

MEMORANDUM TO CABINET  
BY THE PRIME MINISTER

Honourable Ministers will recall that they had decided in Cabinet (Memorandum No. 817) that the Revised Draft Petroleum (Production) Regulations be sent to Shell, Agip, Sinclair (U.S.A.), ERAP (France), Esso and the Malta-American Exploration Co. Ltd for their comments. The companies were also to be advised that it was not proposed to make any changes in the current rate of income-tax on the profits derived from petroleum production (10/- in the £) and that concurrently with the publication of the Regulations an amendment would be effected to the Income Tax Act, 1948, to provide for royalties to be treated as an expense and not as a deduction from income-tax payments.

2. Comments on the draft Regulations have been received from Shell, Agip and ERAP. Esso has stated that as it had not been possible 'to gather sufficient favourable data on the overall venture to warrant a decision to risk exploration capital in offshore Malta' they should refrain from making any comments whilst Malta-American Exploration have stated that 'we have no comments to make at this stage'. No reply has been received from Sinclair (U.S.A.).

3. The draft Regulations do not show the rate of royalty, scale of rental, minimum expense obligations, cash bonus and production bonus as these would appear in the call for applications and would eventually be inserted in a Schedule to be attached to the licence, and the companies have pointed out that their comments cannot be considered as final in this respect. They have stated, however, that competitive bidding might not be the best way of ensuring a quick and comprehensive exploration of the area and that the rentals should be as low as possible especially during the first years of exploration. They have also implied that a royalty of 12½% is too high and comparisons have been made with the royalty payable in Italy (8% for liquid and 5% for gaseous hydrocarbons).

4. The companies have reiterated that legislation and terms on the Middle East pattern are not applicable as the prospects of the Maltese offshore areas are modest and operations would be lengthy and expensive. Apart from the technical difficulties due to the depth of the sea, Agip has stressed that

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the available information about the area does not allow the assumption of the discovery of large fields with big reserves. The area can only be compared with areas in S.E. Sicily where the results achieved were moderate both as regards reserves and type of crude and in some cases the finds almost uneconomical to work.

5. The alterations to the draft Regulations suggested by the companies have been divided into three groups:

- a) amendments of financial character (Appendix A)
- b) amendments of general character (Appendix B)
- c) other amendments.

6. The Oil Committee has recommended the acceptance of the amendments at Appendix A and B but has not recommended the acceptance of the amendments at group (c). This last group includes amendments which run counter to our legal practice as well as amendments to clauses which are also found in Western European legislation and have already been accepted by the companies in other countries.

7. An amendment to the Petroleum (Production) Act, 1958, will be necessary to give the Minister powers to issue the Regulations and in particular to provide for the incorporation of model clauses in the licences; if the recommendations regarding the tax-system are approved it will also be necessary to amend the Income Tax Act, 1948, in conjunction with Commissioner of Inland Revenue, but only to subject to tax profits derived from petroleum obtained from the Continental Shelf.

8. Hon. Ministers are invited to advise whether the draft Petroleum (Production) Regulations be revised in the light of the comments made by the companies, as recommended by the Oil Committee at Appendix A and Appendix B.

7th May, 1968.

APPENDIX A

Amendments to the Petroleum (Production) Regulations

SECOND SCHEDULE - PRODUCTION LICENCE

Clause 9(4) - Minister's option to take crude vice royalty

This sub-Clause gives the Minister the option to take up to 12½% of the licensee's crude oil production the value of which is to be set off against the amount due as royalty. The crude is to be delivered by the licensee f.o.b. seaboard terminal Malta and valued at market price in Malta.

2. Shell point out that it is a normal procedure for the Government to take the royalty wholly or in part, in cash or in kind. Being unaware of the rate of royalty, they say however that the sub-clause is objectionable, as it could give the Minister a part of the production which could exceed the royalty in kind. They also add that transportation and delivery costs between wellhead and delivery point for crude taken vice royalty should be borne by the Minister.

3. Similar comments are made by Agip.

4. In Italy royalty is payable in kind (8% for liquid and 5% for gaseous hydrocarbons) unless the Government opts for cash, and in the former case the royalty due is delivered at the delivery point less transport, treating costs and storage costs.

5. RECOMMENDATION: That in conformity with the principle that the value of such crude should be equivalent to the value of royalty, the percentage of crude oil production to be taken by the Minister should be equivalent to the percentage of the royalty and that transport and delivery expenses on such crude should be borne by the Minister.

Clause 13 - Crude oil required for internal consumption or use

6. In terms of this clause the Minister may ask a licensee to deliver up to 10% of his annual production for consumption or use in Malta including the manufacture of any product intended for export, such crude to be delivered f.o.b. seaboard terminal in Malta and valued at market price in Malta less 10%.

7. Shell point out that this clause (a) goes beyond the normal practice of pro-rata delivery by all producers (b) the

/obligation .....

obligation is not limited to crude for internal consumption but includes its use in the manufacture of products for export (c) the time of delivery is at the sole discretion of the Minister (d) crude is to be delivered free of transport charges and (e) a 10% discount on the market price is to be allowed.

8. Shell add that the option to take additional crude over and above that which may be taken vice royalty deprives the operator of a large proportion of his production (up to 12½ vice royalty and up to 10% under this clause) and that the 10% discount is an additional tax. They recommend that the principle be followed that producers, on a pro-rata basis, should ensure that production should in the first instance be made to cover the internal consumption of Malta.

9. ERAP expresses surprise that, apart from the right to take royalty vice crude, the Minister has also the right to take crude at a 10% discount and that such crude could be used in the manufacture of products for export purposes and that the uplifting of this crude is possible even if the Minister does not claim his share of crude vice royalty.

10. Rouhani had proposed that an operator should supply at cost plus an operating fee, not more than 10% of his production the quantity not to be disproportionate from that required from other operators, for internal consumption in Malta and that transport costs be borne by the Minister.

11. Under the B.P. licence, the operator had to provide at field storage prices (pro-rata with other producers) sufficient crude to meet the internal domestic consumption of Malta if a refinery were set up in Malta.

12. RECOMMENDATION: This clause has been inserted in the draft Regulations as a result of a Cabinet decision; in view of the strong reaction by the companies and the fact that if the requirement for such crude were to be limited for internal domestic consumption only the quantities so uplifted would be negligible, it is recommended that the total deletion of this Clause should be considered. In terms of the regulations all crude, unless otherwise directed by the Minister, is to be brought to Malta and it is thus possible to safeguard internal requirements, if any, by other means.

Clause 14(3)(ii)(b) - Natural Gas

13. In terms of this sub-clause the Minister may opt for the purchase of a gas-producing well by paying the capital costs for drilling, completing and putting into production such a well and by paying the expenses incurred in producing the gas; the purchase price to be paid by instalments related to the expected life of the well.

14. This sub-clause is reproduced from the B.P. licence which also provided for an allowance of 15% to the operator on production costs but this allowance was purposely omitted from our draft.

15. Agip point out that in the price paid for such a well it is the practice to include a risk reward. Shell, however, say that this option is not an attractive prospect for a would-be investor and suggest that if the option is exercised, the Minister should pay also a proportion of the exploration expenditure incurred in discovering the well and interest on the investment at a reasonable rate.

16. RECOMMENDATION: That if this option is exercised, the operator should be paid an allowance of 15% on production costs and interest at 6% on the capital investment but that no payment be made towards the exploration expenses incurred in discovering the deposit.

Clause 37 - Other payments, Income Tax and Export duty

17. This clause provides that in addition to royalties and other payments, the licensee is to pay all taxes, duties, etc., which may be in force from time to time, that the rate of income-tax is not to be increased throughout the period of the licence and that the licensee is not to claim any double taxation relief to which he is or may become entitled.

18. The preceding clause must be read in conjunction with the proposed amendment to the Income Tax Act, 1948, whereby the present income tax rate at 10/- in the £ will be retained but royalties will be expensed and not credited towards income tax liability.

19. Rouhani had proposed payment of royalty at 12½% on posted price, that for tax purposes certain allowances be made on the posted price and that royalties, rentals, and all other expenses connected with the operations should be expensed.

He also proposed the free import and export of materials connected with the operation of the licence.

20. Under the B.P. licence royalty was 12½% on the value of crude at field storage and payments of royalty and rentals were credited towards income-tax liability fixed at 10/- in the £. Direct and indirect taxes of general application to other industrial undertakings in Malta were also payable but import and export of materials connected with the operations were free of duty.

21. The comments by the companies are conditioned by the fact that they are still unaware of the rate of the royalty and the rentals. In view of this unknown factor, ERAP does not comment on the financial implications of the regulations whilst Agip state that, if in addition to the royalties all the fiscal charges listed in this Clause can be set off against the payment of income-tax, then the system is acceptable. On the contrary, the sum of all these fiscal charges to which are to be added the expensing of royalty would "mean such a heavy burden as to discourage the petroleum search in Malta".

22. Shell point out that under the system now obtaining in Malta a special income-tax rate of 50% is applicable. There is however one major deviation as compared with other countries who have adopted the same system inasmuch as only royalties and rentals are treated as prepayment of income-tax and taxes other than taxes on income are levied without considering these taxes as prepayment of income-tax. Shell add that the proposal to expense royalty would make the system more onerous than that obtaining in countries with comparable - or even better - geological prospects. They further recommend the complete exemption from taxes (other than taxes on income) or that such taxes be also considered as prepayment of income tax.

23. In view of the companies' reaction to the proposed terms, more favourable terms are indicated in order to attract more companies and to ensure a quick and thorough exploration and exploitation of the area. Esso's loss of interest followed the receipt of the revised draft and the risk of loss of interest by Shell and Agip must be kept in mind. Moreover, nothing is known about the Continental Shelf Area, the size of the area precludes the possibilities of large fields and consequently large reserves, drilling is much more expensive in offshore

than in land areas, deep water imposes a limit to economical exploitation (according to Agip 75% of the area is over 100 metres deep, 23% between 50 and 100 metres and 2% less than 50 metres) and both Dr Mina, U.N. expert, and Agip had agreed that on the basis of existing information if oil exists it will be found at a depth of between 8,000 and 12,000 ft.

24. RECOMMENDATION: That the present tax system should not be disturbed i.e. income-tax to remain at 10/- in the £, royalties at 12½%, not to be expensed but to count towards income-tax liability and direct and indirect taxes (other than income taxes and cognate taxes on gains or profits) to be paid by the operator provided that such taxes are no higher than those ordinarily imposed and paid by other industrial undertakings in Malta. It is appreciated that the B.P. licence also embodied an undertaking by the Company to concede better terms to the Government if the company were to obtain other concessions in Mediterranean Countries under more favourable terms to the host country but the retention of the 50/50 system appears to be advisable once that the prospects of the area are in no way comparable with those of Middle East areas where Governments are now obtaining more favourable terms from oil companies.

Amendments to the Petroleum (Production) Regulations

SECOND SCHEDULE - PRODUCTION LICENCE

Draft

Suggested Amendment

Clause 1(1)

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|----|---|--|
| 1. | a) "Commercial quantities" in relation to the discovery of petroleum refers to a minimum production of 250 tons of crude a day for not less than 60 consecutive days. | For technical reason definition impracticable; definition to read '.... such volume of petroleum as can be produced on an economic and regular basis in accordance with good petroleum industry practice'. |
|    | b) Definition of 'Petroleum'  | To add the words 'or obtained from natural gas by condensation or extraction' so as to bring definition in line with the definition in the Petroleum (Production) Act.                                     |
|    | c) Definition of 'natural gas'.   | To qualify the words "all other gaseous hydrocarbons" by adding 'in their natural state' as in the definition of 'crude oil'.  |

Clause 4

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|----|--|---|
| 2. | Twelve months' notice to be given for the surrender of the licence or part of licensed area during the initial ten years' period of the licence. | Reduction of period of notice from twelve to one month. |
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Clause 6(2)

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|----|---|--|
| 3. | Extension of licence for a thirty years' period to start as from the date of discovery of petroleum in commercial quantities. | As the discovery in commercial quantities does not occur on a specific date, the date of commencement of the thirty years' period to be the date when the option for the extension is exercised. |
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Clause 11(2)(a)

4. Gas to be measured in                      Temperature to be measured at  
cubic metres at a temperature 15° Centigrade to conform with  
of 0° Centigrade and a pressure standard industry practice.  
of one kilogramme force per  
square centimetre.

Clause 17(a)

5. Wells not to deviate                      Deletion of the sub-clause to  
substantially from the                      allow for the drilling of several  
vertical.                                      wells from the same platform.

Clause 19

6. Development of any part of              Deletion of the underlined  
licensed area known to contain words as these are in contradiction  
or showing indications of              to the concept of commercial  
petroleum in commercial              quantities.  
quantities.

Clause 29

7. Preservation of samples of              Samples to be kept for six months.  
the seabed and strata, etc., by  
licences for reference  
purposes.

Clause 33(c)

8. Minister's power to                      Deletion of the words  
execute works of normal                      'Development of licensed area'  
development at the expense of              from the sub-clause as, in such  
the licensee, if the latter                      cases, the remedy lies in the  
fails to fulfil his obligations.              revokation of the licence.

Clause 38(3)

9. Minister's power to                      Minister to serve notice, with  
revoke licence without notice.              a period of grace and under certain  
safeguards, prior to revokation  
only in the case of non-compliance  
by the licensee of the terms of the  
licence (Clause 38(2)(b) ) or the  
conditions of a development scheme  
(Clause 38(2)(f) )

THIRD SCHEDULE - EXPLORATION LICENCE

The suggested amendments would also apply to identical clauses in the Exploration Licence.