Question 1

Part 1: The concept of petroleum royalties

Production Sharing Contract(PSC) regimes generally involve the government retaining title to oil and gas resources but gives a right to share production(profit oil)to the oil and gas company.
The oil and gas company recovers its costs of exploration, drilling and production via cost oil recovery as per the terms of the PSC.

Under tax/concession regimes, the government transfers title to the oil and gas resources to the oil company and imposes tax and royalties. The oil and gas company owns the oil and gas produced and pays corporate tax on the related profits.

Royalties are paid for accessing oil and gas resources.

Royalties are usually combined with other tax systems such as PSC and concession regimes because royalties generally give rise to income to the the state as soon production starts, whereas government revenue from Concession and PSC regimes is delayed as the oil company uses carry forward tax losses or allowable costs from prior years.

Royalties under Concession regimes are generally higher than royalties in PSC regimes.

The charging of royalties is generally based on production or value of oil and gas produced. There are several variations. The royalty may be based on the different values including:
-Fixed percentage, for example United States Federal royalties.
- A bid amount, applied in several states in the United States, for example Louisiana state royalties.
-Vary with geological features, for example Nigeria offshore royalties decrease with the geological features of greater water depth.
- Sliding scale royalties based on production, for example China and Abu Dhabi.
-Sliding scale royalties based on several factors, for example Alberta in Canada, based on production and price.
Sliding Scale royalties depending on on IRR, for example Greenland.

In the United States, royalties are paid either to the mineral owner, and may be 'Federal' royalties applying to offshore oil fields beyond state territorial sea jurisdiction or 'state royalties' applying to onshore and state territorial see fields, or paid to the private resource owner. The royalty may be based on their market prices or deemed prices.

Royalties may be based on the well-head price, field terminal price, or export terminal price.

Part 2: Signature and production bonuses

Many countries require signature and production bonuses as payments to be made at stages of exploration and production. Bonuses may arise as part of the bidding process for a new exploration and development license, or be imposed under standard terms such as PSC contracts.

Bonuses for oil and gas may include the following:
- Signature bonus: payable on signing the oil and gas agreement, for example on signing of the PSC or block exploration and development license.
-Capacity building bonus: an amount paid to assist in the development of facilities such as project infrastructure, and generally payable at an early stage in the contract.

-Bonuses may also be payable on discovery, commercial discovery, licence application, specific levels of production, or levels of cumulative production

Signature bonuses may provide compensation for government costs in conducting the bidding process, and will provide income for government oil and gas administration where there are dry wells. The much larger sources of of income are production bonuses where significantly higher amounts are paid on meeting oil and gas production milestones.

Bonuses are generally not cost recoverable under PSC regimes whereby the oil and gas company does not get cost oil to repay these expenses. However, bonuses may qualify for tax relief under Concession regimes, for example, lease bonuses are amortised for United States federal tax purposes.

Bonuses are not paid for oil and gas resources but rather are considered as payments for sharing the benefits of a project when it reaches specific development milestones.

Part 3: Other taxes

Others taxes or levies include the following:

-Rentals - these are additional amounts payable in respect of an oil and gas license on an area used basis. The rental amount may be a fixed fee, or based on the areas of an exploration block, on the area of a specific oil and gas field. Rentals are essentially income for the use of land by the oil company.

-Export duty - these are taxes on amounts of production exported from the production country.

- Indirect taxes and VAT - these are generally imposed on the value of the company's sales with the company allowed a credit for VAT paid on its purchases. VAT therefore applies to the valued added by each stage from production to the the final sale.

- Customs duties - these may be imposed on importation of oil and gas plant and machinery, although in many countries such items are normally exempted from duty.

- Stamp duty - these may be imposed on instruments such as agreements or on transfer of interest in an oil and gas field or block.

Question 2

Part 1: Reasons for arbitration clauses

Principally, international arbitration is important when there are disputes between the oil and Gas Company and the government. Bilateral Investment Treaties (BIT) provide protection to foreign investors and some of the clauses of the BIT may require that the disputes are resolved amicably and if not resolved for within a specified period (e.g six months), then the aggrieved party may submit its case for arbitration.

Disputes may arise in respect of changes in the tax code, new interpretation of the existing tax code or misapplication of contractual provisions, the government failing to honour its part of the bargain in the contract such as refunding VAT to the oil and gas company. Such actions may be considered to be a contravention of the contractual terms and if not resolved amicably, arbitration provides an avenue for addressing the oil and gas company's grievances.

Arbitration provides the oil and gas company an "independent ear".

The oil and gas company seeks for protection against measures harmful to its investment in the country.

In some cases, due to weak institutions such as the loca courts in the host country, independence of such institutions is not guaranteed and as such, they may not be impartial in handling the grievances of the oil and gas company.

The oil and gas company may not have sufficient local expertise to handle the disputes on its behalf and may therefore prefer to use an international arbitration mechanism.

The local institutions may also not have the experience of handling matters associated with the oil and gas dispute with the government due to the complexity and technicalities involved, in which case an international arbitration is the viable option.

Due to the high value of amounts involved in oil and gas disputes, local institutions may be leaned towards ensuring that the oil and gas company pays or incurs the cost, without objectively reviewing the contractual terms of the agreement between the government and the oil and gas company.

Due to the bureaucracy of government institutions in resolving disputes, matters take so long to resolve and an international arbitration provides an avenue to expedite resolution of disputes.

Part 2: Impact of arbitration clauses

Arbitration clauses provide an independent avenue for resolving tax disputes and provide protection to the oil and gas company against harmful tax measures which are contrary to the contractual terms agreed with government. An example of cases which involved arbitration include:
- RosInvest Co UK v Russian Federation where it was ruled that Russia arbitrarily increased taxes.

However, governments are reluctant to accept international arbitration on the basis that this renders its local institutions redundant in respect of oil and gas disputes and as a sovereign state, such matters can be handled locally.

Part 3: BITs and Energy Charter

These provide protection to foreign investors against harmful state measures
They provide an avenue for arbitration and resolution of disputes
They provide a framework for efficient use of energy
They provide for mutual understanding and cooperation and encourage trade

Part 4:

The government not having the competence represents a major risk in the sense that the government, as a sovereign state, it may not accept the outcome of the arbitration and this may negatively impact on the project.
Lack of competence also delays resolution of matters under dispute.

The oil and gas company can provide training and funding to increase the competence of government officials on specific technical areas.
Continuous dialogue and communication with the government in respect of matters connected to the project can help the government to bridge the perception of incompetence.

Question 4

Part 1:

Yes, the additional funding can be obtained.

Part 2:

Yes, the new loan would require tax considerations for example, whether the interest is deductible.

Question 5

Part 1: finance and operating leases

Finance leases generally result in additional debt on the balance sheet of the lessee as the transaction is treated is a loan to acquire the asset under the finance lease agreement. On the other hand, an operating lease is generally treated as a mere rental of an asset from the lessor and this does not result in debt on the lessee's balance sheet.

With a finance lease, the lessee is treated as the economic owner of the asset although he may not have legal ownership of the asset.

Under an operating lease arrangement, related lease payments are generally fully tax deductible as the lessee is treated as merely renting the asset. For a finance lease arrangement, generally only the interest component of the lease payments will be treated as deductible.

The lessee under an operating lease is not treated as an asset owner and therefore cannot claim capital allowances attributable to the leased asset. Under an operating lease, the capital deductions on the leased asset are claimed by the lessor.

Under finance lease, the capital allowances are claimed by the lessee as the economic owner of the asset.

Operating leases may therefore provide tax advantages compared to the finance leases where the increased deduction of the full operating lease payments are greater than the interest component and depreciation deductions under a finance lease. This analysis depends on the interest rates, the detailed terms of the lease, and the extend of depreciation allowances in particular countries.

Withholding tax may be imposed on the lease payments under cross-border leasing and this depends on the domestic tax rules of the lessee country and any applicable tax treaty between the countries of the lessee and the lessor. For example, the lease payments may be defined in the domestic tax code as royalties subject to withholding tax or only the interest component under a finance lease may be subject to withholding tax.

Indirect taxes such as VAT may also apply differently on the finance lease and an operating lease depending on the domestic tax code of the respective countries. Operating leases are generally treated as supply of services for VAT purposes. Under a finance lease, VAT may have to be accounted for on the full selling price or on the periodic lease payments, or treated as a finance charge exempt from VAT, depending on the domestic tax rules.

To the lessor country under a cross-border lease, there may be potential for VAT exemption, for example as an export of goods to a lessee in another European Union (EU) state or to a country outside the EU. However, at the point of importation, the lessee may be liable for the VAT under a cross-border lease.

There may also be transaction taxes on leases such as stamp duty in the United Kingdom, where the leased assets are fixtures attached to land.

Where the finance or operating lease transactions is conducted between related parties, these may be subject to transfer pricing rules which generally require that transactions be carried out at arm's length.

In addition, for cross-border finance or operating leases, the consideration of creating a permanent establishment in the country of the lessee needs to be taken into account.

Treatment as an operating lease for tax purposes generally depends on establishing that there is not an economic sale of the asset to the lessee. This includes reviewing factors such as the the lease term compared to the economic life of the asset, and the absence of terms for the lessee to acquire the asset at less than market value under a 'bargain purchase option'. The Netherlands rules, for example, allow operating lease treatment the lease term does not exceed 85% of the estimated economic life of the asset.

Part 2: Accounting recognition and measurement of leases

For lessees, the International Accounting Standards Board (IASB) proposed the recognition of a liability and a right-of-use asset for all leases with a profit or loss impact dependent on the classification of the lease. These lessee accounting rules generally require that at commencement date of the lease, the lessee discounts the lease payments using the rate the lessor charges the lessee, or if that rates is unavailable, the lessee's borrowing rate. The lessee then recognises the present value of the lease payments as a liability, and at the same time, recognises a right-of-use asset equal to the lease liability. This approach potentially creates a question of whether credit agencies such as Standard and Poor's would also treat operating leases as obligations equivalent to debt.

Question 6

The tax due diligence team will generally set a materiality level for issues. The tax due diligence process generally reviews 'open' financial years, where the tax assessments can be changed if there are errors or tax disputes. The tax related issues in an oil and gas acquisition include the following:

i) Essential taxes apply to the proposed transaction including rules for recovery of exploration expenses, treatment of capital expenditure, carry forward losses, repatriation of profits, capital gains, transfer taxes, and indirect taxes such as VAT.

ii) Hydrocarbon taxes ring fence issues, such as restriction on interest deductions against ring fence income.

iii) Determination of the holding structure, including election of a branch, single company or double company holding structure, consideration of taxation on income flows, withholding taxes, potential capital gains taxes on exit, and the funding structure of the investment.

iv) The holding structure used if there are local or foreign partners.

v) Whether an intermediate holding country should be used for dividends, capital gains tax and related tax treaties.

vi) Preparing a tax leakage calculation for the preferred structure, e.g calculation from 100% of oil and gas income, reduction for taxes including any profit oil sharing under Production Sharing Contract (PSC) regimes, calculating back to the net after tax cash to be received in the parent country.

vii) Determining whether the seller is taxable in its own country of residence or the country whether its assets are located, and estimating the amount of tax.

viii) Reviewing transfer taxes or stamp duty applying to the sale and related asset or share transfers, including the estimated amount, and whether these amounts are payable by the seller, the buyer, or are shared.

ix) Determining any carry forward tax losses under a tax and concession regime, or allowable costs under PSC regime, in the transferred company or license asset, and reviewing whether these amounts are preserved by the transfer, and whether there is any group relief, tax consolidation, or tax loss contribution available in the new holding structure.

x) Reviewing what related party and external funding requirements apply for the acquisition and anticipated future expenses and whether the interest payments on borrowed funds will be deductible.