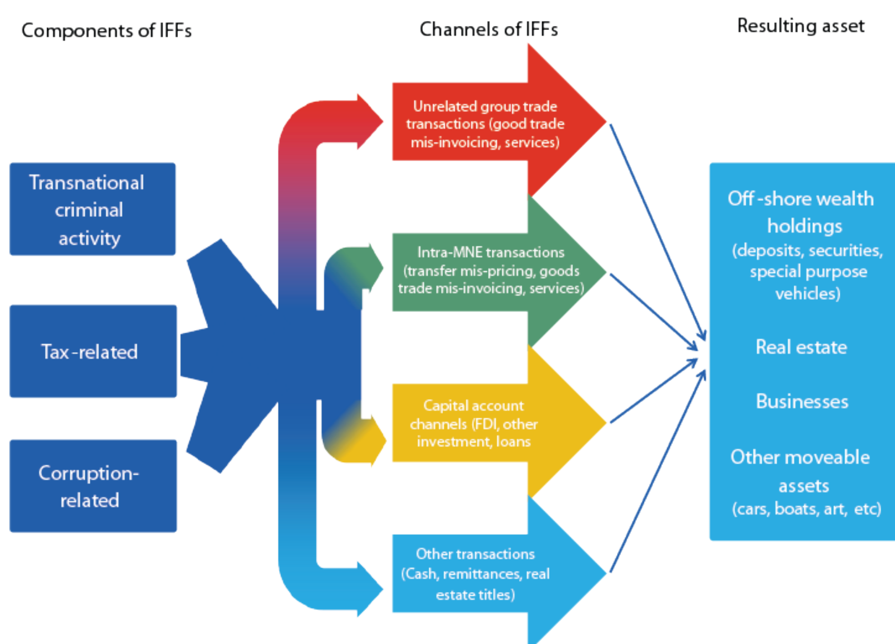
➢➢ ***The commercial structure of the Coral South FLNG project is complex and not usual, which provides an opening for inflating costs and for abusive transfer prices and therefore for a resulting reduction of the tax base;***

➢➢ ***In the current context of the Government's reduced supervisory and monitoring capacity, how will the use of the instruments provided by the RPT decree be ensured?;***

➢➢ ***The tax authorities need to be notified by companies about the transactions between the taxpayer and related parties (as well as having to validate the truthfulness of the collected information) and determine the transfer pricing methods used, before they are able to understand the transactions made. A study on the extractive sector in African countries, prepared by the Natural Resources Governance Institute (NRGI) in 2016, showed that obtaining necessary information from companies is one of the most significant challenges for the successful implementation of transfer pricing rules.***

The figure below clarifies how abusive transfer prices can be used as a channel for illicit capital outflow.

Figure 3: Transmission mechanism for the illicit outflow of capital



Source: Prepared by the author

2.2. Financing the FLNG Platform

Abusive transfer prices can be used to transfer profits from one jurisdiction to another, usually from a higher tax jurisdiction to a lower one. This is a very well-known scheme for illicit capital flows[5].

The Government approved on 17 May 2017 Decree 13/2017, which establishes the financing structure of the FLNG Coral South project in area 4 of the Rovuma basin. According to the same decree, the Government intends, through this structure, to allow implementing the engineering, construction, installation and

[5] https://www.cmi.no/publications/file/6382-lifting-the-veil-of-secrecy.pdf 13
Dubai Multi Commodities Centre.

mobilization of a floating infrastructure with the capacity to liquefy 3,370,000 metric tons of gas per year for the purpose of processing natural gas, as well as storing and marketing liquefied natural gas.

For that purpose, the partners of area 4 have created a special purpose vehicle (SPV) to provide financing to the vessel -- the FLNG vessel. The SPV (Coral South FLNG DMCC13, a company registered in Dubai, United Arab Emirates, UAE, in a free trade area), secured financing of 4.7 billion dollars, covering about 65% of the development costs of the midstream operation[6].

Companies registered in free trade areas enjoy tax benefits related to their location. Therefore, the registration of Coral South FLNG DMCC in a free trade zone in Dubai gives the company a number of benefits, such as an exemption on the withholding tax on dividends and interest under the double taxation treaty[7] signed between the UAE and Mozambique (signed in April 2004), thus generating transfers of profits, which would not happen if the company were registered in Mozambique. This represents in itself an illicit outflow of capital.

According to Fjeldstad et al (2017)[8], illicit financial flows and the transfer of corporate profits resulting from abusive transfer prices are fundamentally the same phenomenon when they involve "tax havens" and/or "jurisdictions of secrecy".

3. Conclusions and Recommendations

From the foregoing, it can be concluded that the first project to be operated in the Rovuma Basin presents impending risks of an illicit outflow of capital by applying transfer prices originating with the commercial structure adopted for the project.

A possible additional source of risks regarding illicit capital outflows is the financing structure, which provides for the financing of the vessel from an SPV registered in a free trade area in Dubai, with benefits of tax exemption for this entity.

Therefore, it is recommended that the Government:

- ➢➢ Draft specific legislation on transfer pricing in the extractive sector, given the fact that extractive sector companies are, in most cases, transacting with related companies or of the same group;
- ➢➢ Provide capacity building to the relevant institutions, in order to guarantee the application of the Decree on the Transfer Pricing Regime (Decree No. 70/2017, of 6 December) regarding the control of transfer prices approved in the country;
- ➢➢ Undertake a comprehensive analysis of the options for resource exploitation presented by the companies, taking into account their impact on revenue collection.

---

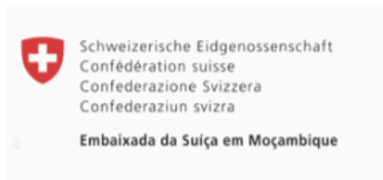
[6] The midstream segment of the oil and gas industry encompasses facilities and processes that are located between upstream and downstream segments.

[7] http://www.at.gov.mz/por/Media/Files/Convencao-dos-Emiratos-arabes

[8] Fjeldstad, Odd-Helge, Sigrid Klæboe Jacobsen, Peter Henriksen Ringstad, Honest Prosper Ngowi. 2017. Lifting the Veil of Secrecy: Perspectives on International Taxation and Capital Flight from Africa. Bergen: Christina Michelson Institute.

CENTRO DE INTEGRIDADE PÚBLICA
Anticorrupção - Transparência - Integridade

Partners:



Editorial information

Director: Edson Cortês
Author: Inocência Mapisse
Editorial Review: Percida Langa

Peer Review: Baltazar Fael, Borges Nhamire, Celeste Banze

Técnical team: Baltazar Fael, Borges Nhamire, Ben Hur Cavelane, Celeste Banze, Inocência Mapisse, Stélio Bila

Ownership: Centro de Integridade Pública
Layout: Liliana Mangove

Rua Fernão Melo e Castro,
Bairro da Sommerschield, nº 124
Tel: (+258) 21 499916 | Fax: (+258) 21 499917
Cel: (+258) 82 3016391
@CIP.Mozambique @CIPMoz
www.cipmoz.org | Maputo - Moçambique