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THE ROVUMA GAS CONTRACTS:

The Details and What They Mean

The confidential terms of the Rovuma Basin contracts govern how much revenue the government will get, and when they will get it, for 30 years of production. The most important elements – royalties, cost recovery limits and r-factor scales – are heavily weighted in favor of the companies. The government will receive the bulk of its share far down the production timeline.

Introduction

Mozambique is on the cusp of a natural gas boom. Recent finds of the coast of Cabo Delgado are reportedly among the most significant anywhere in the world in recent years. But will the exploitation of these vast gas fields result in measurable improvements in the lives of ordinary Mozambicans? Here the volume of gas is not the most important question; rather it is the terms of the contracts that govern the production and sale of the gas. And although gas production will not begin before the end of the decade, the terms that govern thirty years of production were negotiated in contracts signed in 2006. For the Rovuma Basin, the decisions have already been made.

But what terms were actually agreed in 2006 and what are their significance. Only a few people in Mozambique actually know: some Ministers, some senior government officials and, of course, the companies themselves. The people of Mozambique, the ultimate beneficiaries of the natural resource wealth of the country, have no access. The contracts are confidential.

A properly informed public debate cannot take place in the absence of the details in these contracts and an awareness of what they mean. This is the first in a series of briefing papers that seek to bring much needed transparency to the discussion on the terms under which extractive sector companies operate in Mozambique. In the following pages, we will describe the nature of the petroleum exploration and production system in Mozambique, spell out the terms of the four contracts covering the Rovuma Basin, and compare them with the terms that exist in the publicly declared fiscal regime.

Production Sharing Concessions

The current framework for the exploration and production of petroleum in Mozambique was established in law in 2001 and refined through regulation in 2004.[1] Mozambique adopted a concession system where petroleum underground and offshore remains the property of the state. Private companies, selected through public tender, conduct petroleum exploration and production. The contracts provide for a minimum period of eight years of exploration and thirty years of production. These contracts establish the range of company rights and responsibilities. Companies have exclusive right to conduct petroleum operations within their concession, and the right to a portion of all petroleum produced. They are required to pay designate taxes and royalties as established by the fiscal regime, while the government reserves the right to partial State ownership.

The Licensing Round for the Rovuma Basin concessions was launched on 5 July 2005. Five concessions were offered: four offshore and one onshore. The broad framework for the public tender was provided in a model contract. Petroleum operations would be managed through a Production Sharing Agreement or PSA, where government revenues were drawn partly from royalty payments and corporate incomes tax, but more significantly from the ownership of a portion of the petroleum produced. The core terms of the production sharing arrangement however were determined through the bidding process and are confidential.

The successful bids for the four offshore concessions are listed in Table 1. The regions covered, and the initial breakdown of equity shares in the respective consortia, are shown in Figure 1.[2]

Two of the concessions have generated all the enthusiasm. Only minimal exploration has taken place in the onshore concession, with no finds of commercial interest. And there has been no exploration at all in either the Statoil or Petronas concession offshore to the south. The important gas finds to date are in the concessions held by Anadarko (Area 1) and ENI (Area 4). The analysis below will compare all four Rovuma Basin offshore concessions, as there are important differences, particularly with the Petronas contract signed in 2008.

Exploration and Production Timelines

The EPC contracts establish the timeframes within which exploration and production will take place. Governments offer Exploration and Production contracts in order to encourage active exploration leading, hopefully, to commercial finds. Companies wish to hold the rights to the concession but may not see it in their interest to prioritize early exploration. In order to ensure that companies do not "sit" on a concession, contracts define the allowable time for exploration, commercial assessment, development and production. A generic example of petroleum project timelines is shown in Figure 2.

The exploration period begins immediately following the signing of the EPCC and can last for a period of up to eight years. During this

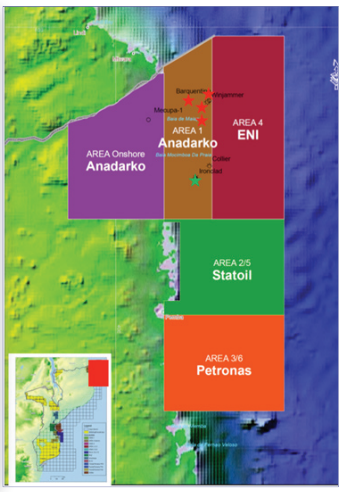
Table 1: EPC Contracts for the Rovuma Basin

EPC Contract	Company and Date
Rovuma Basin Area 1	Anadarko (20 December 2006)
Rovuma Basin Area 4	ENI (20 December 2006)
Rovuma Basin Area 2&5	Statoil (Date 16 February 2006)
Rovuma Basin Area 3&6	Petronas (Date 10 October 2008)

Figure 1: Rovuma Concession Equity Shares

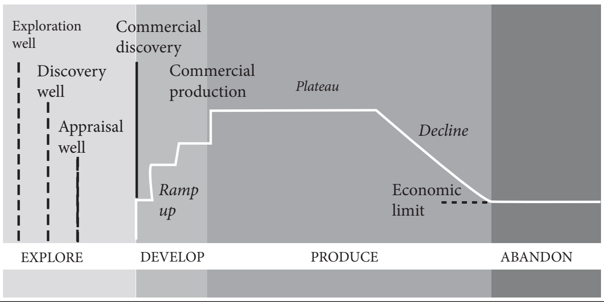
ROVUMA BASIN (5)

Concession	Partners
Area Onshore	Anadarko (35.7%), Artumas (15.3%) Maurel & Pron (24%), ENH (15%) & Cove Energy (10%)
Area 1	Anadarko (36.5%), Mitsui (20%), ENH (15%), BPRL (10%), Videocon (10%) & Cove Energy (8.5%)
Area 4	ENI (70%), ENH (10%), KOGAS (10%) & Galp Energia (10%)
Area 2 & 5	Statoil (90%) & ENH (10%)
Area 3 & 6	Petronas (90%) & ENH (10%)



period the company commits to a certain pace and expenditure for exploration operations including drilling both exploration and appraisal wells. Failure to meet these targets results in the company losing the rights to the concession. In addition, companies are requires to relinquish portions of the concession not under active exploration over time. Following a discovery of commercial interest, a period of "commercial assessment" of up to eight years begins. During this period a "Development Plan" is prepared by the company and submitted for approval to the government. The approval of this document marks the beginning of the development phase and the construction of LNG plants.

Figure 2: Petroleum Project Timeline



For natural gas that is not found alongside oil (non-associated gas), the timeframe from the signing of the EPCC until the beginning of production is limited to fifteen years, though provisions exist for its extension depending on the terms of the Development Plan. Once the first LNG plant has been constructed, the period of Production begins. It is initially set at thirty years but is also subject to extension depending on the Development Plan. When the reserves are depleted to the point where the production of natural gas from the Rovuma Basin is no longer commercially viable, a decommissioning phase begins leading to the eventual abandonment of the project.

Government Revenues

The broad fiscal regime adopted by Mozambique is known as a Production Sharing Agreement. Within this system there are three principal sources of government revenue. The government receives a small percentage of all gas produced as a royalty payment. As is the case with all companies operating in Mozambique, Corporate Income Tax is assessed on the basis of annual profits. The vast majority of government revenue however comes from the share of the total production that the government receives. This share is very small in the early years of production but increases substantially as the project becomes more profitable.

Royalty Payments

The first regular source of government revenue from gas production will be royalty payments. These are payment made to the government based on the value of the gas produced and start from the day that production begins. Royalty rates are a simple benchmark when assessing the terms of a contract, but they are not a significant source of revenue. They do however provide some guaranteed government income in the early years of production.

It is commonly assumed that the royalty rate for the production of natural gas in Mozambique is 6%. However, the rate for the first three of the Rovuma EPCCs is based on a sliding scale depending on water depth. As all gas finds in the Rovuma Basin are in water deeper than 500m, only the lowest of these potential rates is relevant. The relevant rate for the Anadarko, ENI and Statoil concessions is 2% (See Table 2).

Table 2: Royalty Rates

	Anadarko	ENI	Statoil	Petronas
Royalty Rate	2%	2%	2%	6%

The rate for the Petronas concession, negotiated two years later, coincides with the publicly declared figure of 6%.

Corporate Income Tax

Petroleum companies, like any other private company in Mozambique, are expected to pay

Corporate Income Tax. Taxable income is comprised of total income less eligible expenses. The main categories are set out in Table 3.

Table 3: Expense Depreciation Terms

Expense Category	Terms
Exploratiom	100%
Capital Expenses	25% straight-line
Operational Expenses	100%
Carry-forward	6 years

The rate of Corporate Income Tax in Mozambique is set at 32% and this is the rate that applies to the Petronas contract.[3] The government however offered tax incentives in the pre-2007 period including a 25% reduction in Corporate Income Tax for the first eight years of production (See Table 4).[4]

Table 4: Corporate Income Tax Rates

	Anadarko	ENI	Statoil	Petronas
Income Tax Rate	24%*	24%*	24%*	32%

Given the broad range of allowable deductions Corporate Income Tax in the early years of production will not contribute much to government revenue. Over the lifetime of the project, Corporate Income Tax is more significant than Royalty payments, but both are far less important than the government's share of the gas produced.

Production Sharing

The bulk of government revenue from the Rovuma concessions will come from the share of gas production that accrues to the government under the formula for the division of what is know as "profit gas." The first step though is for companies to recover their investment from what is know as "cost gas."

The EPCC contracts set out the rate at which costs can be recovered (See Table 5). All eligible exploration costs can be recovered from the first year of production. Capital investment (the costs of constructing the LNG plant) can be deducted at a rate of 25% each year. Operational expenses (the cost of running the plant) are fully deductible in the year that they were incurred. Any eligible costs that cannot be used in a particular year can be carried forward into future years until they are fully recovered.

Table 5: Cost Recovery Terms

Expense Category	Terms
Exploration	100%
Capital Expenses	25% straight-line
Debt financing	Unlimited
Operational Expenses	100%
Carry-forward	Unlimited

In the initial years of a project, expenses will exceed the total value of production. In order to guard against all post-royalty gas being allocated to the recovery of company costs, a "cost recovery limit" is included in the Rovuma EPCCs. The specific terms are set out in Table 6. A higher percentage means that the company recoups its investment more quickly. Under the ENI contract, for example, in the early years of production three quarters (75%) of post-royalty gas will go to the company to recover its costs.

Table 6: Cost Recovery Limits

	Anadarko	ENI	Statoil	Petronas
Cost Recovery Limit	65%	75%	70%	85%

The gas that remains after royalty gas and cost gas have been removed is known as profit gas. At the outset, the volume of profit gas is easy to calculate: it is total gas less royalty gas less the full percentage of allowable cost recovery. Over the course of several years, exploration and capital costs will be recovered leaving only modest annual operating expenses.

Profit gas is split between the company and the government on a sliding scale based on the profitability of the project. The relative percentages change depending on the ratio of cumulative income to cumulative expenses known as an "r-factor." R is less than one when total project expenses exceed total project income. When r equals one (1), the company has achieved "payout" – it has earned as much as it has spent.

When R equals two (2), the company has earned twice the total amount invested. The split of gas between company and government begins heavily in the company favor. In the longer run, the profit gas is either split equally, or a somewhat larger share goes to government (See Table 7). In the case of Anadarko, for example, in the first year of production, 90% of the profit gas goes to the company and 10% to the government.

Table 7: R-Factor Scale – Company Portion

R-Factor Scale	Anadarko	ENI	Statoil	Petronas
R less than 1	90%	85%	90%	90%
R 1 - 2	80%	75%	80%	75%
R 2 - 3	70%	65%	70%	50%
R 3 - 4	50%	55%	60%	40%
R 4+	40%	45%	50%	30%

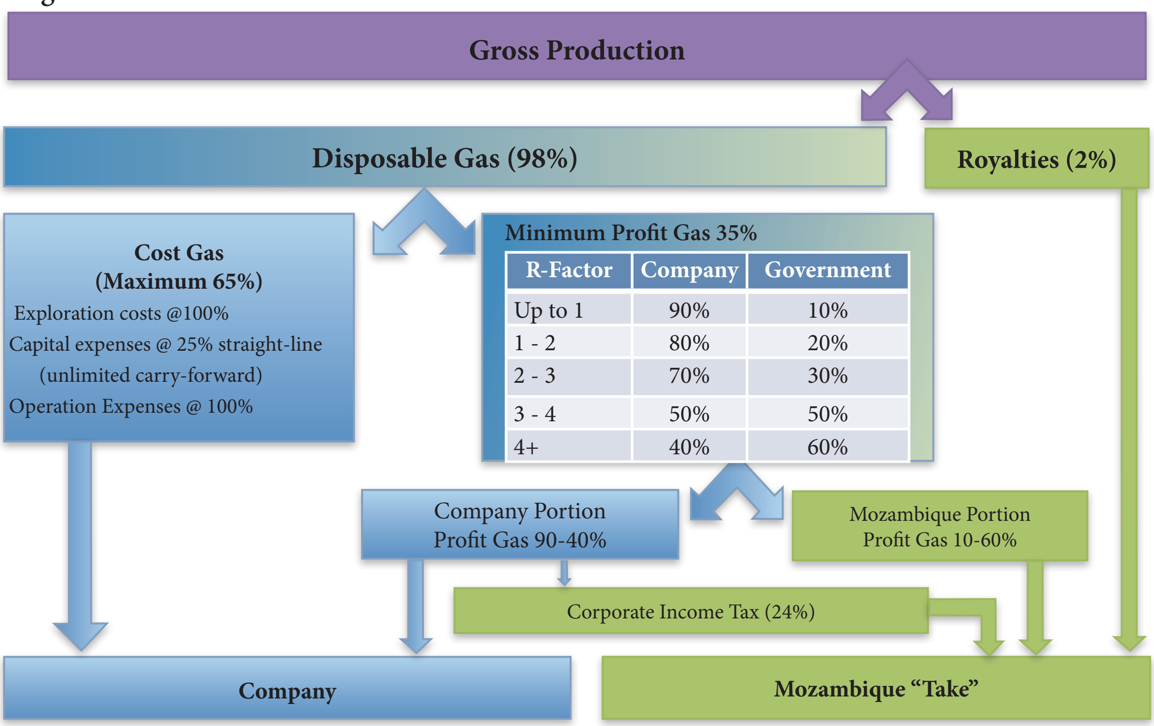
An Overview of the Fiscal Terms

A graphic representation is useful to understand how these various terms fit together.

Figure 3 below illustrates the fiscal regime as it applies to the Anadarko EPCC. Starting with Gross Production, the 2% Royalty payment is removed first. Next, expenses are recovered through Cost Gas to a maximum limit of 65% in any one year. The portion leftover after eligible costs becomes Profit Gas and is split according to the r-factor scale. At the beginning of the project, 10% of the Profit Gas goes to the government. When the project has produced four times as much income as expenses, the government gets 60% of the profit gas.

CIP will prepare additional reports to assess the implications of these terms both for future government revenue and for how they compare with peer countries. One conclusion however is obvious from the outset: the government will receive its portion of the overall revenue far down the production timeline. Contracts can be characterized as either front or rear loaded, depending on how the timing of government income compares to the company's recovery of its investment. Front-loaded systems provide substantial government revenue before all investment costs have been recovered. Rear-loaded systems give priority in early revenue to the company. The contracts for the Rovuma Basin are all heavily rear-loaded: all the terms that effect the timing of revenue allocations – royalties, cost recovery limits and r-factor scales – are heavily weighted in favor of the companies.

Figure 3: Anadarko EPCC Overview



Gas Price

The fiscal terms analyzed above establish the percentages for dividing gas between the company and the government, and the rate at which profits will be taxed. All of these percentages however will ultimately be calculated based on an agreed price for the natural gas. The Rovuma contracts were drafted in the expectation that oil would be found. Thus there is considerable detail on how oil prices would be established. Given Mozambique's experience with the Sasol pipeline, there is also some detail on setting the price of gas transported by pipeline.

There are no specifics however on how the price for LNG export gas will be set. The EPCCs simply say that the terms for the sale of gas must be approved by MIREM and that in the application the company must demonstrate that "the prices and other terms of sale of such Natural Gas represents the market value obtainable for such Natural Gas."[5]

The price of gas immediately before it enters the LNG plant has yet to be established. The price will likely be set by taking the price in the long-term sales agreement (probably benchmarked against Asian oil-prices) and reducing by the costs of production and transport. Clarifying this price is one of the most important elements yet to be negotiated for Rovuma Basin natural gas. The negotiation of a fair price is essential, as it will determine the cash value of the government's share of gas.

Other Sources of Revenue

The EPC contracts contain several other sources of government revenue including Production Bonuses as well as company commitments for Institutional Support, Training and Social Investment.

Production Bonuses are payments made to government once specific milestones are reached (See Table 8). The first bonus is paid when commercial production begins. The second payment is made when commercial production exceeds a threshold set in barrels of oil (25,000 per day) but convertible into gas production. There are then subsequent payments each time productions first reaches further tranches of an additional 75,000 barrels of oil per day.[6]

Table 8: Production Bonuses

	Anadarko	ENI	Statoil	Petronas
Commercial Production	$5m	$1m	$0.2m	$0.2m
First Production Target	$10m	$1m	$0.2m	$0.2m
Subsequent Targets	$20m	$5m	$0.2m	$0.2m

While the contracts encourage companies to employ citizens of Mozambique, they contain no specific requirements. They do however require companies to provide institutional support and training for government.[7] Companies may also commit to pay the government an annual amount "for social support projects for the citizens of the Republic of Mozambique in areas where Petroleum Operations take place."[8] For the levels of commitment across the four contracts, see Table 9.

Table 9: Institutional Support and Social Investment

	Anadarko	ENI	Statoil	Petronas
Institutional Support	$2m	$1m	$1m	$1m
Training Support	$1m	$0.5m	$0.45m	$0.35m
Social Investment	$1m	$0.25m	0	0

State Ownership

The Rovuma EPCCs clarify the size of the stake allocated for potential government ownership (See Table 10). The government is "carried" through the exploration phase. During this period there is no financial risk to the government; the company pays all the exploration expenses. If the exploration is successful, however, the government is required to pay its share of the exploration costs, plus interest, when production begins.[9]

Table 10: Mozambique Ownership Stake				
	Anadarko	ENI	Statoil	Petronas
Right Percentage Stake	15%	10%	10%	10%

No provision is made in the contracts for state participation to be "carried" during the development phase. The government stake therefore cannot be funded out of the government's share of profit gas. In order to take advantage of its right to a stake in the concessions, the government will be required to pay its full share up front. While this is not uncommon, the scale of capital investment necessary for the construction of LNG plants will make raising the necessary financing difficult.

Stabilization

As is common in petroleum contracts, provisions exist to ensure that future governments do not fundamentally change the nature of the deal on which the investment decision was taken. In the past, provisions often sought to "freeze" the terms of the deal, irrespective of future changes in legislation and regulation. A more recent approach, evident in the Rovuma EPCCs, is the use of an "equilibrium" provision. Laws and regulations may be changed, but the government commits to negotiate revisions to the original contracts such that the initial financial position of the company is retained.

Thus, the EPCCs say that, in the event that changes in the laws and regulations of Mozambique create an "adverse effect of a material nature on the economic value derived from the Petroleum Operations" the government will make "changes to this EPC which will ensure that the Concessionaire obtains from the Petroleum Operations, following such changes, the same economic benefits as it would have obtained if the change in the law had not been effected."[10] There are provisions in the contract, therefore, that seek to ensure that the fundamental split in benefits between the company and the government remains unchanged.

Confidentiality

A final set of provisions relates to the confidentiality of the contracts themselves and other documents generated and data collected. The Rovuma Basin EPC contracts contain an article which says that, "This EPC, the Documentation and other records, reports analyses, compilations, data, studies and other materials are confidential and except as authorised by applicable law or this Article shall not be disclosed to any third party."[11]

Governments and companies often argue that there are commercial reasons for keeping contracts confidential, but this position is unconvincing. The terms of petroleum contracts are widely known within industry circles. In fact, the details are often available for a fee from high-priced corporate databases (e.g. Barrows). Furthermore, the terms of the contracts can be divulged under specific circumstances including where required by a recognized stock exchange. Some elements of the Rovuma Basin EPCCs have long been in the public domain through exactly this process.[12]

In recent years, the call for greater transparency in petroleum sector contracts has been growing.[13] One solution is to put the core terms of the deal in a generic petroleum law leaving little to be negotiated in the contract itself. While a useful step, as long as contracts remain confidential it is impossible to know that the decisive terms in the contracts align with the provisions in the law. The solution is to adopt full contract transparency. Mozambique should commit to full transparency for all future contracts, and also publish all past contracts after securing the consent of the relevant companies.

Notes

[1] *Petroleum Law* No. 3/2001 of 21 February 2001 and *Petroleum Operation Regulation,* Decree No. 24/2004 of 20 August 2004.

[2] Ownership has remained fairly stable, though there have been changes in each of the concessions. In Area 1, Cove Energy sold its 8.5% stake to PTT Exploration and Production of Thailand, and Anadarko and

Videocon are each seeking to sell 10% stakes. ENI has announced a sale, pending government approval, of a 20% stake to the China National Petroleum Corporation. Percentages have also been sold by both Petronas (40% to Total), and Statoil (25% to Tullow).

3 See Code of Fiscal Benefits 2007.

4 See the Code of Fiscal Benefits 2002.

5 Article 17.6

6 Article 12. The numbers are slightly different in the Anadarko EPC, with the second payment made at 20,000boe and subsequent tranches paid at each multiple of 50,000boe.

7 Article 18.4-6.

8 Article 18.6(c).

9 Interest fees begin to be calculated from when they were incurred and are set at LIBOR + 1%.

10 Article 11.9.

11 Article 23.1.

12 For example, a section entitled "Mozambique Offshore EPC" includes the terms of the r-factor sliding scale as well as training and social project funding commitments for the Anadarko-led Rovuma Area 1 Concession. See Cove Energy, Proposed Acquisition of Mozambique Assets" 18 September 2009, p. 20.

13 See for example: IMF, Guide on Resource Revenue Transparency, 2007; and Peter Rosenblum and Susan Maples, Contracts Confidential: Ending Secret Deals in the Extractive Industries, Revenue Watch, 2009.

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