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Mozambique's New Petroleum Legislation: Are Investors Ready to Hit the Gas?

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Mozambique's new Petroleum Law and new Petroleum Tax Law have been long awaited by foreign investors who have been looking for a clear and comprehensive legal framework to facilitate investment in the development of the country's huge offshore gas reserves. Do these new laws provide that framework?

There has been a dramatic change in the prospects of Mozambique since the end of the country's 15 year civil war in 1992. Then the country's GDP per capita was the second lowest in the world at US$137.[1] However, with the discovery of a staggering amount of untapped coal and natural gas reserves over the past decade, the country has been propelled to the front of the global energy stage.

In the Rovuma Basin alone, the Anadarko and ENI-led consortia have reportedly discovered a total of approximately 170 trillion cubic feet of natural gas. As a result of these discoveries, Mozambique has gone from a modest natural gas exporter to one of the top countries in the world in terms of natural gas reserves and with ambitions to become a very significant player in the LNG market.

These dramatic changes in circumstances made it apparent to both the Mozambican Government and foreign investors that the existing legal framework for petroleum operations was no longer appropriate. Foreign investors lobbied the Government to develop a clear and comprehensive legal framework to facilitate investment in the development and financing of the natural gas discoveries (and, in particular of LNG facilities, which were not contemplated by the then existing law). On its side, the Government was keen to reform the petroleum legislation to increase the benefit to Mozambique of its hydrocarbon resources and to safeguard national interests. These reforms have been awaited for a period of over two years and have taken the form of a new Petroleum Law (Law No. 21/2014 of 18 August 2014, which replaced Law No. 3/2001) and of a new Petroleum Tax Law (pending publication, which replaced Law No. 12/2007).

Under these new laws, the Government's aim to increase the country's share of benefits from its hydrocarbon resources comes across strongly – and more so than was anticipated. The new Petroleum Law in particular is very different to the draft petroleum bills made available by the Government over the past two years and includes onerous additional requirements to be complied with by operators in the Mozambican petroleum sector (such as allocating at least 25% of petroleum production to the domestic market in Mozambique).

[1] World Bank data based on current US Dollar.

These laws come at a decisive time in the Mozambican political backdrop. They have been passed just two months ahead of the general elections which will see President Guebuza mandatorily step down from his 10 year term and his ruling party FRELIMO put forward Filipe Nyussi, a relatively new member of FRELIMO's leadership, as presidential candidate. Under the new Petroleum Law and new Petroleum Tax Law, the outgoing Government has taken a strong stance towards investment in its petroleum resources. What is the impact of these new laws on foreign investors?

First Step in Establishing LNG Specific Regime

One of the key changes introduced by the new Petroleum Law is the broadening of its scope of application to include, amongst other things, all midstream oil and gas infrastructure, including, in particular, LNG facilities. However, while establishing a legal regime for LNG activities was ostensibly one of the key drivers for the reform, the new Petroleum Law is only the first step in doing so.

The reforms of the new Petroleum Law in this respect are largely limited to stating that the development and operation of LNG plants constitutes a "petroleum operation" falling within the scope of the new Petroleum Law and that it requires the grant of a separate concession to the extent it is not already contemplated by upstream concession arrangements.

> "With respect to establishing a legal regime for LNG activities [...] the new Petroleum Law can only be seen as a first step."

Helpfully for operators already holding petroleum concessions, such as the Anadarko and ENI-led consortia, the new Petroleum Law states that concessionaires who have discovered natural gas deposits can be given the right to develop and operate LNG plants without having to apply for a separate concession even if their upstream concession arrangements did not contemplate the development and operation of LNG facilities.

In light of this structure, it is unclear the extent to which existing concessionaires such as the Anadarko and ENI-led consortia would be affected by the new Petroleum Law. In addition, the new Petroleum Tax Law states that it would not apply to existing petroleum concessions which would continue to be subject to pre-existing tax laws. Therefore, the new Petroleum Tax Law would seemingly not apply to Offshore Areas 1 and 4 which are the concessions operated by the Anadarko and ENI-led consortia, respectively. The new Petroleum Law states that it would not affect rights acquired under existing concessions. However, the right to conduct LNG activities may not be seen as an "acquired right" if it was not originally contemplated by the concession, meaning that the performance of LNG activities by existing concessionaires may still be subject to the new Petroleum Law.

The new Petroleum Law does not provide an indication of the specific terms that would apply to new LNG concessions or to the development of LNG facilities under an existing concession. In the context of the development of Offshore Areas 1 and 4, it is anticipated that this will be addressed in project-specific decree laws for which an enabling law was passed at the end of August (pending publication). In respect of other LNG projects, the specific terms may be further developed in the regulations that are to implement the new Petroleum Law (required by law to be published by 17 October 2014). To the extent LNG activities are not undertaken on the same terms as existing concessions, they would constitute a "petroleum operation" and be subject to the general rules applicable under the new Petroleum Law and the new Petroleum Tax Law.

Significant Changes to the Regime Applicable to Petroleum Operations

The new Petroleum Law and new Petroleum Tax Law have introduced significant changes to the regime applicable to petroleum operations.

While some of the requirements imposed by these new laws are not uncommon (e.g., production sharing arrangements), others are unusual. The cumulative impact of these changes will need to be considered by foreign investors and financial institutions financing such operations when assessing the feasibility of investment in the Mozambican oil and gas sector.

The new Petroleum Law and the new Petroleum Tax Law are mostly focused on the upstream and LNG sectors. Despite there being significant interest in their development in Mozambique, the new laws do not appear to provide a legal regime for gas-to-liquids projects as they seem to fall outside the scope of "petroleum operations". However, the new Petroleum Law clearly requires the State and *Empresa Nacional de Hidrocarbonetos* (ENH), the state owned National Hydrocarbon Company, to be involved in gas to liquids projects (including in marketing the liquids). It is unclear whether a specific regime will be developed for these projects similar to that applicable to petroleum operations or if the general regime relating to large scale projects would apply to them.

> "The new Petroleum Law is very different to the draft petroleum bills made available by the Government over the past two years and includes onerous additional requirements."

A. Investment Structuring Requirements

As was the case under the previous Petroleum Law, petroleum concessions can be granted to both Mozambican and foreign companies.

Investment from Transparent Jurisdictions

However, under the new Petroleum Law any foreign legal person which directly or indirectly holds an interest in a concession contract has to be established, registered and administered from a "transparent jurisdiction", being a jurisdiction that allows the Government to check its ownership, management and tax position. It appears that this requirement is a reaction to the use by foreign investors of offshore investment vehicles which the Government viewed as opaque and as frustrating the payment of Mozambican tax. However, the provision as drafted has far-reaching consequences within groups of companies (the restriction seems to apply to any indirect holder of the concession interest, irrespective of its level within a group) and could be problematic given that investors in the energy sector have often utilised corporate structures involving holding companies that are offshore vehicles.

Listing on Mozambican Stock Exchange

In addition to the above, the new Petroleum Law requires all oil and gas companies operating in Mozambique to be listed on the Mozambican Stock Exchange. This is one of the requirements that was introduced shortly before the law was passed. The law does not provide any further details of the time frames for the listing or how much of the share capital is to be listed. This will need to be understood more fully by investors so they can take it into account in structuring their investments. For instance, investors looking to develop projects on a project finance basis will need to understand the impact of this requirement on the share security and completion support available to lenders. While there is precedent in other jurisdictions on how to address similar issues, it is not clear whether such precedent solutions would be permitted in Mozambique.

Under-capitalisation

Under the new Petroleum Tax Law, the State must approve the financing plan for a petroleum discovery as part of the development plan to be approved before that discovery can be developed. This is to ensure that the State is comfortable that the concessionaire will be able to service its debt. The new Petroleum Tax Law introduces a concept of under-capitalisation. Under-capitalisation will occur if the debt to equity ratio of the petroleum concessionaire exceeds 2:1 during any tax year in which the concessionaire has a negative net operating cash flow. In the event that under-capitalisation occurs, the new Petroleum Tax Law provides that any deductions for interest and other financing charges that relate to debt in excess of this threshold will be disallowed for tax purposes. It is unclear whether shareholder loans would be considered as debt for the purposes of this calculation. This concept could have a significant impact on the financing arrangements for the development of petroleum discoveries and related infrastructure, particularly if these are to be developed using a project finance model.

Shareholder Arrangements and Support

The State must also approve any agreement between joint venture partners relating to the submission of a request to conduct petroleum operations. This may include shareholder and joint operating arrangements.

Consistent with the previous Petroleum Law, investors are required to provide financial guarantees in respect of their

obligations under concessions granted to them. However, the quantum and terms of the financial guarantees are to be set out in the implementing regulations and may be different than under previous regulations.

B. Investment Protection

The new Petroleum Law sets out an investment protection regime which is based on that set out in the Investment Law (Law No. 3/93 of 24 June 1993). This is useful as the Investment Law specifically excludes the oil and gas sector from its scope. Under the new Petroleum Law, the State guarantees protection of foreign investors' property rights and undertakes to provide "just" and timely compensation in case of expropriation.

However, the types of investment subject to investment protection only cover cash investments to the extent such cash is applied in payment of development costs. Cash investment per se (e.g., subscription of share capital) does not appear to constitute foreign investment for the purposes of investment protection under the new Petroleum Law. As concerns expropriation, it is unclear what is covered by "just" compensation and whether there is scope to negotiate in the concession a particular level of compensation payment with the State upfront; for instance, to include as a minimum debt and swap breakage costs. Also, the new Petroleum Law does not include a right to repatriate investments, which is, however, provided for under the Investment Law in respect of investments in other sectors.

The new Petroleum Law also addresses circumstances in which a petroleum concession is granted over an area which is subject to an existing concession relating to other natural resources (e.g., mining concessions). In this case, the State has the right to choose which concession should be terminated. This could be the pre-existing concession, thereby reducing the stability of acquired rights. Investors in a concession may wish to specifically make provision for such a risk in the concession arrangements.

The new Petroleum Tax Law limits the scope of the tax stabilisation that can be granted to petroleum concessionaires to 15 years from the date of approval of a development plan. After this period, the concessionaire would cease to be entitled to compensation for increased taxes. This tax stabilisation period can be extended until the end of the initial term of the petroleum concession but subject to payment of a higher royalty on petroleum production (2% higher than would otherwise be payable).

C. Local Participation

One of the most prominent traits of the new Petroleum Law is its emphasis on increasing Mozambique's participation in the petroleum sector, both from the Government and private legal and natural persons.

Greater Role for the State and ENH

As under the previous Petroleum Law, the State reserves the right to participate in petroleum operations at any stage on terms to be agreed. To date this has usually been done by giving ENH an interest in petroleum concessions.

The new Petroleum Law formalises ENH's role as representative of the State in petroleum concessions and makes it a legal requirement that any investor's exploration and production activities in Mozambique are carried out in partnership with ENH. The new Petroleum Law also requires the State to seek to increase its participation in any oil and gas concession over time.

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From an investor perspective, ENH's participation may be a helpful indication of Government support. However, it raises governance issues as well as issues relating to the financing of ENH's equity interest, particularly if this interest is to increase over time. The new Petroleum Law does not specify the target stake ENH would be looking to acquire.

The Government has been previously criticised by the IMF for insisting that ENH acquire participations in capital intensive projects such as LNG facilities which the IMF considered to be an inefficient use of Government resources. However, given the terms of the new Petroleum Law, this does not appear to have changed the Government's approach to require State participation in the hydrocarbon sector through ENH.

In fact, in addition to having an interest in petroleum operations, the new Petroleum Law requires the involvement of the State and ENH across the oil and gas value chain, including in the context of refining, transportation and marketing of oil and gas. In particular, the new Petroleum Law requires ENH to "assume leadership" in marketing oil and gas products. This appears to relate to sales of products both within and outside Mozambique. It is unclear how ENH would discharge this function in practice and how the offtake arrangements would need to be structured. However, leaving all petroleum marketing in the hands of ENH is likely to cause discomfort to foreign investors (including their lenders).

More Stringent Local Content Requirements

The new Petroleum Law sets out local content requirements for the procurement of goods and services for petroleum operations which are designed to promote the development of Mozambican businesses and know-how. These include a requirement for foreign persons to associate themselves with Mozambican persons to supply goods and/or services to the oil and gas sector in Mozambique and for operators in the oil and gas sectors to give preference to Mozambican goods and services to the extent they are of comparable quality to foreign goods and services and that their cost does not exceed that of foreign goods and services by more than 10%. This may have an impact on the availability of financing from export credit agencies, which we would expect to be a key financing source for large-scale oil and gas projects. Additional requirements may be imposed (for instance, through the implementing regulations) as the new Petroleum Law mandates the Government to develop mechanisms to allow the participation of Mozambican businesses in the oil and gas sector.

As concerns the development of local know-how, companies operating in the oil and gas sector are required to provide employment and technical training for Mozambican nationals, with a preference for the population residing in the immediate vicinity of the concession area. Oil and gas exploration companies are specified as being required to ensure the training and employment of Mozambicans. The new Petroleum Law does not, however, provide any detail of how many Mozambican workers are required to be trained and employed to comply with this requirement. It is therefore unclear whether and to what extent the new Petroleum Law would impose more stringent obligations than those currently in force under Mozambique's labour laws which, for instance, include a quota regime for the employment of local and foreign workers.

D. Increased Control on Transfers of Interests in Petroleum Concessions

The new Petroleum Law seeks to remedy certain loopholes in the previous legal regime, in particular, concerning the restrictions on transfers of interests in oil and gas concessions.

More Extensive Consent Rights

Under the previous legal regime, the Government of Mozambique's consent was only required for transfers of interests in petroleum concessions by the concession holder and not in case of a change of control of the concession holder. The new Petroleum Law now clearly states that any change of control of a concession holder also requires the Government's prior consent. In the context of a project financing, the lenders may wish to

have the Government agree in a direct agreement to certain objective criteria relating to the identity of a transferee which, if satisfied, would constitute consent of the Government. Such objective criteria could relate to technical competence, financial capability, upstream and/or LNG ownership and/or operations.

More Onerous Capital Gains Tax Regime

The tax regime applicable to transfers of interests in petroleum concessions has also become more onerous, although very similar to that introduced by Law No. 19/2013 of 23 September 2013, which reforms the Mozambican capital gains tax regime in respect of transfers of interests in Mozambican companies and companies holding assets in Mozambique in force since 1 January 2014. Under the new Petroleum Tax Law, capital gains are levied at a flat rate of 32% on any transfer of interests in petroleum concessions between two non-Mozambican tax resident entities (including any transfer of shares in companies holding petroleum concessions). Tax relief available to entities holding participations for a certain period of time does not apply to such transfers.

Capital gains tax so arising is payable within 30 days of transfer. To incentivise payment of such tax, the new Petroleum Tax Law provides that the purchaser and the entity holding the petroleum concession are jointly and severally liable for the capital gains tax. Purchasers of interests in petroleum concessions will therefore want to ensure that the capital gains tax liability arising from such transfer is discharged as soon as possible.

E. Reform of Existing Tax Structures and Practices

The new Petroleum Tax Law does not overhaul the fiscal regime applicable to the oil and gas sector but largely limits itself to reforming existing tax structures (such as petroleum production taxes) and codifying existing Mozambican practices (such as production sharing). However, the changes made to these structures and practices could have a significant impact on the tax liabilities of undertakings operating in the Mozambican oil and gas sector.

Petroleum Production Tax/"Royalty"

The petroleum production tax regime under the new Petroleum Tax Law is in many respects very similar to that previously applicable under the previous petroleum tax law. The tax liability arises when petroleum is extracted, is levied on the basis of the value of such petroleum and can be paid in cash or, if required by the Mozambican State, in kind. The tax rates applicable to crude oil and natural gas have remained 10% and 6%, respectively.

The main difference relates to the way in which the value of the crude oil and natural gas are determined for the purposes of such royalties. While the principle is still for the value of the crude oil or natural gas to be determined by reference to the average price achieved by the petroleum producer, the new Petroleum Tax Law contains much more detail as to how the value of crude oil or natural gas is to be determined. In particular, it distinguishes between sales of crude oil and natural gas and, amongst them, between sales to affiliated companies and non-affiliated companies with a view to ensuring that the tax is levied on a sales price which is representative of market prices in all circumstances.

Assessment of Corporation Tax Liabilities

Companies holding concession contracts will be subject to the same rate of corporation tax as other Mozambican tax-resident companies, which is currently 32%. However, unlike other Mozambican tax-resident companies, the corporation tax liability of companies holding concession contracts will be assessed separately for each concession area. This means that if a company holds multiple concession rights, it will have to account for its tax liability under each concession separately such that, for instance, costs incurred with respect to one concession area cannot be deducted from the tax liabilities relating to another concession area although the cost and revenue are both generated by the same company. However, where more than one entity holds interests in a concession area (e.g., through an unincorporated joint venture), each such entity would have a separate tax liability.

This has significant consequences in the context of transfer pricing as, under Mozambican law, capital gains are included as part of the corporation tax liability. For instance, under the new Petroleum Tax Law, a company holding two concessions would generate a capital gains tax liability if it were to transfer an asset from one concession area to another concession area (such as natural gas from an upstream concession to a midstream concession). Notwithstanding this it is a clear possibility for holders of existing concessions to be granted the right to conduct LNG activities under the upstream concession. The new Petroleum Tax Law sets out specific rules relating to the calculation of gains, tax deduction and amortization in the context of petroleum activities.

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Production Sharing Arrangements

The new Petroleum Tax Law requires petroleum produced in Mozambique to be subject to production sharing arrangements. While this is consistent with previous practice in Mozambique, the new Petroleum Tax Law codifies the production sharing mechanism (including the determination and allocation of cost and profit petroleum), thereby reducing the scope for negotiation of such mechanisms in the context of individual petroleum concessions.

Under the new Petroleum Tax Law, the sale of petroleum is to be undertaken by the concessionaire on a joint and undivided basis with the State. The proceeds of a sale are to be divided between the concessionaire and the State on the basis of the production sharing arrangement. To the

extent an upstream and midstream (e.g., LNG facilities) project is integrated, the point of sale for the purposes of the production sharing arrangement may be the sale at the midstream level (e.g., sales of LNG).

The new Petroleum Tax Law allows the proceeds of up to 60% of "available petroleum" production to be allocated as cost petroleum, with the remaining proceeds being paid to the Mozambican State. "Available petroleum" is determined by deducting from the proceeds of sale of total petroleum produced the amounts payable to the State to satisfy petroleum production tax/royalty liabilities. Any costs incurred that cannot be recovered through the cost petroleum proceeds will be carried forward to the next year.

As concerns the calculation of profit petroleum, the new Petroleum Tax Law does not detail how the various components of the profitability calculation are determined. For instance, it is unclear what would and would not constitute operating costs.

More Limited Tax Incentives

The new Petroleum Tax Law grants an exemption from customs duties in respect of capital goods and goods listed in the new Petroleum Tax Law for a period of five years from the date of approval of the development plan for the relevant petroleum development.

This is similar to the tax incentives provided under previous legislation, except that (a) the previous tax incentive regime also entitled oil and gas operators to an exemption from VAT in respect of capital goods imported within five years of approval of the development plan; and (b) the customs duty exemptions apply both to capital goods and to a specific list of additional assets considered equivalent to capital goods rather than to capital goods, explosives and equipment necessary to conduct geological studies, as was the case under the previous regime.

Conclusion

Foreign investors have long awaited the legislative reform of the Mozambican petroleum sector, hoping for a clear and comprehensive legal framework that facilitates investment in the development of the country's huge offshore gas reserves. While the new Petroleum Law extends the application of oil and gas legislation to petroleum infrastructure (including oil and gas production facilities and LNG facilities), which was previously missing from Mozambican law, it does not provide much detail as to the specific regime applicable to them.

For existing holders of upstream concessions looking to develop LNG facilities, such as the Anadarko and ENI-led consortia, the most helpful provision of the new Petroleum Law is that they can be undertaken under an existing concession, which appears to exclude such pre-existing concessions (and any LNG activities to be undertaken thereunder) from the scope of the new Petroleum Law and new Petroleum Tax Law. However, this would likely not apply if the LNG facilities were to be developed by different entities under a separate concession from the upstream. In the case of the Anadarko and ENI-led consortia, the development by them of Offshore Areas 1 and 4, respectively, will be subject to the terms of project-specific decree laws. However, it is unclear which regime would apply to others looking to develop LNG projects from existing concessions. It is unclear whether these projects will require project-specific laws or whether the implementing regulations will extend to adequately cover these projects.

Notwithstanding significant investor interest in gas-to-liquids projects, this type of project seems to have been excluded from the scope of the new Petroleum Law. While these are mentioned in the context of the role of the State and ENH, they do not appear to fall within the scope of "petroleum operations". It is unclear what regime will apply to gas-to-liquids projects.

In light of the above, the real focus of the new Petroleum Law and new Petroleum Tax Law seems to increase the State's control and participation in the oil and gas sector. While this shift was anticipated as it is reflective of Mozambique's current legislative trend and consistent with the draft laws made available by the Government, many of the requirements that are likely to be controversial for investors (such as the IPO requirement and the requirement to allocate no less than 25% of oil and gas production to the domestic market) were introduced in the very late stages of development of the new legislative regime and against a backdrop of political transition in the country. The impact of this increased control, however, may be more apparent than real given the largest natural gas wealth in Offshore Areas 1 and 4 could be subject to a distinct regime and not to these new laws.

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