

TAXATION OF THE OIL SECTOR IN CENTRAL AFRICA (CEMAC AREA)

*Main rules governing production sharing
between States and Oil Companies*

Recueil Penant – 1^{er} quarter 2011

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The Hydrocarbons legislations of countries that belong to the Monetary and Economic Community of Central Africa (CEMAC: Cameroon, Central African Republic, Congo, Gabon, Equatorial Guinea, Chad) all provide, as a rule, that hydrocarbons contained in the soil and subsoil are the property of the State and therefore belong to the public domain².

Agreements entered into with the State by oil companies mainly take two different legal forms in the oil legislations of the countries of the CEMAC area:

- **Concession Agreements**, which grant to the oil company an exclusive production right (for a given resource) which has the characteristics of a real estate property right³, separate from the ownership of the soil.

The case holder, who produces for his own account and generally owns the entire production extracted, is liable vis-à-vis the State of usual common taxes (notably corporate income tax)⁴ as well as one or several specific royalties (proportional mining royalties, surface royalties, etc.)⁵.

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² For instance, article 1 of the Hydrocarbons Law of the Republic of Equatorial Guinea states that “hydrocarbons deposits contained in the soil and subsoil of Equatorial Guinea, including in its internal waters, territorial waters, exclusive economic zones and continental shelf are the ownership of the State, and thus belong to the public domain”.

³ Which in some States can be mortgaged.

⁴ When applicable, subject to the specific terms and potential particular exemptions provided by the concession agreement.

⁵ The oil company can also be liable for the payment of a dividend to the State when it is a shareholder, directly or through a national company.

- **Production Sharing Contracts (PSC)**, which have the legal characteristics of service contracts defining the framework of the services provided and which do not grant to the oil company any real estate property right⁶.

In this contract, the oil company explores and produces a resource on a delimited area on behalf and for the account of the State, in consideration for a remuneration “in kind”⁷.

If an oil field is discovered, the oil company will have a right to a share “in kind” of the production representing (i) the reimbursement of the costs incurred and (ii) its remuneration.

Although the concession system has prevailed in the first decades of oil production in Central Africa, production sharing contracts have progressively spread in the national legislations of the oil producing countries since the 1980s:

Cameroon	PSC and Concessions - Law n°99-013 dated December 22, 1999
Central African Rep.	PSC and Concessions - Ordinance n°93.007 dated May 25, 1993
Congo	PSC* - Law n°24-94 dated August 23, 1994
Gabon	PSC* - Law n°14/82 dated January 24, 1983
Equatorial Guinea	PSC - Law 8/2006 dated November 3, 2006
Chad	PSC and Concessions - Law n°006/PR/07 dated February 2, 2007

* Conventions and agreements entered into with the State before the promulgation of the Laws instituting the regime of PSCs have remained in force.

“Taxation” of the upstream sector in the CEMAC area has therefore significantly evolved to include the rule of attribution to the State of a part “in kind” of the production corresponding to its share, to which must be added the *other levies* of the State to determine the “government take”, i.e. the overall share belonging to the State⁸.

These other levies are mainly:

- (i) Proportional and surface royalties ;
- (ii) Certain usual common taxes, such as corporate income tax and VAT, which can be subject to specific provisions in the PSC, which deserve special attention (exemptions, specific modalities of application, etc.) ;
- (iii) bonuses of signature, discovery, production, etc.

⁶ No mortgage can be taken in this specific case, thus other types of securities must be envisaged.

⁷ Contracts of this type providing for a remuneration in cash are called “risks services contracts”.

⁸ The production share belonging to the State pursuant to the contract derives from a contractual agreement negotiated according to the rules stated in the Hydrocarbons Law, which do not strictly correspond to a levy mandatorily required from taxpayers, which is the theoretical characteristic of a *tax* (see on this question: Stéphane ESSAGA, « *l'autonomie relative des codes pétroliers en matière fiscale en Afrique noire : exemple à partir de l'impôt sur les sociétés en droit camerounais et ivoirien* »). Even if the strict *tax* nature of the production share could be discussed, this mechanism constitutes one of the main elements of the *pressure borne* by oil companies, taken into account in the macro-economic models of assessment of the “apparent tax pressure” of the Jumbo model used by the French Development Agency-AFD (Blaise LEENHARDT, « *Fiscalité pétrolière au sud du Sahara : la répartition des rentes, Afrique Contemporaine n°216-2005*). It is this global *pressure* which constitutes the oil taxation.

Even though the tax provisions of countries from the CEMAC area can be very different concerning the "other levies" (thereby requiring a case by case approach), the general structure of production sharing is similar from one state to another.

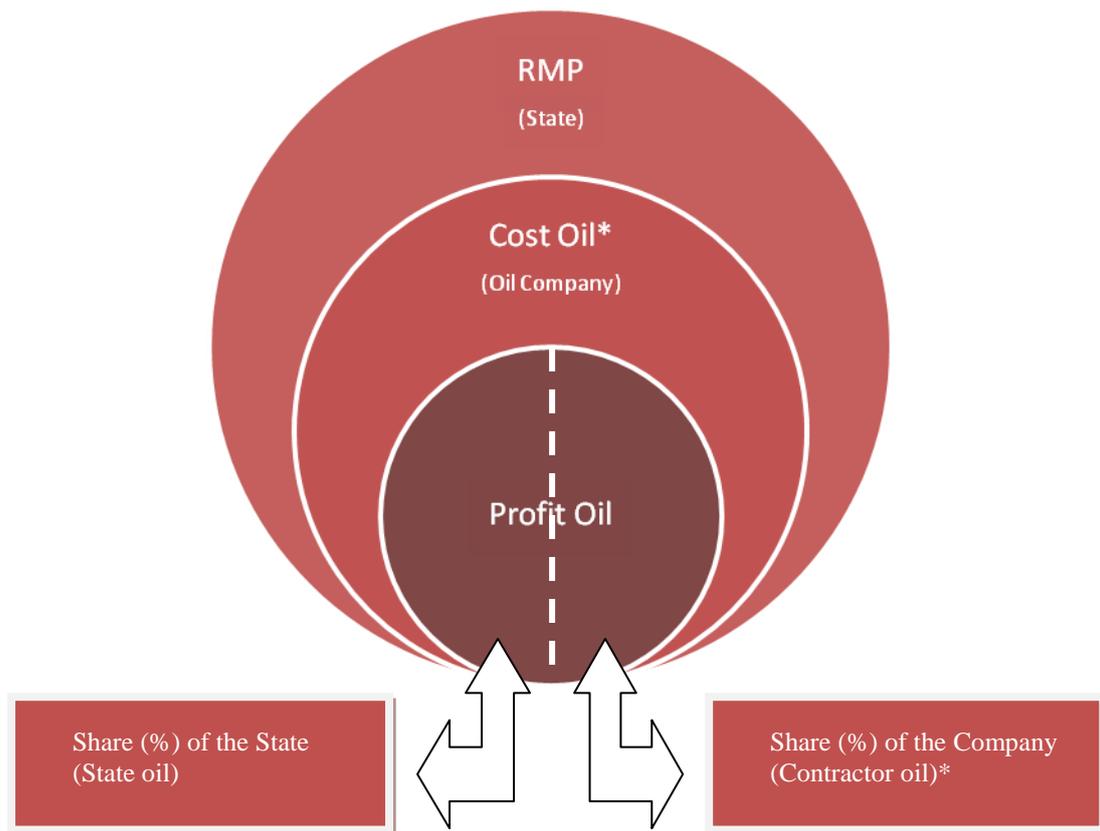
It has therefore seemed useful to us to present the main rules governing production sharing in the States of Central Africa (CEMAC area) and we will see that the determination mechanisms are sometimes directly inspired by common rules of taxation.

I Steps in production sharing

Hydrocarbon laws of CEMAC countries, as well as the PSCs which they refer to for the definition of the particular production, provide for the production sharing of the hydrocarbons between the State and the oil company according to the following terms:

- A **mining proportional royalty (RMP)** is due in priority on the gross production, whatever the level of profits made and before any recovery of petroleum costs ;
- After application of the RMP, the oil company has a right to recover **the petroleum cost** ("Cost oil") that it has incurred alone for the needs of the oil operations, i.e. the State usually does not finance such operations. This recovery of the petroleum cost is operated by a levy on the corresponding hydrocarbons production ;
- The total annual hydrocarbons production, after deduction of the RMP and the "cost-oil" abovementioned, constitutes the hydrocarbon production to be shared ("profit oil") between the State ("State Oil") and the Oil company ("Contractor oil").

Gross production sharing diagram



* If applicable, shared between the oil company acting as operator (in charge of the operations) and other « financial » partners (contractors), according to their respective % of interest in the PSC.

II Main rules governing each step of production sharing

II-1 Phase 1: Production of hydrocarbons - determination and valuation

Production sharing requires the prior determination of the quantity of hydrocarbons produced, under the control of the contracting State⁹, but also its valuation in respect to:

- the computation of the mining proportional royalty due to the State : such royalty is most often paid in cash (even if in theory a payment in kind is provided by the PSC); a valuation of the production (price/barrel) is therefore necessary to determine the amount due to the State;
- the determination of the quantity of hydrocarbons levied for the purpose of the recovery of the petroleum costs by the oil company.

In order to prevent the conflicts that could result from a disagreement on the valuation of the production, mainly transfer pricing issues regarding inter-company sales (between affiliates), the volumes of hydrocarbons produced are valued on the basis of a sale price determined according to the terms agreed upon by the parties to the PSC.

The price of the barrel can be determined in the following ways:

- The **“official transfer price” method** (Cameroon, Congo and Gabon) : the quantities of hydrocarbons are valued by reference to a price which must reflect the real market price provided by the State after negotiating with the oil companies;
- The **“average price” method** (Equatorial Guinea, art. 10.1 of the model PSC): the valuation is carried out quarterly by reference to the average price of sales made by the oil company to third parties (i.e. not affiliates). If sales made to third parties represent less than 15 % of the total quantities produced on the oil field covered by the PSC, reference is then made to international rates (published in Platts) agreed upon by the parties to the PSC.

⁹ In this regard, we will take the example of the PSC model of Gabon (www.minesgabon.org) which provides that the point at which the counting is done and the measure of the quantities of hydrocarbons is performed, as well as the point at which are established the instruments, devices and installations that are allocated to the counting, must be approved by the Administration. The competent Agents of the Administration check these measures and counting and control the installation and devices used at least once each quarter (art.29.1).

II-2 Phase 2: Computation of the mining proportional royalty

Basis

The mining proportional royalty is computed on the basis of the overall hydrocarbon production on the zone covered by the PSC, minus all quantities used for the needs of the oil operations.

The deduction of the “*quantities used for the need of the oil operations*” must be carefully analyzed because some States give it a restrictive meaning. For instance, the Congo limits the deductible amounts to the sole (i) hydrocarbons re-injected in the oil field for the maintaining of the energy or (ii) hydrocarbons burnt after authorization of the hydrocarbons Minister (hydrocarbons code of Congo, article 49). Thus, the quantities used by the oil company for its oil operations are subject to the RMP¹⁰.

Rates

The approach taken in determining the rate varies substantially from one country to another.

The rate can be fixed permanently by Law or negotiated in the PSC and can also vary according to other variables, such as the production quantities or the depth of the oil fields.

The rates of RMP (for liquid hydrocarbons) can vary as follows:

Cameroon	- *
Congo	15 %
Gabon	< 200 m : 10 % > 200 m et < 400 m : 5 % > 400 m : 0 % since 5 years, after: 5 % **
Equatorial Guinea	13 % (minimum provided by Law)
Chad	16,5% (minimum provided by Law)

* The RMP does not apply to PSCs in Cameroon

** Model of PSC

II-3 Phase 3: Cost oil recovery

II-3.1 Accounting and separate recovery of petroleum costs

Pursuant to the provisions of the PSCs and the accounting appendixes (notably in Congo, Gabon and Equatorial Guinea), a specific accounting of petroleum costs of each PSC is held separately from the general accounting, according to an accounting classification specifically provided for by the accounting appendix to the PSC.

¹⁰ The corresponding costs can, if applicable and subject to the precise terms of the PSC, be recovered as petroleum costs.

Recovery of petroleum costs is generally ring fenced, i.e. limited only to the oil produced on specific areas or pursuant to specific permits, without the possibility to consolidate all costs borne by the company (e.g. notably on other areas or permits)¹¹.

The rules of separation are to be analyzed on a case by case basis according to the specific rules defined in the hydrocarbons Law or the applicable PSC; for instance, Equatorial Guinea limits the recovery of the petroleum costs to the production resulting from a single area delineated by the PSC.

II-3.2. Unlimited carry forward of petroleum costs

The Oil company party to the PSC has a right to recover petroleum costs from the very beginning and throughout the production, with no time limitation.

As a consequence, when the net production (gross production – RMP) of a given year does not allow the recovery of the total petroleum costs recoverable for that given year, unrecovered petroleum costs are carried forward to the following years until their total recovery or the termination of the contract.

Petroleum costs do not elapse in the system of production sharing, unlike carry forward losses of corporate income tax which elapse after a certain number of fiscal years in the countries of the CEMAC area¹².

II-3.3. Cost stop

The recoverable amount of petroleum costs (cost oil) for a given year is systematically capped at a percentage of the annual hydrocarbons production, above which the cost oil is saturated (“cost stop”).

When the cap is exceeded, unrecovered petroleum costs are carried forward to the following years with no time limitation, in the abovementioned conditions.

Caps are negotiated in the PSC and generally range from 60% to 70% of the annual production.

For instance, the Hydrocarbons Code of Congo (art.35) states that the cap is provided within the PSC but that it can not exceed 60% of the annual production of the production permits deriving from a single exploration permit. This maximum amount can be extended to 70% when the importance of the works, the use of expensive technology or an exceptional difficulty justifies it.

Other caps can also vary according to the depth of the oil field; the PSC model of Gabon provides for example the following rates according to the depth of the oil field:

< 200 m : 50%
> 200 m and < 400 m : 70 %

¹¹ There can be exceptions (mainly investments incentives) to this principle of non consolidation, to be analyzed on a case by case basis.

¹² Generally three fiscal years, each member State of the CEMAC deciding the applicable timeframe for the carry forward, according to article 50 of the directive dated August 3, 2001, revising Act 3/72-UDEAC-153 dated December 22, 1972, instituting corporate income tax in the CEMAC area.

> 400 m : 80%

II-3.4. Limited recovery of certain specific petroleum costs

Some petroleum costs are always subject to recovery caps and others are strictly unrecoverable.

Since it is impossible to provide a comprehensive list of petroleum costs in the framework of this article, we have listed the most distinctive ones below:

- Loan interest

Like the limitations on the deductibility of loan interests pursuant to the normal principles of corporate income tax in the CEMAC area¹³, their recovery as petroleum costs is strictly regulated in the hydrocarbons laws and PSCs.

For instance:

- ✓ Congo limits the recovery of loan interests contracted for the financing of prospection, exploration, exploitation and transport activities to 50% of the development investment ;
- ✓ Gabon prohibits, in its PSC model, the recovery of interests related to the fraction of the loan and debts exceeding 50% of the development and production cost, to which must be added a rate limit (BEAC rate + 2 points) when the interests are paid to an affiliated company or a partner in the PSC ;
- ✓ Equatorial Guinea prohibits, in its PSC model, any recovery of interests for petroleum costs recovery purposes; it only authorizes the deductibility, for the determination of the tax due on the share of profit oil of the oil company (“impuesto sobre la renta”), of interests for which the rate has been approved by the Minister in charge of Hydrocarbons and relating to loans granted by companies not affiliated to the borrower.

- General costs

PSCs usually provide for fixed ceilings of deductibility of general costs paid outside the country, which are negotiated by the parties and set in the accounting appendix to the PSC (see for example article 2.5 of appendix C to the Equatorial Guinea PSC model).

The PSC model of Gabon provides, for example, a maximum ceiling of recovery of 3% of the recoverable oil cost (excluding the general cost) of a considered year.

- Bonuses

Bonuses (of signature, discovery, production) are generally not recoverable.

¹³ Deduction of interest remunerating shareholders current accounts is notably limited to the rates of the loans made by the BEAC increased by 2 points, according to article 28 of the directive dated August 3, 2001 revising Act 3/72-EDEAC-153 dated December 22, 1972 instituting corporate income tax in the CEMAC area.

- Fines and penalties

Just like the general principles of corporate income tax applicable in the CEMAC states, these costs are not recoverable¹⁴.

II-3.5. Right to audit

PSCs always provide for a right of the State to audit the Petroleum Costs, which in certain countries can be subject to statutes of limitation:

- ✓ Gabon provides, in its PSC model, a right to audit only within two years following the end of exploration periods¹⁵;
- ✓ Equatorial Guinea provides for a right to audit limited to the three years following the filing of annual detailed Petroleum Costs statements¹⁶.

II-4 Phase 4: Oil production sharing

Hydrocarbons laws of Central Africa refer to the PSC for determining the oil production sharing rates between the State and the oil company.

PSCs most often provide for different sharing rates, depending on the number of barrels produced by the oil field, which is for example the case of PSCs in Equatorial Guinea.

Other PSCs, like most of them in Gabon, sometimes differentiate the rates by reference to the quantities produced or to the depth of the field, in order to encourage deep water exploration.

For instance, Gabon's PSC model provides for different sharing rates when the oil field is deeper than 400 meters:

- Average daily production for a calendar month $\leq 15\ 000$ barrels:
 - the State : 50%
 - the Oil company : 50%
- Average daily production for a calendar month $> 15\ 000$ barrels and $\leq 30\ 000$ barrels :
 - the State : 55%
 - the Oil company : 45%
- Average daily production for a calendar month $> 30\ 000$ barrels :
 - the State : 55%
 - the Oil company : 45%

The share of the State is normally delivered "in kind", but it can request that the oil company buy it (Equatorial Guinea) or give a power of attorney to the oil company to sell it on its behalf (Gabon).

¹⁴ See article 23 of directive dated August 3, 2001 revising Act 3/72-EDEAC-153 dated December 22, 1972 instituting corporate income tax in the CEMAC area.

¹⁵ Article 48.3 of the PSC model.

¹⁶ Article 16.3.1. of the PSC model.

