return to AMPLA 2003 Table of Contents

The Timor Sea Treaty and the Conduct of Petroleum Operations in the Joint Petroleum Development Area

Robert Merrick*

SUMMARY

On 20 May 2002, Australia and East Timor signed a Treaty for the further development of petroleum within the area formerly known as the Zone of Co-operation between Australia and East Timor, and now known as the Joint Petroleum Development Area. The Timor Sea Treaty was ratified by Australia under the Petroleum (Timor Sea Treaty) Act 2003 (Cth), which received royal assent and came into effect on 2 April 2003.

The new Timor Sea Treaty does not record an agreement between Australia and East Timor as to the delimitation of their respective seabed boundaries. Accordingly, the Timor Sea Treaty may be amended upon a permanent resolution of the location of each country's seabed boundaries.

The Timor Sea Treaty is different in significant respects from the Timor Gap Treaty entered into by Australia and Indonesia in 1989 and confirmed by Australian and the United Nations Transitional Administration in East Timor in February 2000. In addition, there is no model form production sharing contract and the current petroleum mining code is interim only.

This paper examines the Timor Sea Treaty and identifies some of the issues and risks facing both contractors who have existing production sharing contracts and companies considering investing in the Joint Petroleum Development Area.

INTRODUCTION

In the early 1970s, Australia and Indonesia entered into negotiations to delimit their respective maritime boundaries. Given that East Timor was at that time

* LLB (Murdoch), Partner, Freehills. The writer wishes to thank Stuart Barrymore of Freehills for his comments on, and assistance with, this paper.

occupied by Portugal, the boundary lines negotiated by Australia and Indonesia contained a "gap" in the area of the Timor Sea between Australia and East Timor which became known as the "Timor Gap".

East Timor was subsequently annexed by Indonesia in 1975. Australia recognised Indonesia's sovereignty over East Timor in 1979. The two countries negotiated over several years in an endeavour to agree the boundary between the two countries in the Timor Gap, but never reached agreement.

The Timor Gap was recognised for its prospectivity for petroleum. To allow petroleum exploration and exploitation to be conducted in the Timor Gap, Australia and Indonesia entered into the *Treaty between Australia and the Republic of Indonesia on the Zone of Co-operation in the Area between the Indonesian Province of East Timor and Northern Australia* on 11 December 1989 (Timor Gap Treaty). The Timor Gap Treaty provided an interim legal and fiscal regime for the exploration and exploitation of petroleum in the Timor Gap (which became more formally known as the "Zone of Co-operation") pending a permanent delimitation of the maritime boundaries.[1]

Some of the petroleum operations conducted under the Timor Gap Treaty were extremely successful. Others were more disappointing.[2]

On 30 August 1999, the people of East Timor voted for independence from Indonesia. With effect from 25 October 1999, the United Nations Transitional Authority in East Timor (UNTAET) was entrusted with transitional authority over East Timor until it became an independent nation state.[3]

The Timor Gap Treaty between Australia and Indonesia effectively came to an end upon the transition from Indonesian annexation to UNTAET administration.[4] A new legal and fiscal regime was therefore required to support the existing petroleum operations being conducted in the Zone of Co-operation and to provide a basis upon which future investment decisions could be made.

On 10 February 2000, an Exchange of Notes and Memorandum of Understanding were signed by Australia and UNTAET to provide for the

1 The Timor Gap Treaty is discussed in more detail in Stuart Cave, "Timor Gap Joint Authority" [1997] AMPLA Yearbook 78-90 and Sean A B Nicholson, "Role of the Timor Gap Treaty in Establishing the Timor Gap Zone of Co-operation as a New Petroleum Province" [1997] AMPLA Yearbook 91-108.

2 A discussion of some of the successes and failures are contained in Stuart Cave, "Timor Gap Joint Authority" [1997] AMPLA Yearbook 84-87 and Jim Godlove, "Practical Implications of East Timor's Transition to the Timor Gap Treaty" [2000] AMPLA Yearbook 141-143.

3 United Nations Security Council Resolution 1272 of 1999.

4 East Timor's transition to the Timor Gap Treaty is examined in more detail in Jim Godlove, "Practical Implications of East Timor's Transition to the Timor Gap Treaty" [2000] AMPLA Yearbook 138-150, Christopher J Ward, "An Independent East Timor: The Timor Gap Treaty and International Law" [2000] AMPLA Yearbook 151-171 and Bruce Johnston, "The Impact of East Timorese Independence on the Timor Gap Treaty" [2000] AMPLA Yearbook 172-193.

continuation of the Timor Gap Treaty between Australia and UNTAET and of all production sharing contracts issued under the Timor Gap Treaty. These transitional arrangements were expressed to apply until the date of independence of East Timor.

East Timor became an independent nation state on 20 May 2002, and a new treaty – the Timor Sea Treaty – was signed on that date by the Prime Minister of Australia, Mr John Howard, and the Prime Minister of East Timor, Mr Mari Alkatiri.

Article 25(a) of the Timor Sea Treaty provides that the Treaty enters into force on the day on which Australia and East Timor notify each other that their respective requirements for entry into force of the Timor Sea Treaty had been complied with, upon which the Timor Sea Treaty is taken to have effect from 20 May 2002. To ensure that petroleum operations could continue during the period between 20 May 2002 and the date on which the Timor Sea Treaty entered into force, an Exchange of Notes was entered into by Australia and East Timor on 20 May 2002 (2002 Exchange of Notes). The 2002 Exchange of Notes provided for the continuation of the legal and fiscal arrangements that were in place on 19 May 2002.

East Timor ratified the Timor Sea Treaty on 17 December 2002.[5] Australia enacted the *Petroleum (Timor Sea Treaty) Act* 2003 (Cth) to give effect to the Timor Sea Treaty, and the Act received royal assent on 2 April 2003 and the Timor Sea Treaty entered into force on that date, but with effect from 20 May 2002 (the date of signature of the Timor Sea Treaty both by Australia and East Timor).

A number of existing and proposed projects proceeded cautiously during the transition from Indonesian annexation to East Timor sovereignty, unwilling to commit significant expenditure to the region until an appropriate legal and fiscal regime was secured. These projects included:

- The Elang-Kakatua field, located in the area of PSC 91-12, which had been producing crude oil since 1998.
- The Bayu-Undan field straddling PSC 91-12 and PSC 91-13, and which was the subject of a unitisation agreement between the contractors to each PSC (ConocoPhillips, Kerr-McGee, Santos, Inpex and ENI). The unit participants had proposed developing the Bayu-Undan field in two phases. The first phase would involve the "stripping" of condensate and liquefied petroleum gases from the natural gas stream and the re-injection of the natural gas into the reservoir. The second phase would see the export of the natural gas via pipeline to a liquefaction facility to be constructed near Darwin in the Northern Territory. The resulting liquified natural gas (LNG) production would be sold under long-term contracts to Japanese customers. The final investment decision for the project required the adoption of the Timor Sea Treaty.

[5] Media Release by the Office of the Prime Minister of East Timor dated 18 December 2002.

- The Greater Sunrise fields straddling the Zone of Co-operation (in PSC 95-19 and PSC 96-20) and Australian waters (including NT/RL-2 and NT/P55). The fields contain an estimated 8 trillion cubic feet of natural gas and 280 million barrels of condensate. The Greater Sunrise participants (Woodside, Shell, ConocoPhillips and Osaka Gas) had been considering the viability of developing the fields for LNG production and/or domestic gas marketing. In any event, it was recognised that any development option would require an international unitisation agreement between Australia and East Timor which provided for the manner in which the revenues from production would be shared.

The Timor Sea Treaty is intended to provide the legal and fiscal security required for these projects, and other contractors operating in the Timor Sea, pending the establishment of a permanent border delimitation.

LEGAL EFFECT OF THE TIMOR SEA TREATY

Like the Timor Gap Treaty, the Timor Sea Treaty does not determine Australia's and East Timor's competing claims to the Timor Sea. Rather, the Timor Sea Treaty is an interim measure which provides for the continued exploration for, and exploitation of, petroleum resources in the Timor Sea pending a permanent agreement between Australia and East Timor as to their respective boundaries.

Arrangements of this nature are encouraged by Art 83(3) of the *United Nations Convention on the Law of the Sea* which requires signatory states with opposite or adjacent coastlines to:

> "make every effort to enter into provisional arrangements of a practical nature and, during this transitional period, not to jeopardize or hamper the reaching of a final agreement. Such arrangements shall be without prejudice to final delimitation."

Article 2 of the Timor Sea Treaty provides that the Timor Sea Treaty is intended to comply with the obligations imposed on Australia and East Timor by Art 83(3), and that the Timor Sea Treaty is without prejudice to Australia's and East Timor's position on their competing claims to seabed entitlements.

The Timor Sea Treaty will cease to be of effect upon a permanent seabed delimitation between Australia and East Timor being determined.[6] At that time, petroleum operations that have been conducted under the auspices of the Timor Sea Treaty will most likely fall entirely within the legal jurisdiction of either Australia or East Timor. In an attempt to assure petroleum operators that their right, and the terms on which they are entitled, to conduct those petroleum operations will continue, Art 22 of the Timor Sea Treaty contains a grandfathering provision which provides that such operations will continue "under conditions equivalent to those in place under the Treaty"[7]. While this provision

[6] Article 22 of the Timor Sea Treaty.

[7] This provision is similar to that contained in Art 34 of the Timor Gap Treaty.

gives contractors some comfort that their rights will remain, the continuation of any regime once the Timor Sea Treaty terminates will require the enactment of domestic legislation. For example, if a project previously conducted under a production sharing contract and tax regime under the Timor Sea Treaty was subsequently found to be located entirely within Australian waters, Australia would be required to adopt domestic legislation so as to allow that prevailing production sharing contract and taxation regime to continue under Australian law. The precise terms of those petroleum operations will not be secure until such legislation is enacted.

TERMS OF THE TIMOR SEA TREATY

There are a number of key differences between the Timor Sea Treaty and the former Timor Gap Treaty.

Joint Petroleum Development Area

The Joint Petroleum Development Area (JPDA) is established under Art 3(a) of the Timor Sea Treaty. Australia and East Timor are jointly charged with responsibility to control, manage and facilitate exploration, development and exploitation of the petroleum resources of the JPDA for the benefit of the peoples of Australia and East Timor.[8]

The JPDA covers the same area as what was Area A of the Zone of Co-operation under the Timor Gap Treaty, and which was under the joint control of Australia and Indonesia. The Timor Sea Treaty does not apply to those areas that comprised Area B (which was under Australian control) and Area C (which was under Indonesian control) under the Timor Gap Treaty. Those areas are now under the absolute control of Australia and East Timor respectively.

Sharing of Petroleum Production

Article 4(a) of the Timor Sea Treaty provides that Australia has title to 10%, and East Timor has title to 90%, of all petroleum produced in JPDA.

Under the Timor Gap Treaty, the ownership of petroleum production was:

- shared equally between Australia and Indonesia in Area A;
- 90% Australia and 10% Indonesia in Area B; and
- 10% Australia and 90% Indonesia in Area C.

[8] Article 3(b) of the Timor Sea Treaty.

There is no sharing of petroleum in what were formerly Areas B and C. Australia has control of all petroleum in Area B and East Timor is entitled to all petroleum from Area C.

Administration

Under the Timor Gap Treaty, Area A was administered by the Ministerial Council and the Joint Authority.

The Ministerial Council was comprised of an equal number of ministers from Australia and Indonesia[9] and had overall responsibility for all matters relating to petroleum exploration and exploitation in Area A.[10] Decisions of the Ministerial Council required unanimity.[11]

The Joint Authority comprised an equal number of Executive Directors nominated by Australia and Indonesia; technical, financial and legal directorates which were responsible to the Executive Directors; and a corporate services directorate that provided support functions to the Executive Directors and the other directorates.[12] The Joint Authority was responsible for the day-to-day management of operations in Area A, subject to the directions of the Ministerial Council.[13] Decisions of the Executive Directors were required to be arrived at by consensus.[14]

Administration of the JPDA under the Timor Sea Treaty has substantially changed. There are now three tiers of administration of the JPDA.

Ministerial Council

The Ministerial Council consists of an equal number of ministers from Australia and East Timor. The Ministerial Council can consider any matter referred to it by Australia, East Timor or the Joint Commission.[15] It is envisaged that the Ministerial Council will have a far lesser day-to-day role than the Ministerial Council established under the Timor Gap Treaty[16].

The Timor Sea Treaty does not provide for the manner in which decisions are to be made by the Ministerial Council, but where the Ministerial Council is unable to resolve a matter, either Australia or East Timor can invoke the dispute resolution procedures contained in Annex B of the Timor Sea Treaty.[17] Annex B provides for disputes to be settled by an arbitral tribunal taking into account the provisions of the Timor Sea Treaty and relevant international law.

9 Article 5(2) of the Timor Gap Treaty.
10 Article 6 of the Timor Gap Treaty.
11 Article 5(5) of the Timor Gap Treaty.
12 Article 9(1) of the Timor Gap Treaty.
13 Article 8 of the Timor Gap Treaty.
14 Article 7(4) of the Timor Gap Treaty.
15 Article 6(d)(i) of the Timor Sea Treaty.
16 Article 6(d)(iii) of the Timor Sea Treaty provides that the Ministerial Council must meet at the request of Australia or East Timor or at the request of the Joint Commission.
17 Article 6(d)(ii) of the Timor Sea Treaty.

Joint Commission

The Joint Commission consists of commissioners appointed by Australia and East Timor. East Timor is entitled to appoint one more commissioner than Australia.[18] At the time of writing, two commissioners have been appointed by East Timor and one by Australia. The Joint Commission must meet at least annually, and Australia and East Timor take it in turns to appoint the chair of the meeting.[19]

The Joint Commission is responsible for establishing policies and regulations relating to petroleum activities in the JPDA, overseeing the work of the Designated Authority and performing the additional non-exclusive functions contained in Annex D of the Timor Sea Treaty.[20] In this respect, the Joint Commission has assumed many of the functions previously performed by the Ministerial Council under the Timor Gap Treaty.

As with the Joint Commission, the Timor Sea Treaty does not set out the manner in which the Joint Commission must make decisions, but the commissioners of either country can at any time refer a matter to the Ministerial Council for resolution[21].

Designated Authority

The Designated Authority is responsible to the Joint Commission and is charged which the performance of the day-to-day regulation and management of petroleum activities in the JPDA.[22] The Designated Authority's functions are not dissimilar to the Joint Authority's role under the Timor Gap Treaty. A non-exclusive listing of the Designated Authority's powers is contained in Annex C of the Timor Sea Treaty. The Designated Authority is vested with legal capacity under the laws of Australia and East Timor to enable it to perform its functions.[23]

Article 6(b)(i) of the Timor Sea Treaty provides that the Joint Commission must designate the Designated Authority for the first three years after the Timor Sea Treaty enters into force, or such longer period as Australia and East Timor agree. At the end of the period referred to in Article 6(b)(i), the Designated Authority will be the East Timor Government Ministry responsible for petroleum activities or an East Timor statutory authority nominated by the Ministry[24].

The Designated Authority was designated by the Joint Commission at a meeting held on 2 April 2003. At the same meeting, the Joint Commission resolved that:

- for the three year period referred to in Art 6(b)(i) of the Timor Sea Treaty (or such longer period as may be agreed) the Designated Authority will be headed

[18] Article 6(c)(i) of the Timor Sea Treaty.
[19] Article 6(c)(iv) of the Timor Sea Treaty.
[20] Articles 6(c)(i) and 6(c)(ii) of the Timor Sea Treaty.
[21] Article 6(c)(iii) of the Timor Sea Treaty.
[22] Article 6(a) of the Timor Sea Treaty.
[23] Article 6(b)(iii) of the Timor Sea Treaty.
[24] Article 6(b)(ii) of the Timor Sea Treaty.

by an Executive Director and a Deputy Executive Director, each of whom will be responsible for the day-to-day management of the Designated Authority;

- the Executive Director is authorised to sign documents on behalf of the Designated Authority, and to delegate signing authority to other directors in his or her absence;
- the legal name of the Designated Authority will be the "Timor Sea Designated Authority for the Joint Petroleum Development Area"; and
- the Designated Authority will maintain offices in Darwin and Dili until the functions of the Darwin office are fully transferred to Dili.

Petroleum Mining Code

Article 7(a) of the Timor Sea Treaty requires Australia and East Timor to negotiate an agreed Petroleum Mining Code (PMC) which governs the exploration, development and exploitation of petroleum within the JPDA and the export of petroleum from the JPDA.

At the time of writing, Australia and East Timor are yet to agree a PMC as contemplated by Article 7(a).[25] Accordingly, as provided for in Article 7(b) of the Timor Sea Treaty, the Joint Commission adopted an interim PMC at its meeting on 2 April 2003 (Interim PMC). The Interim PMC has effect from 20 May 2002 (the date on which the Timor Sea Treaty came into effect) until a final PMC is adopted.

The Interim PMC is in substantially the same form as the Petroleum Mining Code for Area A of the Zone of Co-operation which was contained in Annex B of the Timor Gap Treaty. In summary, the Interim PMC provides for:

- the dividing of the JPDA into graticular blocks in relation to which production sharing contracts can be granted;[26]
- a general description of the rights to be conferred by production sharing contracts,[27] which include the following:
  - contractors have the exclusive right and responsibility to undertake petroleum operations in the contract area;
  - a production sharing contract does not confer upon the contractor ownership of petroleum in ground, but rather provides for the contractor to take a share of petroleum production as payment for the petroleum operations undertaken by the contractor;

[25] The writer understands that detailed negotiations on the PMC have not taken place. Australia's and East Timor's focus until now has been on the approval of the Bayu-Undan Project arrangements. Given that these approvals are now largely in place, Australia and East Timor intend moving their focus to the PMC.

[26] Article 2 of the Interim PMC.

[27] Part III of the Interim PMC.

– the point at which title to the contractor's share of petroleum passes to the contractor, and the circumstances and manner in which the contractor can be authorised to market the Designated Authority's share of production;

– the term of the contract; and

– the minimum work program and expenditure commitments that the contractor is obliged to undertake;

- advertisement and award of production sharing contracts using a work program bidding system and the procedures for applying for contracts, the consideration of applications and the grant and refusal of contracts;[28]
- a requirement that contractors notify the Designated Authority of discoveries of petroleum and that the Designated Authority declare a discovered petroleum pool as a "discovery area";[29]
- the requirement that contractors obtain Designated Authority approval before constructing any production structures or pipelines in the JPDA;[30]
- work practices;[31]
- administration of production sharing contracts (ie variations, exemptions and termination);[32]
- release of information and data;[33]
- the requirement to obtain Designated Authority approval to any change in the contractors or contract operator to a production sharing contract;[34] and
- the fees that the Designated Authority can impose in relation to the grant of contracts and other registration fees.[35]

Apart from conforming changes to reflect the Timor Sea Treaty and the production sharing contracts which have been grandfathered to the new regime, the only material change made to the Interim PMC is in relation to the point at which title to production passes to the contractor. Previously, ownership in petroleum was taken to have passed at the "point of tanker loading". This test was inappropriate for natural gas production exported by pipeline. The Interim PMC clarifies the position by providing that title to production passes:

- in the case of petroleum exported by tanker, at the point of tanker loading;
- in the case of petroleum exported by pipeline, at the input flange of the export pipeline; and

28 Articles 8 to 13 (inclusive) of the Interim PMC.
29 Articles 15 and 16 of the Interim PMC.
30 Articles 17 and 18 of the Interim PMC.
31 Article 24 of the Interim PMC.
32 Articles 28 and 48 of the Interim PMC.
33 Article 36 of the Interim PMC.
34 Article 39 of the Interim PMC.
35 Part IV of the Interim PMC.

- in the case of petroleum exported by any other means, at the point agreed between Australia and East Timor.

The Interim PMC is supplemented by Interim Directions,[36] Interim Regulations[37] and Interim Administrative Guidelines.[38] The Interim Directions and the Interim Regulations contain many of the same provisions that were contained in the Directions and Regulations issued under the Timor Gap Treaty. The Administrative Guidelines, however, are significantly different from those previously in force.

Production Sharing Contracts

Article 3(c) of the Timor Sea Treaty provides that petroleum activities conducted in the JPDA must be carried out pursuant to a contract between the Designated Authority and a limited liability corporation or entity specifically established for the sole purpose of the contract. As mentioned above, the Interim PMC specifies the manner in which production sharing contracts can be offered by the Designated Authority.

This is the same position as under the Timor Gap Treaty, with the exception that a pro-forma production sharing contract is not annexed to the Timor Sea Treaty or the Interim PMC. A "Model Production Sharing Contract" was contained in Annex C of the Timor Gap Treaty, and Art 5(1) of the PMC under the Timor Gap Treaty required the Joint Authority to conclude contracts "on the basis of the Model Form Production Sharing Contract" in Annex C.[39]

There is no reference to a Model Form Production Sharing Contract in the Timor Sea Treaty. The expression "Model Form Production Sharing Contract" is still used in the Interim PMC, but it is not defined. At the time of writing, neither the Designated Authority nor the Joint Commission have resolved to adopt the Annex C version of the Model Form Production Sharing Contract.

All production sharing contracts must be between the Designated Authority and the contractor. Given that the Designated Authority will ultimately be an East Timorese government department or agency, contractors will need to satisfy themselves that the East Timorese legal system is capable of adequately enforcing a production-sharing contract against the Designated Authority. Contractors will

[36] *Interim Directions issued under Article 37 of the Interim Petroleum Mining Code – Specific Requirements as to Petroleum Exploration and Exploitation in the Joint Petroleum Development Area*, which were approved by the Joint Commission on 16 June 2003.

[37] *Interim Regulations issued under Article 37 of the Interim Petroleum Mining Code – Specific Requirements as to Petroleum Exploration and Exploitation in the Joint Petroleum Development Area*, which were approved by the Joint Commission on 16 June 2003.

[38] *Interim Administrative Guidelines for the Joint Petroleum Development Area*, which were approved by the Joint Commission on 16 June 2003 (Interim Administrative Guidelines).

[39] See Stuart Cave, "Timor Gap Joint Authority" [1997] AMPLA Yearbook 83-84 for a summary of the key terms of the Model Form Production Sharing Contract.

also need to establish whether or not the nominated government department or agency will have the necessary legal capacity to perform its rights and obligations under the production-sharing contract.

The absence of a pro-forma production-sharing contract means that the terms of any new production sharing contracts will need to be negotiated between the Designated Authority and each prospective contractor. While the absence of a model form production sharing contract may allow the Designated Authority greater flexibility to impose fiscal and regulatory provisions which suit a particular project, there is less certainty surrounding what those terms and conditions may be.

The Timor Sea Treaty leaves it open to Australia and East Timor to agree to fiscal regimes for petroleum projects conducted in the JPDA. Article 5(a) of the Timor Sea Treaty provides that, unless a fiscal regime is otherwise provided for in the Treaty, Australia and East Timor must make "every possible effort" to agree on a joint fiscal regime for each petroleum project in the JPDA. The expression "fiscal regime" is defined in Art 1(e) of the Timor Sea Treaty as:

> "a royalty, Production Sharing Contract, or other scheme for determining Australia's and East Timor's share of petroleum or revenue from petroleum activities and does not include taxes referred to in Article 5(b) of this Treaty."[40]

If Australia and East Timor are unable to agree on a joint fiscal regime, they are required to appoint an independent expert to recommend an appropriate fiscal regime. The expert's recommendation is not binding so, notwithstanding the expert's recommendation, either country is free to impose its own fiscal regime on the proportion of petroleum to which it is entitled under Art 4(a) of the Timor Sea Treaty.

Obviously, the Designated Authority will be keen to ensure that the fiscal terms offered to parties participating in the first acreage release under the Timor Sea Treaty are as attractive as possible so as to encourage future investment in the JPDA. The fiscal terms sought by prospective contractors will partly be a function of the costs incurred and risks assumed in performing the conditions of the production sharing contract. The procedures set out in the Interim Administrative Guidelines for the assessment and award of applications for production sharing contracts are worth considering in this regard.[41]

The Interim PMC and the Interim Administrative Guidelines establish a work program bidding system for production sharing contracts in the JPDA. The bidding system requires applicants to submit a guaranteed proposed exploration

[40] The broad definition of fiscal regime suggests that the contract to be entered into by the Designated Authority and contractors for operations in the JPDA may not necessarily be production-sharing contracts. The Interim PMC requires production sharing contracts to be offered for the time being, but the Timor Sea Treaty clearly leaves it open for a final PMC to be adopted which permits the award of other types of contract. The writer understands that the Designated Authority is considering other forms of contract and a final decision will be made in conjunction with the form of final PMC. The writer also understands that whatever form of contract is adopted, a pro-forma will be published.

[41] See Guidelines 1 and 2 of the Interim Administrative Guidelines.

work program and expenditure commitments for the first three years of production sharing contracts (primary program) covering data evaluation, seismic surveys and the drilling of exploration wells and a negotiable work program for the remaining three years of the production sharing contract (secondary program), covering further evaluation, survey and exploration drilling.

The Interim Administrative Guidelines provide that in assessing competing bids, the Designated Authority's key objective will be to identify the work program and expenditure commitment which will "best and expeditiously evaluate the petroleum potential" of the acreage, and that the successful applicant is likely to be the one who is willing to "undertake the greatest exploration effort which results in the most comprehensive assessment of the exploration/geological play concepts" relevant to the acreage. With these key objectives in mind, the primary assessment criteria are:

- acceptance of the production sharing contract (which will include the fiscal terms on offer);
- the number of wells to be drilled in the primary program; and
- the extent to which the primary program reflects the available technical information.

Other criteria include the technical and financial capacity of the applicants and, in the case of competing applications that cannot be distinguished, preference will be given to consortia with East Timorese participation.

The bidding system is similar to the work program bidding system under the *Petroleum (Submerged Lands) Act* 1967 (Cth). Some of the difficulties inherent in this system were highlighted in the much-publicised circumstances surrounding the award of exploration permits WA-265-P and WA-266-P adjacent to the Cornea discovery.

In that case, a bidding group comprising Shell Development (Australia) Pty Ltd, ChevronAsiatic Limited and Cultus Timor Sea Limited submitted a proposed primary work program involving the acquisition of 1,200 km^2 of 3-dimensional seismic and the drilling of 46 exploration wells at a total estimated cost of $177 million. Having been awarded the permits and completed the drilling of five wells, it became apparent to the consortium that the technical basis for the bid was flawed and that the permits did not contain any plays which supported further examination. The consortium's application to surrender the permits prior to completion of the primary program was rejected and the permits were subsequently cancelled. The consortium members were only able to maintain their good standing by undertaking to transfer the incomplete elements of the work program to other acreage.

Under the Interim PMC and Interim Administrative Guidelines, production sharing contracts can be terminated for non-performance of the conditions of the production sharing contract.[42] There is, however, no restriction on a contractor that

[42] See Guidelines 17 to 22 of the Interim Administrative Guidelines.

has had its production sharing contract terminated from bidding for future acreage. The absence of a "good standing" or "black spot" system means that there is nothing to discourage these contractors from submitting artificially high bids in order to secure acreage. While the Designated Authority's stated aim is to favour bids which contain the "greatest exploration efforts", care will need to taken to ensure that all bids are supported by available technical data. Failure to balance these factors may undermine the integrity of the bidding system and, inevitably, bidders will demand more favourable fiscal terms to compensate for the artificially high exploration effort.

Taxation

Both the Timor Gap Treaty and the Timor Sea Treaty make provision for the taxation of petroleum activities within Area A (in the case of the Timor Gap Treaty) and the JPDA (in the case of the Timor Sea Treaty).[43] Each Treaty allows each country to treat Area A and the JPDA as if it were part of their own country for taxation purposes. To avoid the problem of double taxation, both treaties establish Taxation Codes in similar terms.[44]

The Taxation Code under the Timor Sea Treaty applies to all persons that are resident in Australia and/or East Timor for taxation purposes that are involved in the exploration and exploitation of petroleum in the JPDA.[45] The taxes covered by the Taxation Code are:

- Australian income tax (but excluding Petroleum Resource Rent Tax), fringe benefits tax, goods and services tax and the superannuation guarantee charge;
- East Timorese income tax, value added tax and sales tax on luxury goods and sales tax; and
- other identical or substantially similar taxes imposed by Australia and East Timor after the date of the Timor Sea Treaty.

The main difference in the Taxation Code under the Timor Sea Treaty is that it gives effect to the 90:10 revenue sharing arrangements rather than the 50:50 arrangements that existed in respect of Area A under the Timor Gap Treaty. The way that this occurs (using tax on business profits and losses as an example) is that the profit/loss derived from the JPDA in a year by an Australian resident (for example) is taxed in Australia at an amount which is reduced by 90% (called the "reduction percentage") or, in other words, tax is imposed on 10% of the total taxable profit or loss.

The general dispute resolution procedures contained in Annex B of the Timor Sea Treaty do not apply to the Taxation Code, which has its own dispute resolution procedure.[46] If a person has a dispute about the application of the Taxation Code,

[43] Articles 5(b) and 13 of the Timor Sea Treaty and Art 29 of the Timor Gap Treaty.
[44] Annex D of the Timor Sea Treaty and Annex D of the Timor Gap Treaty.
[45] Article 2 of the Taxation Code.
[46] Article 20 of the Taxation Code.

then that person can, within 36 months of the first notification of the action resulting in taxation, present a case to the competent authority of the country in which that person is resident. The competent authority must endeavour to resolve the case by agreement with the competent authority of the other country with a view to avoiding double taxation and having regard to the objects and purposes of the Taxation Code. The competent authorities of Australia and East Timor must also jointly endeavour to resolve any difficulties or doubts as to the interpretation of the Taxation Code, failing which by a procedure agreed to by Australia and East Timor. Finally, any dispute as to the applicability of the Taxation Code may be brought before the Council for Trade and Services[47] with the consent of Australia and East Timor.

Pipelines

The Timor Gap Treaty and the PMC adopted under the Timor Gap Treaty did not deal with the construction and operation of pipelines in any detail. Article 18 of the PMC simply provided that a contractor could only construct or operate a pipeline in Area A of the Zone of Co-operation with the approval of the Joint Authority and that the Joint Authority could direct a contract operator that owned a pipeline to enter into an agreement for the transportation of another contract operator's petroleum.

Pipelines are dealt with in significantly more detail in Art 8 of the Timor Sea Treaty. The elevation and expansion of these provisions from the PMC to the Treaty demonstrates Australia's and East Timor's recognition of the economic significance of gas export pipelines in underwriting investments in downstream infrastructure and markets.

Under Art 8 of the Timor Sea Treaty:

- The construction and operation of pipelines in the JPDA is subject to the approval of the Joint Commission. This is similar to Art 18 of the Timor Gap Treaty which provided that a "*contract operator* shall not construct a pipeline …without the approval of the Joint Authority, nor …operate…that pipeline without the approval of the Joint Authority." (emphasis added). The critical difference is that Art 8(a) does not contain a reference to "contract operators" therefore suggesting that pipelines can be owned by persons that are not party to production sharing contracts. It is unlikely, however, that third party pipeline owners and their financiers will be willing to invest in the JPDA without a contract, licence or other form of tenure for the pipeline. While tenure could be provided by a multi-lateral agreement between Australia, East Timor and the pipeline owner, it is doubtful that any of the Designated Authority, Joint Commission or Ministerial Council have the power under the Timor Sea Treaty to enter into such an agreement.

[47] The Council for Trade and Services is established under the General Agreement on Trade in Services.

- A country in which an existing pipeline lands may not object to or impede decisions of the Joint Commission regarding a pipeline to the other country, except where the construction of the new pipeline may cause the supply of gas to be withheld under existing contracts. Decisions of the Joint Commission in relation to a pipeline are reviewable by the Ministerial Council.[48]
- Australia and East Timor must not object to or impede a proposed floating gas to liquids processing and off-take facility in the JPDA if it would produce higher royalties and taxes for Australia and East Timor than if the gas was transported by pipeline, except where the proposal would cause the supply of gas under existing contracts to be withheld.[49]
- Article 8(b) provides that pipelines landing in East Timor are under the jurisdiction of East Timor and pipelines landing in Australia are under the jurisdiction of Australia. Under Art 8(a), however, Australia and East Timor must consult on the "terms and conditions of pipelines exporting petroleum from the JPDA to the point of landing". The application of these provisions together, and the meaning of "terms and conditions of pipelines" is not entirely clear. It is likely that "terms and conditions of pipelines" refers to, by way of example, the technical, safety, environmental, fiscal and other conditions that pipeline licensing authorities in Australia ordinarily imposed on holders of pipeline licences issued under applicable state and Commonwealth legislation. In the case of a pipeline from the JPDA to Australia, for example, Australia must consult with East Timor on these terms and conditions but ultimately has the power to impose the conditions that it sees fit. If this is the case, it is likely that the terms and conditions of any pipeline to Australia will be influenced by the conditions that would otherwise be imposed on the pipeline pursuant to the pipeline licence issued under the *Petroleum (Submerged Lands) Act* 1967 (Cth) in respect of that part of the pipeline located in Australian waters. The benefit of this approach is that it avoids the need for an inter-governmental agreement between the Designated Authority and Australia to provide a consistent and stable regulatory regime for the entire pipeline route, as is often the case with international cross-border pipelines.
- Article 8(h) provides that there must be open access to all pipelines in the JPDA and that open access arrangements must be "in accordance with good international regulatory practice". Open access regimes are typically designed to balance the competing interests of pipeline owners who want to ensure that they receive an appropriate return on capital and pipeline users who want to ensure that capacity is available on competitive terms. These principles are embodied in the *National Third Party Access Code for Natural Gas Transmission Pipelines*, and it is quite possible that a pipeline from the JPDA to Australia will adopt a similar approach to regulation. Whether or not this regime reflects "good international regulatory practice" however is, in light of a number of recent disputes between pipeline owners and regulators over the tariffs and terms that owners can offer, open to debate.

[48] Articles 8(c) and (d) of the Timor Sea Treaty.
[49] Articles 8(e) and (f) of the Timor Sea Treaty.

- Petroleum produced from fields within or straddling the JPDA have priority of carriage along any pipeline carrying petroleum produced from the JPDA.[50] The priority afforded to JPDA gas is likely to diminish the commercial attractiveness of tying-in pipelines from fields outside of the JPDA.

Unitisation

Under Art 9 of the Treaty, Australia and East Timor agree to treat petroleum reservoirs which straddle the JPDA boundaries as a single entity for management and development purposes. Where such a reservoir exists, both countries must work expeditiously and in good faith to agree the most efficient and equitable manner of exploiting the resource.

EXISTING PETROLEUM PROJECTS IN THE JPDA

As mentioned in the Introduction to this paper, there are a number of existing and proposed projects in the Timor Sea. It was essential that, if these projects were to continue, the fiscal arrangements under the Timor Gap Treaty would need to be at least maintained following the entry into force of the Timor Sea Treaty and the projects could not be prejudiced from a tax perspective.[51] In the case of Greater Sunrise, an international unitisation agreement was also required before any development could proceed.

Annex F of the Timor Sea Treaty required new production sharing contracts to be offered to the contractors holding PSC's 95-12, 95-13, 95-19 and 96-20 (ie Elang-Kakatua, Bayu-Undan and Greater Sunrise) in the same terms as the existing contracts, but modified to take into account the administrative structure under the Timor Sea Treaty or as otherwise agreed by Australia and East Timor.

The Timor Sea Treaty does not contain grandfathering provisions in respect of the other production sharing contracts that had been issued before the Treaty's entry into force. The position of these contactors going forward is less clear. Other arrangements have also been entered into in relation to each of the grandfathered projects.

Bayu-Undan

The Bayu-Undan contractors have entered into an understanding agreement with the Government of East Timor, which came into effect upon the ratification of

[50] Article 8(g) of the Timor Sea Treaty.

[51] This point was made by a number of contractors, including ConocoPhillips, Santos, Shell and Woodside in their submissions to the Joint Standing Committee on Treaties inquiry into the Timor Sea Treaty.

the Timor Sea Treaty. The understanding agreement was entered into for three reasons:[52]

- the tax regime applicable to the resource under the JPDA would change as a result of the Timor Sea Treaty. Under the Timor Gap Treaty, 50% of the resource was taxed at the Australian rate of about 30% and 50% of the resource was taxed at Indonesian rate of about 45%. Under the Timor Sea Treaty 10% of the resource will be taxed at the Australian rate of 30%, while 90% of the resource will be taxed at East Timorese rate of 45%, resulting in an overall increase in the amount of tax payable by contractors;
- the contractors required protection from double taxation, in order to provide fiscal security for their investment; and
- the existing production sharing contracts, and the fiscal terms contained in those contracts, were designed with oil production in mind and did not adequately provide for the production of natural gas.

As a result of the understanding agreement, East Timor has agreed to give the Bayu-Undan contractors certain tax concessions which will be enacted in the *Taxation of Bayu-Undan Contractors Act*. Key among the taxation concessions is the imposition of income tax at a rate of 30% and the entry into a Tax Stabilisation Agreement which will ensure that the agreed tax regime for Bayu-Undan will remain in place for the duration of the project. The *Tax Stability Act* will authorise the Government of East Timor to enter into the Tax Stabilisation Agreement.[53]

The understanding agreement also contains proposals for variations to the Bayu-Undan production sharing contracts to be implemented by the Designated Authority in accordance with Art 5 of the Timor Sea Treaty. The variations principally relate to the fiscal terms offered to the project, particularly the rules for valuing natural gas production for production sharing and income tax purposes.[54] The amended production sharing contracts have been entered into, but their terms are confidential.

It is quite possible that the Designated Authority will be influenced by the rules for valuing natural gas which are contained in the Bayu-Undan production sharing contracts when it comes to offering fiscal terms to new projects in the JPDA.

Greater Sunrise

Annex E of the Timor Sea Treaty contains an agreement between Australia and East Timor pursuant to Art 9(b) of the Treaty in relation to the unitisation of the

52 Joint Standing Committee on Treaties "Report 49: The Timor Sea Treaty" 12 November 2002, p 33.

53 At the time of writing, the Bayu-Undan taxation legislation is still to be enacted. The Tax Stabilisation Agreement will be entered into after the legislation comes into effect.

54 Refer to the testimony of Mr Michael Lawry, Manager Group Taxation, Santos Ltd given before the Joint Standing Committee on Treaties (Reference: Timor Sea treaties) on 8 October 2002 at Canberra.

Greater Sunrise reserves. Under Annex E, Australia and East Timor agree to unitise the Greater Sunrise reserves on the basis that 20.1% of the reserves lie within the JPDA and to distribute production from Greater Sunrise on the basis that 20.1% is attributed to the JPDA and 79.9% is attributed to Australia. Provision exists for the production sharing formula to be reviewed and adjusted with the agreement of Australia and East Timor. The unitisation agreement is without prejudice to a permanent delimitation of the seabed between Australia and East Timor and, in that event, Australia and East Timor must reconsider the terms of the unitisation agreement.

Pursuant to the Memorandum of Understanding between Australia and East Timor of 20 May 2002, both countries agreed to work expeditiously and in good faith to conclude a unitisation agreement for Greater Sunrise. This agreement (International Unitisation Agreement or IUA) was signed by Australia and East Timor in Dili on 6 March 2003.[55]

The purposes of the IUA is to supplement the Timor Sea Treaty with further fiscal and regulatory provisions which will facilitate the integrated exploitation of the Greater Sunrise reserves. The need for the IUA was explained by the operator of Greater Sunrise, Woodside Energy Ltd, as follows:

> "The [Timor Sea Treaty]…provides only a starting point for the required unitisation and fiscal and regulatory certainty and stability required for the commercialisation of the Greater Sunrise Fields.
>
> The [Timor Sea Treaty] does not address the ongoing fiscal and regulatory regime to be applied to the development and operations throughout the Sunrise Project, as these issues are more appropriately addressed in an IUA."[56]

Like the Timor Sea Treaty, the IUA is expressed to be without prejudice to Australia's and East Timor's respective maritime boundary claims.[57] It comes into force on the day on which Australian and East Timor have notified each other that their respective requirements for entry into force of the IUA have been complied with and, in the event that a permanent delimitation is established, both countries are required to reconsider the terms of the IUA.[58] Any new unitisation agreement entered into as a consequence of a permanent delimitation of maritime boundaries must ensure that petroleum activities entered into pursuant to the IUA continue under equivalent terms.[59]

[55] The full name of the IUA is "Agreement between the Government of Australia and the Government of the Democratic Republic of Timor-Leste relating to the Unitisation of the Sunrise and Troubadour Fields". A copy of the IUA is available at www.austlii.edu.au/au/other/dfat/treaties/notinforce/2003/6.html. At the time of writing, Australia and East Timor are yet to complete their respective requirements for entry into force of the IUA.

[56] Woodside Energy Ltd, Submission to Joint Standing Committee on Treaties, July 2002, p 3.

[57] Article 2 of the IUA.

[58] Article 27 of the IUA.

[59] Article 27(3) of the IUA.

The IUA recognises the 20.1:79.9 apportionment of petroleum (the Apportionment Ratio) pursuant to the Timor Sea Treaty,[60] but allows for that Apportionment Ratio to be redetermined or reviewed. Australia or East Timor can request a redetermination at any time[61], although a redetermination must not occur more than once every five years except, as is commonly the case in most unitisation agreements, a redetermination can occur within 12 months of the commencement of production[62] once the features of the reservoir are better understood. The redetermination is conducted by the unit operator,[63] although the redetermination does not take effect until agreed by the Designated Authority established under the Timor Sea Treaty and the Joint Authority established under the *Petroleum (Submerged Lands) Act* 1967 (Cth) (these bodies are collectively referred to in the IUA as the Regulatory Authorities) or determined by an expert.[64] Changes to the Apportionment Ratio apply retrospectively and past receipts and costs must be adjusted accordingly.[65]

The Apportionment Ratio may be reviewed at any time at the request of Australia and East Timor. Any resulting alteration to the Apportionment Ratio requires the agreement of both countries.[66]

The conduct of petroleum operations at Greater Sunrise are regulated by the Regulatory Authorities and a Sunrise Commission whose role is to facilitate the implementation of the IUA and coordinate the respective Regulatory Authorities so that Greater Sunrise is developed as a single entity. The Sunrise Commission can consider matters or disputes referred to it by the Regulatory Authorities and make recommendations. The Sunrise Commission consists of three members – two from Australia and one from East Timor.[67]

The IUA requires the Greater Sunrise participants to enter into joint venture agreements which regulate the exploitation of the Greater Sunrise reserves in accordance with the IUA. The joint venture agreements must contain provisions which provide that the IUA prevails in the event of an inconsistency. The terms of the joint venture agreements must be approved by the Regulatory Authorities, and any amendment or waiver cannot be implemented without the prior approval of the Regulatory Authorities.[68] At present, variations to the joint venture agreement would require approval and registration under s 81(2) of the *Petroleum (Submerged Lands) Act* 1967 (Cth) and approval of the Designated Authority under the terms of the production sharing contracts. It is less clear how the Regulatory Authorities will handle a proposal to “waive or depart from” a provision of a joint venture agreement.

[60] Article 7 of the IUA.
[61] Article 8 of the IUA.
[62] Article 8(1)(c) of the IUA.
[63] Articles 8(1)(a) and 8(1)(d) of the IUA.
[64] Article 8(1)(e) of the IUA.
[65] Article 8(1)(f) of the IUA.
[66] Article 8(2) of the Timor Sea Treaty.
[67] Article 9 of the IUA.
[68] Article 5 of the IUA.

Production from Greater Sunrise cannot commence until a development plan has been approved by the Regulatory Authorities. The Greater Sunrise operator is responsible for the preparation of the development plan, which must set out:

- a description of the proposed reservoir development;
- a management program that includes details of the sub-surface evaluation and production facilities;
- the production profile over the life of the project;
- the estimated capital and non-capital expenditure covering feasibility, fabrication, installation and pre-production stages; and
- an evaluation of the commerciality of the development.[69]

Given the different regulatory regimes applying in Australia and in the JPDA, the respective Regulatory Authorities are likely to have regard to different criteria when considering any proposed development plan. Accordingly, the Sunrise Commission can coordinate the approval process by making recommendations to the Regulatory Authorities.[70]

The Regulatory Authorities must approve the development plan where:

- the project is commercially viable;
- the participants are technically and financially competent to exploit the reservoir to the best commercial advantage;
- the participants are seeking to exploit the reservoir to the best commercial advantage in accordance with good oilfield practice;
- the participants could reasonably be expected to exploit the reservoir during the specified period; and
- the participants have entered into contracts for the sale of gas from the project which are consistent with arm's length transactions.[71]

The Regulatory Authorities are not prohibited by the IUA from approving a development plan that does not meet the above criteria. The IUA contemplates that, for example, a development plan which includes a gas sales agreement on other than arm's length terms may be approved.[72] Even though the IUA provides guidelines for determining whether or not a contract is arm's length,[73] it is likely that the approval of any development plan will be the subject of extensive

[69] Articles 1(c) and 12(1) of the IUA.

[70] Article 12(2) of the IUA.

[71] Article 12(3) of the IUA.

[72] See Art 16 of the IUA and the petroleum valuation principles contained in Annex III to the IUA which relate to the valuation of petroleum that is not sold on arm's length terms.

[73] Paragraph 3 of Annex III to the IUA provides that the Regulatory Authorities must, in determining whether an arm's length transaction exists, have regard to the functions performed, assets used and risk assumed. In assessing risk allocation, regard must be had to the outcomes expected of parties acting at arm's length.

negotiation between the project proponents, the Regulatory Authorities and the Sunrise Commission.

The valuation of production provisions in the IUA are critical. These provisions determine the value of production for cost recovery and production sharing purposes under the production sharing contracts granted under the Timor Sea Treaty. Where Australia and East Timor agree that petroleum is sold on arm's length terms, then that value is used for cost recovery and production sharing purposes.[74] Where petroleum is sold on other than arm's length terms, however, the petroleum must be valued in accordance with Annex III of the IUA. Under Annex III, petroleum sold on a non-arm's length basis is, in the first instance, valued by reference to a comparable uncontrolled price at the point of valuation (ie a price at which petroleum is sold at an arm's length basis at the same valuation point). If there is no comparable uncontrolled price, the petroleum is valued using a discounted cash flow formula which will provide a rate of return for a floating gas-to-liquids project of 14% and 10.5% for gas sold via an export pipeline.

Elang-Kakatua

East Timor became entitled to receipt of revenue from the sale of production from Elang-Kakatua upon the date of its independence. Pursuant to the 2002 Exchange of Notes, Australia and East Timor agreed that during the period between East Timor's independence and the entry into force of the Timor Sea Treaty revenue from the sale of petroleum from Elang-Kakatua and income tax levied on the contractor by Australia in respect of petroleum production, that East Timor would otherwise have collected had the Timor Sea Treaty entered into force would be placed into separate interest bearing escrow accounts and that the monies from those accounts (including interest) would be paid to East Timor on entry into force of the Timor Sea Treaty.

CONCLUSION

The entry into force of the Timor Sea Treaty is obviously a significant milestone in the history of petroleum operations in the Timor Sea.

On 16 June 2002, the Designated Authority gave approval to ConocoPhillips, Santos, Inpex and ENI to proceed with the development of the Bayu-Undan gas project. The decision by these companies to invest significant sums of money in the Timor Sea demonstrates their acceptance of the Timor Sea Treaty as providing a suitable legal and fiscal arrangement for the development of that project, notwithstanding that Australia and East Timor have provided additional incentives to secure its development.

[74] Article 16(1) of the IUA.

Similarly, the IUA provides a stable fiscal and regulatory regime for the development of the Greater Sunrise reserves regardless of whether the Greater Sunrise parties decide to proceed with floating LNG, domestic gas marketing or a combination of both.

Whether the Timor Sea Treaty is, of itself, adequate to attract further petroleum investment remains to be seen. Much will depend upon the adoption of a workable permanent Petroleum Mining Code, the attractiveness of the production sharing contracts and fiscal terms offered by the Designated Authority and, perhaps most of all, the petroleum industry's view of the region's prospectivity.

return to AMPLA 2003 Table of Contents