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Comment Letter on the Revision of the Petroleum Legislation of Mozambique

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Introduction

The Petroleum Law No. 3/2001 of 21 February 2001 (the "Petroleum Law") is intended to provide a sound and sustainable legal environment for the development of the oil and gas industry in Mozambique in a manner that will benefit Mozambicans. Although there is no significant commercial production from Mozambique's fields yet, the substantial oil and gas discoveries will very likely represent the most significant opportunity for the country to develop its economy and bring prosperity to its citizens.

The Petroleum Law and the Regulation Decree No. 24/2004 of 20 August 2004 that stems from it ("the Decree") address several key issues and are in many respects well drafted. However, this body of legislation needs to be robust enough to support the development of the oil and gas industry over several decades. Indeed, the complexity of the petroleum industry requires that applicable legislation regulating it be extensive, comprehensive and unambiguous, while at the same time be clear, practicable and self-executing. These comments are provided to the government of Mozambique in good faith and in the anticipation that Mozambique will revise its current legislation accordingly. The purpose of this comment letter is to strengthen the development of a balanced legislative and regulatory framework that permits economic production of oil and natural gas in a manner that benefits Mozambique and its citizens, without creating undue risks and hazards for current and future generations of Mozambicans. Indeed, "Petroleum resources are assets whose proper exploitation can contribute significantly to national development" (Preamble of the Petroleum Law). Such "proper exploitation" entails balancing present returns against overall benefits for present and future generations of Mozambicans.

Thus, the ideas developed in this Comment Letter revolve around the role of the petroleum industry in contributing to the development of Mozambique, and the rights and obligations that stem from it. This means that the petroleum industry has a public function and is a service industry for the nation. It also requires that the petroleum industry should be responsible for all of its actions and should cover all costs that arise from its operations. It is not for the State to subsidize those costs. Indeed, Mozambique has the benefit of leveraging the experiences of other nations, including such diverse countries as Ecuador, Nigeria, Georgia, Liberia, Uganda and Afghanistan as well as the United States.

These comments (the "Comment Letter"), the Annotated Version of the Petroleum Law, and the Annotated Exploration and Production Concession Contract (the "EPC Contract") are preliminary and illustrative of the areas the current legislation fails to address adequately, and should not be regarded as exhaustive. They are grouped in nine policy proposals:

1. Increase checks and balances
2. Strengthen governance

3. Fill the legal and institutional capacity gaps
4. Balance rights with obligations – combined with the proper incentives
5. Provide full compensation for damages
6. Extend liability to the parent company
7. Strengthen environmental, health and safety regulations
8. Promote transparency
9. Establish a clear profit sharing and tax scheme

Policy Proposals

1. Increase checks and balances

The Petroleum Law grants decision-making powers to the Council of Ministers but fails to establish an adequate system of checks and balances to monitor the exercise of those powers. Indeed, the State is asked to act both as a businessman ("the State reserves to itself the right to participate in Petroleum Operations", Article 8 of the Petroleum Law) and as a regulator whose role is to "contribute to the social and economic development of the country" (Article 4). This means that the Government will inevitably be in a position where its commercial interests could stand in conflict with its traditional regulatory and national protective functions.

For this reason, the involvement in any Petroleum Operations of any legal person that is also part of the Government should explicitly be prohibited in order to avoid conflicts of interest (Articles 8 and 9). Similarly, the Government should not be a party to a contract; it should be through a State-owned enterprise ("SOE") in order to limit its own liability as well as such conflicts.

In addition, the Council of Ministers is granted significant powers from policy development and implementation (Article 7 of the Petroleum Legislation) to regulate concession granting (Article 5), contracts and plans approval including designating the competent authorities (Article 10), taxation and royalty collection (Article 24 and 25),[1] and regulation of petroleum operations (Article 28). All aspects of regulating the petroleum industry – from commercial to environmental and public health – ultimately fall on the Ministry of Mineral Resources ("MIREM"), which is an excessive burden if not an impossible one.

No single ministry can be reasonably expected to simultaneously achieve all of the functions granted to MIREM, let alone balance them appropriately. Expertise for regulating these functions should lie with the most relevant, preferably expert, administrators and need to be granted to co-equal ministries or authorities as part of an institutional checks and

[1] The most recent proposed revision of the law has deleted Articles 24 and 25 relating to taxation and royalty so it is not clear which institution will be become responsible for these matters.

balances system. While the concept of a "one-stop shop" to streamline the administrative process is much preferred by investors and appears appealing in concept, there is a risk that present-day commercial considerations become the dominant factor in the decision making of MIREM not only because of pressures to increase the budget but also because success in the commercial realm is easier to calculate and measure than non-mandated externalities such as environment, health, safety, social or cultural considerations[2].

For these reasons the Ministries of Health and Safety, Environment as well as Social Affairs need to be involved in the licensing, monitoring, and enforcement process. This can either require Petroleum Operations to be subject to each of those ministries (in addition to MIREM), or require MIREM to involve the ministries in its decision-making process and to obtain their consent prior to making decisions. The second option has the benefit of preserving the single point of contact for investors, while increasing necessary internal checks and balances within the government.

Furthermore, the functions of licensing, monitoring and enforcement must be structurally and institutionally separated. The entity that grants a license is naturally biased towards ensuring its continuance, as to revoke the license at a later stage implies error in the initial grant. Ironically these pressures are also acute when a national oil company is involved, as that company will lose public image or acceptance in such an event. For this reason, monitoring and enforcement of regulation and license conditions must be conducted by a totally different entity with true independence to carry out its function.

Annex I provides some suggested recommendations on how to ensure that the responsibilities of the Government, and its various ministries, are aligned with time honoured, traditional and universally accepted checks and balances.

2. Strengthen governance

In addition to separating the functions of licensing, monitoring and enforcement to separate institutions, the Petroleum Law should give guidance as to how these discretionary powers are to be exercised in order to provide, among other things, increased confidence. Such guidance is essential for several reasons:

- The lack of guidance increases uncertainty in investors, making it more difficult to predict how public authorities will act *ex ante*. Investors and their financing institutions require such assurance in order to make long term significant investments.
- It decreases the administrative burden on public authorities if they can rely on pre-established procedures rather than having to determine afresh how to proceed in each situation.
- It establishes clear and objective frameworks for decision-making and minimizes

[2] Radon, J. and Thaler, J., "Resolving conflicts of interest in state-owned enterprises" in *From curse to blessing? Using natural resources to fuel sustainable development*, ed. Irakli Khodeli International Social Science Journal (Wiley-Blackwell and UNESCO, 2009), available online at http://onlinelibrary.wiley.com/doi/10.1111/j.1468-2451.2009.00702.x/abstract

the chances of inconsistent or unfavourable decisions from being made. With such extensive responsibilities, public authorities are not expected to be able to exercise a wide discretion consistently without any guidance given by the law.

Specifically, "petroleum exploration, development and production activities shall be carried out under a concession that results from a public tender, simultaneous negotiation or direct negotiation" (Article 5). This provision doesn't specify how that power is to be exercised and the lack of guidance from the law opens the door to subjectivity. The Petroleum Law should stipulate the criteria against which the relevant authority is required to grant a concession, for example by mandating that concessions be awarded through a bidding process which obliges the decision maker to accept the highest bid for the natural resources, while at the same time complying with the most stringent safety and environmental standards. The laws on public tenders in Norway, the EU and the US can serve as reference.

In the same vein, Article 17 provides that the "holder of a reconnaissance, Exploration and Production or Oil Pipeline or Gas Pipeline right is obliged, [...] when the national interest so requires, [to] give preference to the State in the acquisition of Petroleum produced in the Contract Area in accordance with terms to be regulated". This clause should be further elaborated because its implications could be misused. Preferential treatment can be allowed; it does not constitute nationalization and should be done on fair terms, which need to be specified. Proposed modifications to the law extend this obligation to those which construct and operate infrastructure. This specification will also need to be clarified, delineating the manner in and terms on which preferential treatment is permitted and the types of infrastructure the law would apply to.[3]

Another example where governance could be strengthened is evidenced by the obligation to "increase the capacity of the Oil Pipeline or Gas Pipeline System in order that the third party requirements can be satisfied on commercially reasonable terms" (Article 18.2). Expansion of a pipeline is not easy and can be costly, and it is not clear how this requirement – which is not necessarily practical from an operational point of view – is to be implemented. More specification in the Law is needed. Moreover proof of having sufficient funds "to support the cost of the increase in capacity" is not enough to assure that the third parties will actually apply them appropriately. Finally, in case of a dispute, it "shall be submitted for arbitration or to the competent judicial authorities as provided by law." This provision leaves too much to be decided for the future and to the discretion of private parties. It also invites disputes. The Law should set the basic framework for dispute resolution as is customary for a utility (and following the idea of increased checks and balances, an independent commission should be the arbitrator) in order for the parties involved to be able to rely on such pre-established procedures.

[3] *See* Proposed modified Petroleum law of April 2012, Article 18: Obligations of a titleholder of a reconnaissance, exploration and production, or creation and operation of infrastructure and oil pipelines or gas pipelines.

3. Fill the legal and institutional capacity gaps

Institutional capacity relates to the ability of public structures to identify and solve implementation problems. By strengthening its institutional capacity, the Government can elaborate and implement programmes more efficiently and effectively. Similarly, by reinforcing some legal concepts in the Petroleum Law, the country's interests as well as those of the investors can be better protected.

The examples below are merely illustrative and are not exhaustive.

a. Adopt a higher standard for "Good Oilfield Practices"

"Good Oilfield Practice" (Article 1) is a vague, ambiguous and varying concept. The interpretation of good, safe and environmentally friendly practices can too easily conflict with the interpretation of economic and efficient practices, ultimately preventing proper enforcement.

In addition, there are no such generally accepted standards in the international petroleum industry. There are varying national standards, often embedded in law. The definition should specify exactly what standards it is referring to.

In other words it is not enough to refer to "practices that are generally accepted in the international Petroleum industry". As will be further elaborated in policy proposal 4, licensees who are granted a concession should be required to perform in compliance with the best and highest oilfield practices standards in the world, standards which are normally applicable in developed nations. Those are the minimum standards that Mozambique wants and deserves.

Consequently, the Law should adopt a stricter legal standard for such practices and this should also be reflected in the Decree particularly with respect to Design and Construction standards (Article 40), Design Facilities standards (Article 41), Offshore Facilities and Vessels (Article 57), and critically throughout Section I Chapter VI on Safety and Environment.

Finally the licensee should have the burden of proof that it is adhering to requisite standards and should guarantee such compliance.

b. Adopt stricter procedures for the relocation of land owners

Article 20 on the Use and Benefits of Land and Rights of Way fails to establish a formal procedure where a land owner/occupant/user could be denied the use of land. Specifically the rights of land owners should have equal priority to that of licensees and merely paying a fixed, and perhaps a one-time, compensation amount should not be a sufficient reason to force someone to relocate. The concept of relocation needs to be viewed broadly.

Petroleum companies should not have the right to take "any property". There must be exceptions made for certain culturally relevant places and for areas of environmental

sensitivity which should not be available for Petroleum Operations. Objective standards must be established and an independent board could have final decision-making authority.

Interestingly, India is considering a system of future profit sharing with owners of private property that is taken for development. This could establish an inspiring precedent for Mozambique.

c. Use the experience and expertise of more established jurisdictions

With the enactment of the Petroleum Law, Mozambique is taking steps in the right direction. Because its legal framework in relation with that industry is still young and in formation, it would benefit from applying the experience and expertise of more established jurisdictions to ensure the prioritization of environmental[4], health and safety matters and the proper protection of the people of Mozambique in the event of any legal gap in the conduct of Petroleum Operations in the country. Certainly, managing the petroleum industry is a universal challenge for public bodies in all jurisdictions, so knowledge and expertise should be applied from all acceptable sources. Reference to an established body of law, that is continually updated, will assure prospective investors that a recognized and known rule of law will be followed. Moreover international arbitration will provide both the investors and the Government with the assurance that dispute settlements will proceed fairly if it can refer to the laws of an established jurisdiction.

Thus, until it can build upon its own experience at home, Mozambique could rely on the established legal regimes of Canada, the U.S. or Portugal as a reference for guidance, interpretation and completion in respects of those aspects of the Law which are still in formation or incomplete. Although this would be unusual it would fill a void and a gap until the legal system of Mozambique is fully established in such a specialized industry as oil and gas.

d. Enact a separate legislation to fully address natural gas operations

The Petroleum Law only briefly addresses natural gas processing operations and neglects the proper regulation of this asset in, *inter alia*, exploration plans and oil and gas pipeline construction plans, which are to be agreed upon by the National Petroleum Institute ("INP") and approved by the Council of Ministers. As such, the INP's agreement and the Council of Ministers' approval can be obtained for Petroleum Operations, and with it for natural gas operations, without the latter being examined thoroughly.

For instance while the legislation clearly identifies that the purpose of natural gas is for commercialization, it is weak on preventing dangerous flaring of natural gas. The Petroleum Law does permit the flaring of natural gas up to a discretionary Government threshold, and only if demonstrated by the holder of the right to development of Petroleum Operations that such flaring is the only alternative for commercialization ("The flaring of

[4] See the successful example of the BTC agreements which refer to the laws of the Netherlands and Austria in respect of environment.

Natural Gas shall only be permitted […] provided that […] all the alternative methods for the disposal of Natural Gas would prevent the commercial development of the deposit", Article 16). However the Decree does not expand further on the potential severity of the consequences of this practice and how it in fact could prevent commercial development. Flaring should not be permitted except in extreme, emergency, circumstances and operating companies should have the burden of proving that they absolutely need to flare and that there are no other alternatives. Because flaring imposes a potentially severe cost on Mozambique, the commercial benchmark should never be prioritized over environmental, health and safety factors. The proposed modifications to the law would mandate that the flaring of natural gas for the purpose of "testing or verification of the installations for safety reasons" would be subject to authorization on terms to be regulated. Still, even with the requirement of government authorization, the legislation is too vague and needs to be further specified. If flaring is permitted it must be done using "the best and highest technology and management practices" to limit adverse consequences.

Especially given that natural gas is likely going to become one of Mozambique's key assets, this demonstrates that it is in the Government's best interest to fully address natural gas operations either in the Petroleum Law or by enacting a separate Natural Gas legislation which should both (i) adopt the same system of checks and balances proposed for the petroleum industry (policy proposal 1), and also (ii) refer to a suitable, and more established body of law (policy proposal 3) to ensure the prioritization of environmental, health and safety matters in the event of any legal gap in the conduct of these operations in the country.

4. Balance rights with obligations – combined with the proper incentives

In this Law several rights are mentioned, such as: Exploration and Production right (Articles 1, 10), rights for the activities referred to in Article 5.1 (i.e. Petroleum exploration, development and production activities), the right to conduct Petroleum Operations and the preferential right in the granting of Blocks (Article 9), the right to conduct preliminary research work and assessment operations or reconnaissance right (Article 12), the right to construct and operate Oil Pipeline or Gas Pipeline Systems (Articles 13, 14),[5] the right in respect of data (Article 19), the right of use and benefit of the land, and the right of way (Article 20).

Rights entail obligations, which should also be referenced in the Law. Indeed, the purpose of this Law is not only to guarantee "the protection of the rights and assets of participants in Petroleum Operations" (Preamble), but also to ensure that Mozambican citizens have "the right to live in a balanced natural environment", "the right to medical and healthcare", and the "right to a safe, secure and hygienic work condition" as provided in the Constitution of Mozambique. Accordingly, the Law should also ensure that Petroleum Operations be developed in compliance with the highest and best international environmental, health and safety oilfield practices, and should place the burden of compliance on the companies

[5] Among these rights, the proposed modified version of the Petroleum Law enumerates a right for the construction and operation of infrastructure. *See* Modified Petroleum law of April 2012, Article 15: Concession Contract for Infrastructure.

involved in Petroleum Operations. Mozambique is entitled to and should require nothing less than the highest and best international environmental, health and safety oilfield practices because its citizens are to be treated with the same standards as those in developed nations.

Article 17 lists the obligations of a licensee and is a step in the right direction. However the Law must contain stronger protection for the reasons mentioned above. For instance the Law should apply a "strict liability" standard not only for damages that are caused by Petroleum Operations (causality) but also for those that arise from them (Article 17.f and 23 on the Protection of the Environment).

Yet, obligations may lose their meaning if they are not accompanied with a corresponding incentive system, including sanctions. The key is to include enforcement provisions that will clearly and effectively incentivize participants in Petroleum Operations to comply with the revised Law instead of to merely accept paying a fine. Liability for non-compliance should be a strong enough motivation to ensure responsible development and respect for commitments and obligations.

Currently Article 96 of the Decree imposes a fine on companies for not complying "with orders and with specific administrative instructions". This is a vague and non-specified liability which doesn't give any assurance that it will be effectively enforced – nor is it preventive.

Some breaches are more serious than others, and in some instances a mere fine will not incentivize companies to comply with the Law. For instance the Law should provide for situations where a licence should be automatically suspended or cancelled in cases of serious of repeated breaches (these terms must also be carefully defined). This kind of self-executing language will not only place the burden of compliance on companies, it will most importantly oblige companies to take the Law seriously and not try to exert pressures to prevent suspension and cancellation. International oil companies are generally subject to requirements in their home countries to disclose in annual reports any local laws that they are violating that have a serious impact on their operations. Accordingly, this type of provision would require the oil companies to proactively monitor their compliance with all relevant regulations, not only to comply with Mozambican law, but also to comply with their home country law.

When unauthorized conduct of petroleum activities leads to irreversible damages to the environment and to the health and safety of people, it must be punished severely. At a minimum, corporate executives should be subject to criminal penalties. If there are no personal consequences – unfortunately this is the case throughout the world – managers will take unnecessary and serious risks at the public expense and cost.

According to Article 96 of the Decree, the amount of the fine for each day of default ranges between 250,000.00 MT[6] at a minimum and 2,500,000.00 MT[7] at a maximum. For large oil companies, these fines may be the equivalent of mere parking tickets and are not a real penalty. Although unusual, the Government may consider imposing fines as a percentage of the offender's annual revenue to ensure that they are true deterrents. Also, although decrees

[6] Approximately USD 9,300.
[7] Approximately USD 93,500.

have the force of law, companies invariably use lobbying to weaken them, which companies cannot do if the principle is enacted into law as a statute. But a statute should also include built in escalators to account for inflation and changing economics.

In addition to increasing the level of penalties, the Law should ensure that the payment of fines is not cost recoverable or tax deductible.

Finally as suggested in policy proposal 1 in this Comment Letter, each of the applicable ministries should have its own separate compliance division in order to increase necessary checks and balances within the Government.

5. Provide full compensation for damages

It is undeniably a great challenge for any government to successfully balance the promotion of the exploitation of potential resources of their lands while avoiding or minimizing damages. Examples throughout the world show that poor or inadequate compensatory obligations on companies could leave Mozambique with a burden that exceeds the benefits gained from Petroleum Operations. Therefore the ambiguous compensatory clauses in the Petroleum Law need to be reconsidered so that the licensee is held fully liable to compensate for all of its actions including consequent externalities, which the licensee in reality causes.

For instance Article 20 of the Petroleum Law on the "Use and Benefit of Land and Rights of Way" fails to provide a satisfactory standard on compensation, and hence does not adequately protect against damage to the users of lands that may be impacted by Petroleum Operations. Furthermore compensation as presently defined does not even cover situations such as abandonment, flaring of natural gas, or decommissioning, which should be regulated to ensure that society does not bear any of the resulting costs.

Compensation should cover all of these situations in the Law and should be defined as full restoration or replacement, also taking into account prospective future earnings. It needs to cover the full range of damage including material, psychological, economical, etc., and fully offset personal challenges that may be encountered by those damaged, including loss of community.

Moreover, an adequate compensation fund needs to be secured from the start, and terms and procedures for disbursement need to be agreed upon. The licensee should be obliged to present regular up-to-date evidence of financial capability supported by insurance, a parent company guarantee (see below), an unconditional bank guarantee for the parent company, a compensation fund, etc.

Perhaps a Government entity could be dedicated to approving the minimum amount of the fund and constantly checking and supervising that the fund is in order and up-to-date.

6. Extend liability to the parent company

To ensure that a licensee complies with the Law, the Government of Mozambique should never have to expend time, money and effort in order to "pierce the corporate veil" and seek damages from a parent company because the licensee is, for instance, insolvent. Foreign investors should not escape responsibility and liability because they are incorporated elsewhere and operate through a Mozambican company. Accordingly guarantees from foreign parent companies should be a normal and mandatory requirement. Though the present draft of Model Agreement calls for parent company guarantees, the conditions of the Model Agreement are contractual and therefore may in the course of negotiations be modified. Parent company liability must be mandated in the law to guarantee that parent company liability is not a discretionary or negotiable matter and to ensure that the potentially harmful acts of companies are fully compensated.[8]

Both the interests of the State and, thus, those of its people would be best safeguarded if the (foreign) parent owner, which usually possesses the major assets of the group, is required by this Petroleum Law to fully guarantee all of the potential liabilities and obligations of the licensee/subsidiary and, accordingly, submit to the jurisdiction of Mozambique to ensure enforcement. Moreover as suggested above in policy 4, the Petroleum Law should ensure that individuals who manage the offending company also bear responsibility.

7. Strengthen environmental, health and safety regulations

In addition to what has already been proposed above, the protection of the environment, health and safety demands further elaboration. Indeed, the Constitution of Mozambique guarantees that the citizens shall "have the right to live in, and have the duty to defend, a balanced natural environment"[9] - article 90, "the right to medical and health care, within the terms of the law, and shall have the duty to promote and preserve health" - article 89, and "the right to safe secure and hygienic work condition" - article 85.

The Petroleum Law and the Decree takes some positive steps in requiring that Petroleum Operations be conducted in compliance with environmental, health and safety regulations. However the latter are subject to discretionary and "reasonably practical" parameters which call into question the actual adherence to such regulations. Accordingly it is in the best interest of the State and of its people to undertake further measures, including:

- Require that the licensee ensure that there is not only no ecological damage or destruction caused by Petroleum Operations, but also no damage "arising from" these operations (Article 17.f and 23 on the Protection of the Environment) (cf. also policy proposal 4). "Caused by" is too narrow a concept because there may not be a direct cause and effect, whereas all possible measures should be taken to protect the environment. Moreover, "unavoidable ecological damage" must be strictly understood as that which, literally, could not be prevented applying the highest and best international environmental, health and safety oilfield practices.

[8] Mozambique Model EPCC/4th Licensing Round/May2010, section 4.10(b) Parent Company Guarantee.
[9] Constitution of Mozambique, Chapter V: Economic, Social and Cultural Rights and Obligations.

- Incorporate exact standards to govern oilfield practices on the avoidance of damage to petroleum reservoirs (Article 23.1.c) and on disposal (Article 23.2).
- Emphasize on the protection of water resources in the conduct oilfield operations (Article 28).
- Empower the relevant ministries in their respective areas of expertise – environment, health, and safety (see also policy proposal 1).
- Set up an adequate enforcement structure that effectively prevents – and when necessary penalizes – licensees that do not comply with environmental, health and safety regulations. As considered in policy proposal 4, serious infractions or repeated violations could even be a reason for the termination of the contract.
- Use the experience and expertise of more established jurisdictions for guidance, interpretation and completion in respects of those aspects of the Law which are still in formation or incomplete. Although this would be unusual it would fill a gap until the legal system of Mozambique is fully established in such a specialized industry as oil and gas (see also policy proposal 3).

8. Promote transparency

Whereas the Government of Mozambique must preserve competitiveness in the petroleum sector and guarantee the protection of the rights and assets of participants in Petroleum Operations, openness and transparency are the best ways to ensure a country enjoys the maximum benefit from the resource extraction.

The automatic publication of all relevant documents (including petroleum agreements and licences), with very limited and specific exceptions for commercial confidentiality, ensures that the Government, citizens and civil society are all equally aware of the expected benefits of oil and gas extraction, and can participate in its monitoring. In this way, transparency can actually reduce the administrative burden on the State by including civil society as an active participant. It can also reduce the possible influences that a licensee could have obtained through lobbying. Transparency is an effective way to address the expectations of the public, which are not necessarily realistic in the absence of information.

In the same vein, applicants for licences should also be compelled to disclose the identity of all of their shareholders (if a private company) as well as any lawsuits that they or an affiliate has engaged in over the last 10 years with host governments anywhere in the world in order to allow the government to evaluate their track record and with whom they are actually dealing.

Particularly with respect to a SOE, the Law should require that the latter publishes audited financial reports, prepares annual financial statements on royalties received and submits them to Parliament.

These suggestions are illustrative of areas where transparency helps achieve the best outcome for Mozambique and are not exhaustive (e.g. disclosure of information by employees of the SOE, whistleblower protection, access to impact assessments, procedure

for invitation for comments, etc.).

Confidentiality should only be limited to proprietary technological know-how. Still such know-how needs to be disclosed to the regulatory authorities if, for example, it can impact health or environment. This is particularly true to chemicals inserted into the land or fluids used to disperse a water-spill. In addition the Government needs to have a method to determine that the highest and best technology is used with the consequence that such technology need not be made public and can be maintained as confidential but must be disclosed to the regulators of Mozambique.

9. Establish a clear profit sharing and tax scheme

Emerging countries such as Mozambique need to make significant expenditures in order to serve the basic rights of the people of Mozambique. But this requires calculable earnings for the State. This can be accomplished by incorporating a basic and clear profit sharing scheme in the Law designed to maximize the return for the State. The present law mentions a total of 7 different fiscal impositions, which makes it unnecessarily complex to calculate the actual return that the Government will receive.

Income tax and royalty payments are the most important sources of revenue:

- The Petroleum Law establishes that a company shall pay a royalty on Petroleum produced "according to rates between 2% and 15% to be [yet] established by Decree of the Council of Ministers" (Article 25). The Government should consider enshrining the royalty rate in the Law rather than in a decree so that companies may not pressure the Government and negotiate for a lower rate. In addition, royalty rates should be established by objective criteria and should be specified whether they are taken in kind or in cash at the start of a contract with a licensee. At present, royalty may be paid in kind at the discretion of the State after consulting with MIREM[10] and after a six month notice to the company. This makes it difficult for companies to operationally plan.
- The Petroleum Income Tax Rates set forth in Law No. 12/2007 are 10% for crude oil and 6% for natural gas, which are relatively low. The Government should consider a system of super-profit taxation that activates when oil prices[11] rise beyond a stipulated amount. The rationale is that companies make investment decisions on the basis of an assumed or anticipated internal rate of return ("IRR"). Any profit in excess of that expected return is effectively a bonanza and should not disproportionately benefit licensees who merely exploit a public resource that doesn't belong to them in the first place. The owner of this fixed national asset is the State who, more than anybody else, is entitled to maximize the return for itself.

[10] See Decree No.4/2008, of 9 April: Regulation on Petroleum Production Tax, Article 8: Methods of Tax Payment.

[11] Currently, the Law states that "Where the royalty is paid in cash, it shall be calculated […] on the basis of international prices in the case of Crude Oil" (Article 25.4). However, international prices are neither a standard nor market prices, but rather "published prices" and the reference should be made to the appropriate publications.

A precedent has been set by the Australian government which already imposes a resources super-profits tax.

Finally, the Law should ensure that capital gains be taxed appropriately so that some portion of the profit realized on the sale or transfer of capital assets between companies also goes to the State who ultimately owns the petroleum resources. Moreover, the Law, should prohibit stabilization clauses except "pure" fiscal stabilization provisions which are limited for a prescribed period of time and are coupled with a super-profits tax for the simple reason, as explained above, that companies invest based on IRR.

Proposed modifications to the law remove the Articles on royalties and taxes in their entirety. Though this eliminates problems surrounding clarity, it is important that royalties and taxes related to Petroleum Operations be inscribed in law. Article 7 of the modifications on the law would require the government to guarantee that a certain percentage of the income generated through Petroleum Operations be invested in the communities in which the operations are undertaken which is appropriate as the impacted communities need to be fully compensated for the burden these communities bear. The law further dictates that the percentage invested in the community would be fixed in the Budgetary Law.[12] However it is best practice to stipulate such obligation as a separate law and not be included within the budgetary statute for the reason that income earned from Petroleum Operations needs to be considered specically, effectively as an off-bueget matter.

It is important to note, however, that the State Budget for 2011 makes no mention of receipts related to Petroleum Operations and defers that omitted to the State System of Financial Administration (SISTAFE).[13] SISTAFE has the authority to mandate how the country's financial institutions operate, however, it was written in 2002. If control of receipts from Petroleum Operations is to pass from the Petroleum law to the State Budget, which as noted above is not best or even good practices, it is at least important that earnings from the Petroleum Operations be covered separately and in detail in SISTAFE.

Conclusion

At present, the Petroleum Law and the Regulation Decree that stems from it does not yet fully protect the economic and environmental interests of Mozambique and its people.

Given that the substantial oil and gas discoveries will very likely represent the most significant opportunity for the country to develop its economy and bring prosperity to its citizens, it is imperative that the current legislation be amended in order to incorporate the

[12] *See* Proposed modified Petroleum Law of April 2012, Article 7: Administration of Petroleum Operations.
[13] *See* Proposed State Budget Law No./2011 of December, Article 13: Supplemental Legislation, *available at* www.pap.org.mz/downloads/annual_review_2011/Lei_OE_2011.pdf. *See also* Law No. 9/ 2002, The Subsystem of the State budget, Article II: competencies, *available at* http://www.bancomoc.mz/FILES/GAJ/LEI_SISTAFE.pdf, (It is within the competency of the Subsystem of the State Budget (SOE) to create the project for the Budgetary Law and its respective foundations).

policy proposals set forth in this Comment Letter, and that the model agreement be based on the revised Petroleum Law. In doing so, the Government will undoubtedly adopt the highest legislative standards in order for all Mozambicans to benefit from the profitable and sustainable development of Mozambique's petroleum industry.

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Annex I

As it is important to keep in mind that a suitable and acceptable institutional/governmental structure with appropriate time honoured, traditional and universally accepted checks and balances system is necessary to manage such a complex industry, where the input of multiple specialists, experts and public servants is needed and where the self-enforcement of the law will improve its effectiveness and reliability; the following are a suggested recommendations to be considered:

1. Licensing power could be granted to the National Petroleum Institute (INP) to negotiate the EPC and other contracts.
2. Regulatory power should be allocated to specific ministries with specialized authority such as health, safety and environment. Each such ministry would have the right to request information and reports (via the INP), request for amendments in the exploration activities plans, development plans, oil or gas pipeline plans, and decommissioning plans to the extent they impact the specialized authority of a ministry.
3. Enforcement power is to be given to each of the ministries within their areas of competence which would each be authorized to even terminate the EPC or other contracts under certain circumstances such as consistent and persistent violations of the law.
4. Finally, and crucial to the functioning of this administrative structure, it is in the best interests of the state and its people that civil society's participate, under the simple principle of the more eyes and ears the better, in protecting the environment, health and safety of Mozambique and its people, as contemplated in articles 85 89 and 90of the constitution of Mozambique. Civil society provides eyes and ears that any institution lacks as no institution can be everywhere at the same time. Moreover natural resources impact a society in so many different ways that is important that its development, if it is to be viable over time, has the full acceptance of the communities it affects.

Accordingly, any company seeking to develop petroleum resources would need to obtain approval from the INP as well as each of the other relevant ministries. Moreover, all applicable ministries would, as noted, have separate power to enforce rules and regulations within the area of their competence, including closure or the suspension of Petroleum Operations as necessary. And complementarily, the natural empowerment of civil society will provide on the ground eyes and ears. Only such a mechanism will ensure that present-day commercial considerations do not control the decision making process and all the costs and benefits are taken into account, including future costs such as health and environment. A properly functioning industry does not impose costs on the society but instead internalizes theses costs and pays for these costs through the free-market pricing mechanism. Mozambique has an advantage as it can learn from the mistakes of those environmentally rich nations which have already experienced the challenges of petroleum development.

In doing so, any entity wishing to develop petroleum resources would be required to obtain approval from the INP as well as each of the other relevant ministries. And complementary, the participation of civil society will provide the transparency needed to ensure public acceptance. Only such a mechanism will ensure that commercial considerations will not become the predominant or exclusive factor in the decision making process, and that the highest interests of the State and its people are protected.

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