COMMENT ON THE TIMOR GAP TREATY

By D. R. McDonald*

INTRODUCTION

Mr Burmester is to be congratulated on his thorough analysis of the Treaty and the various annexes attached thereto.

My commentary will be from the perspective of a manager of an active substantial Australian based oil exploration and production company genuinely interested in obtaining exploration acreage in the Zone of Cooperation in the area between Australia and Indonesia. My Commentary will also be from the view point of companies not previously involved in this geologic province. However, any opinions expressed in this Commentary are mine and not necessarily held by my employer.

Dr Poll represents a company which has been involved in the exploration of this area previously and in his Commentary he has presented a very fine paper on the current state of knowledge of the exploration potential of the Timor Gap Treaty Area.

The two aspects from Mr Burmester's paper upon which I would like to comment in relation to Area A[1], are:

— Arrangements Governing Petroleum Operations; and
— Existing Petroleum Permits.

ARRANGEMENTS GOVERNING PETROLEUM OPERATIONS

Mr Burmester described the Treaty which has, as Annex B, a Petroleum Mining Code for Area A; as Annex C, a Model Production Sharing Contract ('PSC') and as Annex D, a Taxation Code for the avoidance of double taxation in respect of activities connected with Area A. It is understood that there will be Regulations and Directions still to be issued that will cover specific operations in much the same way as those with which we are familiar under the Petroleum (Submerged Lands) Act 1973 (Cth) in Australia.

There are several provisions in these documents which in my view are unclear or could be amended to make the situation more workable.

First, under the Treaty, there is a Ministerial Council set up by the Contracting States. Reporting to the Ministerial Council is the Joint Authority which is the administration body and under Article 8, an exhaustive list of management functions has been set out. However, throughout the Treaty and in particular, Articles 12 through 18, the Contracting States are again directly involved in surveillance, security, search and rescue, air traffic, hydrographic and seismic survey, research and environmental protection. At this stage one is left with uncertainty as to what branch of Government in each country to approach to transact the

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1 For map of Zone see J. Poll, infra, 267 Figure 1.

required business. Let us hope the Regulations and Directions re-establish the Joint Authority as the sole contact point in these matters.

Secondly, Article 19 of the Treaty refers to the liability of contractors for pollution of the marine environment. As written, it appears as a general statement that could be read that all Contractors are liable for expenses for all pollution arising out of petroleum operations. Hopefully, the individual Production Sharing Contracts will spell out that the liability is limited to pollution arising out of petroleum operations in the individual Production Sharing Contract area.

Thirdly, in Annex B, the Petroleum Mining Code, the following should be noted.

— Article 4, paragraph 3 provides:

> Except as provided in paragraph No. 5 of this Article, the Joint Authority shall authorise the marketing of its share of petroleum production by the Contractor who shall market all petroleum produced from the contract area.

'Contractor' is defined[2] as a corporation or corporations which enter into a contract with the Joint Authority and registered under Article 38 of the Petroleum Mining Code. The imposition placed on the 'Contractor' to market all petroleum produced or joint marketing could be in conflict with Australian Trade Practices legislation, so some tidying up will be necessary here. The exception mentioned in paragraph 5 is a provision allowing the Joint Authority, with the approval of the Ministerial Council, to market any or all petroleum production. This is in itself a worry as most oil companies tend to pride themselves in their marketing expertise as of course any margin on sales goes right to the bottom accounting line.

There appears to be a contradiction between these provisions and s.7.11 of the PSC which limits the Joint Authority's marketing to times when it can secure a higher price than the contractor.

— Article 4, paragraph 7 of the Petroleum Mining Code, reads

> In the case of a Contract entered into with a group of corporations, each corporation shall be jointly and severally liable for meeting the conditions of the Contract and for complying with the requirements of this Petroleum Mining Code and the Regulations and Directions issued by the Joint Authority. Each corporation shall be a signatory to the Contract with the Joint Authority.

The concern here is the concept of joint and several liability. There are several references to liability considerations under Joint Venture Agreements in papers published recently by AMPLA. For example, Gerald L. J. Ryan observed:

> by severally appointing the manager/operator the venturers are lending weight to the view that they do not carry on business 'in common' and therefore could not fall within the statutory definition of partnership with its accompanying problems of joint and several liability.[3]

2 In Art. 1 of the Treaty.

3 G.L.J. Ryan, 'Role of the Operator under a Joint Venture Agreement: Comment on Liability Considerations' (1982) 4 *AMPLJ* 282.

Perhaps a slight amendment to the text could be made to satisfy the Joint Authority that work commitments and all other obligations will be fully met without prejudicing the position of the corporations with the Australian taxation authorities.

There are two further areas of the Petroleum Mining Code where amendments would make for more comfortable working relationships.

First, Article 15, paragraph 3, reads

> The contract operator shall also do such things as the Joint Authority requests to determine the chemical composition and physical properties of any petroleum discovered and to determine the geographical extent of any petroleum pool and the quantity of petroleum in that pool.

This of course could include several unnecessary or controversial costly appraisal wells.

It would be good if the world 'reasonably' could be inserted before 'requests' to put some objectivity into this Article. To be remembered is that the Joint Authority has no track record of making reasonable requests.

Secondly, Article 48 deals with the termination of a PSC for reasons of non-compliance with the provisions of the Petroleum Mining Code, Regulations or Directions issued by the Joint Authority or terms of the Production Sharing Contract.

This Article, as written, states that the Joint Authority shall give 30 days written notice to the contractor of the Joint Authority's intention to recommend termination of the Contract. The Ministerial Council shall not agree to the termination of the Contract until the Contractor has had an opportunity to provide the Joint Authority with reasons why the Contract should not be terminated and the Joint Authority has given full considerations to those reasons. The Contractor must provide reasons for non-termination within 30 days of receipt of notice of the Joint Authority's intention to terminate.

These two 30 day periods are not consecutive, they are concurrent. Therefore, a Joint Venture could *theoretically* be in the midst of an exploration program oblivious to the fact that its Operator was in default of some Regulation or Direction issued by the Joint Authority and in the short period of 30 days have its Production Sharing Contract terminated.

Most of us are familiar with joint venture agreements that provide for participants to notify the operator of a breach of its obligations as operator and allow a period of 30 or more days to remedy the breach. If not satisfactorily remedied, the participants may remove the operator and elect a replacement. This process is usually envisioned to take a further 30 to 90 days. However, in the situation outlined in Article 48 where the PSC can be terminated theoretically in just over 30 days, the joint venture agreement would have to be written with some rather short notification periods for default of the operator. Our suggestion is that a provision be put into Article 48 where the operator (and all other participants of the PSC) can be notified of its short-comings and the operator given a 30 day period to rectify those short-comings. If the short-comings are not satisfactorily rectified then Article 48, as written, comes into effect and the joint venture will have time to respond.

There is, however, a provision in s.13 of the PSC that a Contract shall not be terminated during the first three years after its commencement; however this appears to be in the context of 'firm' work commitments.

Article 36 of the Petroleum Mining Code deals with the release of information and data by the Joint Authority with most of the provisions including the timing of release of basic and interpreted data of two years and five years respectively quite acceptable.

Article 29 requires that all data and information from petroleum operations must be lodged with the Joint Authority which shall have title to such data. However, in paragraph 4 of Article 36, it is written that a contract operator shall have the right to have access to and use all information held by the Joint Authority relating to blocks in Area A adjacent to its contract area.

I have two thoughts on this situation:

— it denies a group of explorers the opportunity of taking possible commercial advantage of some exploration knowledge gained from their exploration program. This commercial advantage could involve data trades, farm-ins, farm-outs, mergers etc; and

— it could have the opposite effect to what appears to have been intended. If a group has an apparently interesting structural trend that is shared with a neighbouring contract area, it is probable with Article 36 as written, the group may postpone exploration work near the boundary (seismic or a well or both) waiting for its neighbours to spend the funds. Therefore, the trend may go unexplored. If a normal commercial competitive situation existed, the two groups possibly would join together and drill a joint well or one group might contribute 'dry hole' money to the other to gain inexpensive exploration data.

In Annex C to the Treaty, the Model Production Sharing Contract tracks the provisions of the body of the Treaty and the Petroleum Mining Code and is, in my opinion, a well written document except for the instances previously mentioned. Presumably, the provisions of the Treaty will take precedence over the Annexes where there is a clash.

There are some noteworthy points in the model Production Sharing Contract:

— In s. 4.2 the work program and expenditure commitments are listed as to *contract* years which were previously defined as the 12 month period following the effective date of the individual Production Sharing Contract. In s.4.7, an approval must be obtained from the Joint Authority two months before the commencement of a *calendar* year for exploration and appraisal strategy for the ensuing *contract* year. In s.4.8 an approval is to be obtained from the Joint Authority one month before the commencement of the *calendar* year for the work program and budget for the ensuing *calendar* year. To be realised is that the ensuing contract and calendar years could be quite different periods in time.

Presumably, Australian tax will, as normal, be calculated on the Australian financial year ending 30 June. Therefore Australian based companies will have three distinct periods to keep track of;

contract year, calendar year and Australian financial year. Clearly these provisions will keep the accountants alert.

Two instances where conditions have been improved from those existing in firstly Australia and secondly Indonesia are:

(a) Non-capital Costs being a part of Operating Costs, incorporate closing down costs which can include the removal of all production facilities *including the removal of platforms.*

(b) Equipment purchased by the Contract Operator pursuant to the work program and budget *remains the property of the Contractor.*

The Taxation Code for the Avoidance of Double Taxation which is Annex D to the Treaty obviously requires specialist comment beyond this author. To be noted however:

— the unpopular Australian Fringe Benefits Tax is included and pursuant to Article 12 makes Australian resident employees more expensive than employees who are not resident in either Contracting State, and

— Article 3 paragraph 2 of the Treaty requires separate companies to be specifically established for each PSC.

Production Sharing Arrangements and Economics

Mr Hitchens was an Assistant Secretary in the Petroleum Exploration and Development Branch of the Department of Primary Industries and Energy in Canberra during the time these outstanding achievements were being negotiated and has authored several papers. In a paper presented in March 1990 he stated:

> perhaps predictably the sharing formula provides a level of incentive to exploration and development somewhere between Australia's R.R.T. and Indonesia's PSC arrangements.[4]

In a study available from Petroconsultants Australia Pty Ltd of Sydney the statement is made,

> given the same set of hypothetical field developments in water depths of 100 metres, the fiscal regime of Area B (RRT) yields the greatest return to the Contract Companies. The model system for Area A (the Joint Authority Model Production Sharing Contract) yields the next highest return followed by the Indonesian First Tranche Petroleum regime for Area C (in water depths of less than 200 metres).[5]

Later on the study adds:

> comparing the fiscal regimes of Areas A and C as regards deep water, the regime for Area A gives slightly higher returns but the difference is not significant in the overall context of exploration and development of petroleum projects.

Whilst accepting there are still several unknowns my company would tend to support the above comments; however we see small difference between the returns to the companies from Area A and Area B.

4 Timor Gap Seminar held at Arthur Robinson & Hedderwicks, Melbourne, 26 Mar. 1990.

5 'Timor Gap — Zone of Cooperation, Economics of Petroleum Exploration' available from Petroconsultants Australia Pty Ltd, North Sydney, NSW.

EXISTING PETROLEUM PERMITS

Mr Burmester notes in his paper that the petroleum permits issued under Australian law that existed in Area A will no longer be able to continue once the Treaty enters into force. When discussing the Petroleum Mining Code for Area A, he writes, 'contracts will be awarded via a work program bidding system with the principal criteria being the amount and quality of the exploration program offered in the bid'. However, under this heading he states with obvious authority, 'in relation to holders of permits covering areas within Area A, Australia and Indonesia concluded an arrangement separate from the Treaty whereby the Ministerial Council, when considering bids for contract areas, will give favourable consideration to bids received from Australian titleholders'.

There is a persistent rumour in the industry that the existing groups will have a pre-emptive right to match the bid for one block only in the area that was previously that of their supposedly pre-existing permit.

In my view this generous treatment is hard to support. We read earlier in Mr Burmester's paper under the discussion of Basic Concepts of the Treaty how it was important to be perceived to be 'Sovereignty Neutral'. How would you feel if you managed an Indonesian based exploration company?

In Figure 2 of Dr Poll's Commentary[6] we see the pre-existing permit boundaries. In Appendix D of Mr Reid's Commentary[7] is the listing of the pre-existing Australian permit holders in Area A.

Let us consider the situation that could exist without these 'preemptive rights'. As has been the custom on the Australian North West Shelf for some years now, seismic contractors ascertain which areas are to be gazetted and they shoot speculative seismic surveys over the areas. These seismic results are sold to companies interested in bidding. If no companies bid, the nation is still better off by having part of its area heavily explored by seismic.

At least one seismic contractor advised they would shoot approximately 10,000 kilometres of speculative seismic in the Timor Gap. A group of companies formed to assess an area prior to bid do not generally purchase all the seismic available but for sake of argument let us assume they purchase 75 per cent of the above total. Costs vary for speculative seismic but $225 per kilometre for a three party group would not be too far wrong in the Timor Gap.

Therefore, assuming a three party bidding group, a budget could be as follows:

Speculative Seismic	$1,687,500.00
Seismic Interpretation,	$ 100,000.00
Geologic Study & Data Analysis Bid Preparation	$ 50,000.00
TOTAL	$1,837,500.00

Therefore, if we make the assumption the speculative seismic will be shot notwithstanding the pre-emptive environment, then we are forcing our local exploration managers to go to their managements to obtain

6 J. Poll, infra, 269 Figure 2.
7 P.C. Reid, supra, 258 Appendix D.

these considerable amounts of scarce risk capital knowing that some long dormant joint ventures can walk off with the plum areas.

It is not inconceivable that 10 or more separate bidding groups would form to assess the Timor Gap. Their cumulative budgets would represent a very large sum compared with what most of the pre-existing permittees have spent on their areas.

It is my firm view that this 'favourable consideration' issue should be looked at carefully. If it is the wish of the Australian Government to recognise some rights of the companies it has granted exploration permits to in these areas, then their generosity should only extend as far as the Australian 50 per cent share at the extreme. In other words, it might be acceptable as a business ethic for the Joint Authority to require the group submitting the winning bid to accept the dormant joint venture of the pre-existing 'permit' as participants of up to 50 per cent of the contract group *providing* that the pre-existing permittees accept the operator of the winning group as operator and further agree to accept all the provisions of the winning group's joint operating agreement.

Pre-emptive rights on benefits to be obtained by sealed (and expensive) bidding are very difficult to support in a mature, fair business environment.

I am not counselling the Australian Government to tear up valid agreements with exploration companies. In the real world, those agreements died when agreement on the seabed boundary between Indonesia and Australia could not be achieved. In my view, we are in a similar situation here which most of us in exploration have experienced in recent times.

How often have we seen exploration areas or pipeline licence access denied because of Native Peoples' sacred sites? How often has exploration or development been denied for environmental reasons? Is not the situation that frustrated the Australian explorers in past years in the Timor Gap yet another facet of the Environment — with a capital E?

CONCLUSION

I fully endorse Mr Burmester's conclusion that the Timor Gap Treaty is a notable legal and political achievement. The authors of the arrangements are to be complimented on the text of the Annexes to the Treaty.

In this Commentary to Mr Burmester's paper I have attempted to highlight some of the real and perceived shortcomings of the Treaty. With so much hard work done, any existing shortcoming should be easily addressed.