

## ARTICLES

---

### PETROLEUM PROJECTS IN PAPUA NEW GUINEA<sup>†</sup>

By Andrew Deszcz<sup>\*</sup> and Rick Ladbury<sup>\*\*</sup>

*The proposed PNG–Australia gas pipeline project has put PNG oil and gas back in the spotlight. This article discusses various PNG legal issues that the authors believe will be of interest to developers and financiers in planning and negotiating oil and gas projects and the financing of those projects. The article discusses the impact of the Oil and Gas Act 1998 (PNG) and customary law on the rights of the state and traditional landowners and the consequences for developers and financiers. The article then considers PNG law issues of broader application which might impact on the project (particularly if the project is project financed) and discusses some of the ways in which those issues can be resolved.*

#### 1. INTRODUCTION

Papua New Guinea (PNG) is a resource-rich country, and resources projects dominate the PNG economy. However, oil and gas production in PNG has only had a short history:

- the first commercial discovery occurred in 1986;
- first production commenced in 1991-92;
- peak production occurred in 1993;
- there has been declining exploration activity and production since that time.<sup>1</sup>

However, in recent times a number of factors have put PNG oil and gas back in the spotlight. The main one has been the proposed PNG-Australia Gas Project – a project to pipe gas from PNG to eastern and central Australia. Press reports value the project in the vicinity of US\$3.5 billion.

PNG has five major basins that are potentially rich in oil and gas. Most of these have not yet been explored, and therefore future opportunities remain. The PNG Government has said that it considers exploration of these potential reserves a high priority. It is estimated that PNG has gas reserves of up to 17 trillion cubic feet.<sup>2</sup>

This article will:

- give a brief overview of the PNG legal system;

---

<sup>†</sup> This article is based on the law as at 1 February 2006. It was previously published in a substantially similar form in (2006) 24 J. of Energy & Nat. Res. Law.

<sup>\*</sup> LLB (Hons) (Monash University); Senior Associate at Malleons Stephen Jaques.

<sup>\*\*</sup> LLB (Hons) (University of Melbourne); Partner at Malleons Stephen Jaques.

<sup>1</sup> The World Bank, Project Performance Assessment Report, Papua New Guinea, Petroleum Exploration Technical Assistance Project (Credit 1279-PNG), Petroleum Exploration and Development Technical Assistance Project (Loan 3670-PNG), 20 June 2002, para 1.

<sup>2</sup> M Bale, P Holden and S Holden, *Papua New Guinea – A Private Sector Assessment*, Report Prepared by the Enterprise Research Institute for the Asian Development Bank, June 2003, 63.

- consider aspects of PNG legislation applicable to oil and gas developments, which the authors think will be of interest to developers; and
- consider other PNG issues relevant to the project financing of oil and gas developments.

## **2. PNG LEGAL SYSTEM**

PNG has a common law legal system that is very similar to the legal systems of England and Australia. Prior to independence, a substantial number of English and Australian Acts of Parliament were adopted by PNG. PNG achieved formal independence in 1975, and the Constitution of the Independent State of Papua New Guinea was adopted. A large part of the statute law that was adopted at that time was derived from Australian law (including in the important areas of company law, income tax and stamp duty).

However, customary law also applies to a limited extent in some cases and, as this article will show, this often has an impact on oil and gas developments.

### **2.1 Promotion of foreign investment**

In recent years, significant attempts have been made to remove regulatory and administrative hurdles. The PNG Government has implemented the National Investment Policy, which aims to promote greater transparency and consistency in decisions relating to foreign investment. It has also established the Investment Promotion Authority and a Business Licensing and Information System to assist with the promotion and facilitation of foreign investment. Specific fiscal measures have also been adopted to reduce the tax burden on oil and gas projects – these will be discussed further below.

### **2.2 Political risk**

Political risk (normally regarded as comprising the risk of war, civil disturbance, expropriation and currency transfer blockage) is, as with most countries, a sensitive issue. In the authors' experience, political risk insurance is typically taken in connection with projects in PNG.

### **2.3 Oil And Gas Act**

The PNG legal issue that will have the most impact on the structuring of oil and gas projects in PNG is the *Oil and Gas Act 1998* (PNG) (the '*Oil and Gas Act*').

The *Oil and Gas Act* is an interesting and important piece of legislation. Its purpose is to seek to regulate petroleum prospecting, development and extraction while at the same time, to achieve social policy objectives. One of those objectives is to govern 'the grant to traditional landowners and Provincial Governments and Local-level Governments of benefits arising from projects for the production of petroleum (including oil and gas)'.

## **3. THE STAKEHOLDERS**

It will become apparent that it will be necessary for a developer to deal with, and to balance the needs of, three distinct groups of stakeholders during the course of planning and developing the project, namely:

- the State of Papua New Guinea (the 'State');
- traditional landowners; and
- provincial governments and local-level governments.

### 3.1 The State

The State can, of course, extract benefits from the project without taking an equity interest (through taxation, production royalties and the imposition of obligations with respect to the provision and maintenance of infrastructure). However, under the *Oil and Gas Act*, the State also has the option to acquire an equity interest in a petroleum development of up to 22.5 per cent.

The most obvious reason why the State might wish to take up an equity interest is that the dividends from the equity interest will provide a direct source of revenue to the State (thereby facilitating the distribution of the benefits of petroleum production to the people of PNG through government expenditure).<sup>3</sup> To some degree, it will also give the State direct influence in the direction of the project through its position as a minority interest holder.

However, another benefit of the equity entitlement is to enable the State to confer direct benefits from the project on traditional landowners and provincial and local-level governments. This will be discussed further below.

### 3.2 Traditional landowners

As in most parts of the world, there is a tension between the need to ensure that the petroleum regime does not discourage developers from investing the large amounts of capital necessary for the production of oil and gas, and the need to ensure that the local communities who are most affected by the development are adequately compensated for the hardships caused to them by the development. In PNG, there is the added element of a dispute as to the ownership of petroleum resources.

Again, consistent with most of the rest of the common law world, the State has claimed ownership of petroleum resources (which carries with it the ability to grant licences to persons to explore for, develop and exploit those resources) through the *Oil and Gas Act* and its predecessor legislation. The position under the *Oil and Gas Act* is quite clear: 'all petroleum and helium at or below the surface of any land is ... the property of the State.'<sup>4</sup> But, the position under customary law is that ownership of subsurface elements (including petroleum resources) vests with the customary owners of the land (whom this article will refer to as 'traditional landowners'), at least where customary law recognises a concept of ownership of subsurface elements.<sup>5</sup> Approximately 97 per cent of the geographical area of PNG is owned by traditional landowners. Even if only those traditional landowners whose customary law recognised the concept of ownership of subsurface elements asserted claims to ownership of petroleum resources, this could still, potentially, represent a claim to ownership of a significant amount of the petroleum resources in PNG.

Over the years, there has been legal and constitutional debate relating to this issue (including the debate as to whether the constitutional prohibition on compulsory acquisition other than for just

---

<sup>3</sup> The Department of Petroleum & Energy, Petroleum Division, Policy Handbook, April 2003 ('Petroleum Handbook').

<sup>4</sup> *Oil and Gas Act*, s 6.

<sup>5</sup> K Ongwamahuna and A Regan, 'Ownership of Minerals and Petroleum in Papua New Guinea: the Genesis and Nature of the Legal Controversy' (1991) 7 *Queensland University of Technology Law Journal* 109, 118; I Marru, 'Customary corporations as mechanisms for landowner representation and benefits distribution in petroleum development projects in Papua New Guinea', *PNG Department of Petroleum and Energy Development Bulletin* 60, December 2002, 54, 54.

compensation on just terms is breached by the vesting of title to petroleum resources in the State) and, regardless of the legal position, there is still the potential for traditional landowners to disrupt the smooth operation of the project if they do not regard themselves as being adequately compensated.<sup>6</sup>

While there have not been many instances of violent confrontation between traditional landowners in respect of petroleum projects,<sup>7</sup> Ongwamahuna and Regan<sup>8</sup> argue that there have been instances in the past in which the question of ownership of other minerals and the control of benefits arising from mining has been an important (if not dominant) factor in civil unrest (in some cases leading to civil war) (see, eg Bouganville and Ok Tedi).

In response to the concern about the ability of traditional landowners to disrupt projects, mining policy since 1988 has been to seek to confer direct financial benefits on traditional landowners without recognising their claims to ownership of the minerals. In the Kutubu project, the State ultimately yielded a share of its equity to landowners and provincial governments,<sup>9</sup> notwithstanding that the landowners had no rights to such equity under the predecessor legislation to the *Oil and Gas Act*.<sup>10</sup>

### 3.3 Provincial and local-level governments

Another factor that impacts on project development is the State's relationship with provincial and local-level governments. It is sometimes thought that the State's ability to exercise direct influence over provincial and local-level governments is limited.<sup>11</sup> As such, the ability to control the distribution of benefits from projects gives the State real power to reach into rural areas and ensure that provincial and local-level governments fulfil their social obligations to the community.<sup>12</sup>

### 3.4 Tenure

The position of traditional landowners is also highlighted by the mechanism for the grant of tenure to developers.

Recall that approximately 97 per cent of the geographical area of PNG is owned by traditional landowners. The *Oil and Gas Act* confers on a tenement holder rights to enter into, and occupy land in the licence area, subject to paying compensation to 'the lawful owners and rightful occupiers of, any persons interested in' land, including customary land.<sup>13</sup> This is coupled with a right of compulsory acquisition by the State;<sup>14</sup> and the compensation paid by the State is a debt due and payable by the tenement holder to the State.

---

<sup>6</sup> Ongwamahuna and Regan, n 5 above, at 112-23; The World Bank, Project Performance Assessment Report, Papua New Guinea, Petroleum Exploration Technical Assistance Project (Credit 1279-PNG), Petroleum Exploration and Development Technical Assistance Project (Loan 3670-PNG), 20 June 2002, para 5.7.

<sup>7</sup> The World Bank, n 6 above, at para 5.7.

<sup>8</sup> Ongwamahuna and Regan, n 5 above, at 110.

<sup>9</sup> The World Bank, n 6 above, at para 5.8.

<sup>10</sup> *Ibid.*

<sup>11</sup> *Ibid.*, para 5.7.

<sup>12</sup> *Ibid.*, para 5.9.

<sup>13</sup> *Oil and Gas Act*, s 118.

<sup>14</sup> *Ibid.*, s 120.

Consistent with the State's position on ownership of subsurface elements, compensation under the *Oil and Gas Act* is calculated without taking into account the value of petroleum or other subsurface elements.

#### 4. DEALINGS WITH ALL THE STAKEHOLDERS

The *Oil and Gas Act* sets out a structured process for negotiation between the stakeholders. The steps include:

- the creation of a development forum consisting of the State, traditional landowners who are 'project area landowners', affected local-level governments, affected provincial governments and developers; and
- the execution of a development agreement between the above-mentioned parties (other than the developers).<sup>15</sup>

The convening of the development forum is a condition of the first grant of a licence in respect of the petroleum project.<sup>16</sup>

At first glance, the concept of 'project area landowners' seems somewhat amorphous. However, section 47 of the *Oil and Gas Act* provides that it is a condition of a licence that the licensee undertake 'social mapping and landowner identification studies'. While not explicitly stated in the *Oil and Gas Act*, it is expected that the landowners will be represented by an incorporated land group.<sup>17</sup> A group of traditional landowners can apply for recognition as an incorporated land group pursuant to the *Land Groups Incorporation Act 1974* (PNG). A group that has been recognised as an incorporated land group has all the powers of a corporation, although those powers are limited to matters relating to land use and management, and must be exercised in accordance with applicable customary law.<sup>18</sup>

##### 4.1 Right of the State to buy in

Under section 165(1) of the *Oil and Gas Act*, the State has a right to acquire directly (or through a nominee) a participating interest in a petroleum project of up to 22.5 per cent.

The State will pay 'a percentage of the unrecouped sunk costs of the vendor attributable to the vendor's interest in the petroleum project' (section 165(3)).

This is a guiding principle only: section 183 provides for licensees to be able to enter into petroleum agreements with the State, and section 165(4) provides that the consideration payable by the State will be determined in accordance with the terms of such petroleum agreements.

The Department of Petroleum & Energy has developed a Standard Petroleum Agreement (dealing with issues such as state participation, landowner equity, import and export obligations, currency and exchange control and domestic requirements/local content). However, the Petroleum

---

<sup>15</sup> Ibid, s 50.

<sup>16</sup> Ibid, s 48.

<sup>17</sup> I Maru, 'Customary corporations as mechanisms for landowner representation and benefits distribution in petroleum development projects in Papua New Guinea', *PNG Department of Petroleum and Energy Development Bulletin* 60, 54, 55.

<sup>18</sup> *Land Groups Corporation Act 1974*, s 13(1).

Handbook stipulates that some of the provisions in the standard form contract can be varied in negotiations.

Insofar as the State's right to buy in is concerned, the Petroleum Handbook provides that the State or its nominee:

is also entitled to the benefit of a carry on all expenditure (including the initial purchase cost) from the other participants, to be repaid (together with a commercial rate of interest) out of petroleum production available to the nominee's share.<sup>19</sup>

#### 4.2 Direct distribution of benefits

Under section 167, an equity benefit (equal to a two per cent participating interest) is required to be held on trust for landowners and the affected local-level governments. The trustee of the equity benefit will be a wholly-owned subsidiary of Mineral Resources Development Company Limited (MRDC).<sup>20</sup>

The State (or its nominee) will bear the costs and liabilities of the equity benefit held on trust up until the commencement of commercial production, after which time, the trustee of the equity benefit is responsible for capital and operating expenses attributable to the interest in question.

Under section 159, a tenement holder is required to pay to the State a royalty equal to two per cent of the wellhead value of petroleum produced from the licence area. Under section 168, the State is required to pay to the trustee a royalty benefit (being the amount of the royalty less a withholding for taxes). The royalty benefit is to be shared between the landowners, local-level governments in the proportions agreed between them in the development agreement (and if there is no such agreement, in the proportions determined by the Minister).

#### 4.3 State as a participant

According to the Petroleum Handbook,<sup>21</sup> the State will exercise its right to acquire an interest in the project either through: the State itself; a company incorporated under the PNG *Companies Act*, MRDC, which is a wholly owned subsidiary of the State; or a State nominee (note that the State nominee may sometimes be a subsidiary of MRDC), (whom this article will refer to as the 'state participant').

Once the state participant acquires an interest in the project, the state participant will become a full joint venture participant and will, subject to a few exceptions (see 'Right of the State to buy in' and below), have the same rights and obligations as any other participant.

PNG oil and gas projects often use the unincorporated joint venture transaction structure, which means (in brief terms) that:

- The relationship between participants is primarily contractual (embodied in a joint venture agreement or unit agreement). For tax and accounting purposes, each participant is separate

---

<sup>19</sup> Petroleum Handbook, para 4.2.3.

<sup>20</sup> *Oil and Gas Act*, s 176.

<sup>21</sup> See also the World Bank, n 6 above, at para 3.6.

from the joint venture itself. No participant can bind another participant; nor is a participant liable to third parties for the act of another participant.

- Each participant separately appoints the operator or manager its agent and each joint venturer is separately liable to the operator/manager.
- Each joint venturer is separately entitled to their share of product and is separately entitled to market that product.

In support of its obligations, each joint venture participant will grant security in favour of the operator/agent and each other in support of their respective obligations to the operator/agent and each other (a 'cross-charge').

Therefore, the state participant will be a party to the joint venture agreement/unit agreement, and will grant a cross-charge.

MRDC and its subsidiaries are companies incorporated under the *Companies Act*. As such, as a general principle, they can sue and be sued in the same way as other companies incorporated under the *Companies Act*. However, it seems from recent cases<sup>22</sup> that there may be some inclination in judicial circles to afford some immunities which are traditionally regarded as State immunities to at least MRDC (and possibly its subsidiaries). In the cases cited, it was held that section 13(1) of the *Claims By and Against the State Act* 1996 (which provides for immunity from execution or attachment or equivalent process) applied to MRDC.

#### **4.4 Landowners as a participant**

Once the trustee for the landholder's equity benefit becomes responsible for capital and operating expenses, it will also grant a cross-charge to secure performance of its obligations.

#### **4.5. Provision of infrastructure**

In addition to other benefits, under section 173 of the *Oil and Gas Act*, the State also has an obligation to provide 'infrastructure, services or other benefits' to affected local-level governments and provincial governments in relation to the petroleum project. The amount and nature of such benefits is to be agreed in the development agreement.

The *Oil and Gas Act* contemplates that such infrastructure or other benefits may sometimes be funded by the licensee. If it is funded by the licensee, the costs of such infrastructure or benefits may be credited as income tax paid, subject to certain limitations.<sup>23</sup>

### **5. OTHER SOCIAL OBLIGATIONS**

There are a variety of other provisions in the *Oil and Gas Act* that seek to engineer direct benefits for the local community and the PNG economy:

---

<sup>22</sup> *Okam Sakarius v Chris Tep* (2003) N2355, National Court, 28 March 2003; *Puran v Ase Tipurupeke Land Group Incorporated*, National Court, 7 April 2005.

<sup>23</sup> See *Oil and Gas Act*, s 173(4).

- there is an obligation to sell processed petroleum within PNG, if such petroleum can be sold on terms equivalent to export terms;<sup>24</sup>
- there is an obligation to purchase goods and services locally where they can be obtained on terms equivalent to import terms;<sup>25</sup> and
- there is also an obligation to ‘encourage and assist’ PNG citizens who wish to establish businesses providing goods and services for the project or a town constructed for the purposes of the project.<sup>26</sup>

## 6. FISCAL REGIME AFFECTING THE PROJECT

A detailed study of the tax regime affecting petroleum projects is beyond the scope of this article. However, it is worth noting that in recent years, a number of changes have been made with a view to encouraging the development of oil and gas projects:

- a concessional corporate tax rate of 30 per cent applies to grantees of petroleum prospecting licences between 1 January 2003 and 31 December 2007 from which a petroleum development licence is granted before 31 December 2017; and
- the controversial additional profits tax has been abolished.

In addition, the following levies are payable:

- royalties (as noted above); and
- a development levy,<sup>27</sup>
- and are both calculated at the rate of two per cent of the wellhead value of petroleum produced from the licence area.

## 7. PETROLEUM AGREEMENT

Before moving on, it is worth mentioning a few more words about the concept of the petroleum agreement (which, as can be seen from the above, is a very important document). It has become even more important in recent times as a consequence of amendments to section 183 of the *Oil and Gas Act*, which now provides that ‘such agreement will, once executed, have effect in accordance with its terms and notwithstanding any other provisions of this Act’.

## 8. OTHER ISSUES RELEVANT TO PROJECTS

### 8.1 Foreign investment restrictions

Foreign enterprises are likely to require a certificate from the PNG Investment Promotion Authority under the *Investment Promotion Act 1992* (PNG) (the ‘*IP Act*’), before they are permitted to carry on business in PNG. There may also be obligations to recertify if there is a change in ownership of that foreign enterprise which meets specified threshold levels.

---

<sup>24</sup> Ibid, s 67.

<sup>25</sup> Ibid, s 129.

<sup>26</sup> Ibid, s 129(1)(c).

<sup>27</sup> Ibid, s 160.



The *IP Act* also contains a number of protections and benefits for foreign investors, which apply except where there is a bilateral or multilateral trade agreement which is more favourable to the foreign investor:

- section 37(2) provides that the property of a foreign investor will not be expropriated except in accordance with law, for a public purpose and in payment of ‘compensation as defined by law’; and
- section 37(4) provides that subject to existing laws or any agreement between the State and a foreign investor, no rate, tax, rent, charge, due, duty, tariff or other levy or related procedure or practice will discriminate against a foreign investor or its investment on the grounds of its origin.

Section 37(3) gives foreign investors the right, subject to taxation and exchange control, to:

- remit overseas earnings and repatriate capital; and
- remit amounts necessary to meet payments of principal, interest and service charges, similar liabilities on foreign loans and the costs of other foreign obligations that are approved by the State.

However, exchange controls do impose real restrictions on these activities and, as such, this article will need to examine them further.

## 8.2 Currency exchange issues

### 8.2.1 Finance documents

There is a system of exchange control in PNG which is administered by the Bank of Papua New Guinea. Those controls will have an impact on how a transaction is structured. Any person who borrows foreign currency from a foreign lender will require a number of approvals:

- an approval to borrow from, or lend money to, a person outside PNG (whether in foreign currency<sup>28</sup> or PNG currency<sup>29</sup>); and
- an approval to transfer money out of PNG (ie repayments), whether the transfer is in PNG or foreign currency.<sup>30</sup>

This will entail the Central Bank reviewing the terms of the finance documents (including the security documents). The practice of the Central Bank is to grant its approval to the terms of the finance and security documents.

The security package for PNG petroleum projects will also commonly involve an export contract and the requirement for proceeds under that contract to be paid into an offshore bank account. The opening and operation of that account will require Central Bank approval, even though the export contract and the operation of the bank account will not involve any movement of currency in and out of PNG. The Central Bank has recognised that such offshore bank accounts form an integral

---

<sup>28</sup> *Central Banking (Foreign Exchange and Gold) Regulation 2000*, reg 6.

<sup>29</sup> *Ibid*, reg 10.

<sup>30</sup> *Ibid*, reg 7.

part of any offshore financiers' security package, and it is willing to grant approval for such bank accounts. However, once moneys cease being subject to the financiers' security package, it seems that the Central Bank will (in the absence of anything else) require that moneys be repatriated to PNG. For example, in project financings, once money is (according to the terms of financing documents) available for distribution to the sponsors, it will often be transferred from an account that is subject to the financiers' security to an account that is not so subject (eg a 'distribution account'). The Central Bank will not, it seems, grant approval to the maintenance of distribution accounts offshore. Even where no distribution account mechanism is used, it seems that the Central Bank may look closely at whether any funds in an offshore bank account, which are clearly surplus to the financiers' security package, should be repatriated. While this position is understandable from the Central Bank's perspective, from the position of the financier, it obviously poses some issues with respect to the certainty of their security.

The Central Bank will have views on what is an appropriate margin for a project and where political risk insurance is taken, what is an appropriate political risk insurance premium, and may withhold approvals if it is not satisfied with either of them.

Failure to comply with the foreign exchange control requirements in PNG will not affect the validity or enforceability of the transaction,<sup>31</sup> but it will constitute an offence. Furthermore, a court may require that property obtained by reason of a contravention be sold, and if the person fails to comply with the sale order, that it be vested in the Central Bank.<sup>32</sup>

### 8.2.2 Sponsor issues

The regulations also cover the repatriation of dividends paid by a PNG company, and a separate approval will be required by the tax authority ('the IRC').

However, as noted above, there will be provisions in the petroleum agreement dealing with the repatriation of profits. Those petroleum agreements will deal with matters such as:

- appropriate debt-to-equity ratios;
- the amount of profit or other amounts available for repatriation; and
- the timing of such repatriation.

## 8.3 Taking security

### 8.3.1 Registration of personal property security interests generally

Like England and Australia (but unlike the United States, Canada and New Zealand), there is no uniform system of registration of personal property security interests given by persons in PNG. Rather, there are numerous ad hoc laws relating to the registration of security over personal property. The applicable system of registration of personal property securities will depend on the identity of the person giving the security, the form of the security and the nature of the property being secured.

---

<sup>31</sup> Ibid, reg 5A.

<sup>32</sup> Ibid, reg 22.

Generally speaking, security interests given by PNG companies are required to be registered with the PNG Companies Register.

Stamp duty is payable in connection with security interests (although securities are typically stamped collaterally to the facility agreement) at the rate of 0.1 per cent of the amount advanced. It is necessary to lodge a separate certificate that applicable stamp duty has been paid at the time of registration with the PNG Companies Register.

### 8.3.2 Mining tenements

It will also be necessary to comply with requirements in respect of security interests granted over tenements. Section 100(1) of the *Oil and Gas Act* states that section 100 of the Act applies to: ‘instrument[s] by which a legal or equitable interest in, or affecting, an existing or future licence is or may be created, assigned, affected or dealt with, whether directly or indirectly, not being an instrument of transfer.’

It is not possible to do any of the things referred to in section 100(1) without an instrument,<sup>33</sup> and section 100(2) provides that:

- an instrument to which this section applies is of no force or effect until –
- (a) the instrument has been approved by the Minister<sup>34</sup> either unconditionally or subject to such conditions as he thinks fit; and
  - (b) an entry has been made in the Register by the Director.

That is, the instrument derives its force from the approval of the Minister and the act of registering the instrument under the *Oil and Gas Act*.

A number of interesting issues arise:

- What is the effect between the parties of an instrument that has not been approved and registered?
- If an instrument has not been approved and registered, what is the effect of that part of it which does not create, assign, affect or deal with, whether directly or indirectly, a legal or equitable interest in, or affecting, an existing or future licence?
- What effect would the imposition of conditions to the approval of an instrument have on the *terms* of that instrument, either as between the parties or with respect to the security interest created?

Those issues are largely beyond the scope of this article.

However, from a financiers’ perspective, the ideal position would obviously be for the instrument to be approved and registered under section 100 of the *Oil and Gas Act* unconditionally prior to drawdown. Given that local advice suggests that the process normally takes approximately 90 days, this poses real issues from a planning perspective.

---

<sup>33</sup> *Oil and Gas Act*, s 99.

<sup>34</sup> The Minister for Petroleum and Energy.

## 8.4 Issues for borrowers

It is often the case that the governing law of the facility agreement is not the same as the law of the jurisdiction in which the assets are located. It is a well recognised principle of English law<sup>35</sup> and Australian law<sup>36</sup> that a party will only be excused from performing its obligations if it is illegal 'by the law of the country in which, according to the express terms of the contract, the obligation has to be done'.<sup>37</sup>

Where the facility is a syndicated facility, and lenders can transfer their participations without the consent of the borrower, it is up to the borrower to ensure that the consents and authorisations extended to any person who might, in the future, become a lender. Indeed, the borrower will typically warrant that all necessary consents and authorisations are in place.

This obviously poses a risk for borrowers (as well as existing lenders). A better way of dealing with this approach is to deal specifically with the process and responsibility for obtaining consents and authorisations to incoming lenders.

## 8.5 Taxation issues for financiers

### 8.5.1 Withholding tax

In common with many jurisdictions in the world, interest withholding tax is payable on interest payments to non-residents (currently at the rate of 15 per cent).<sup>38</sup> This means that the borrower (being the payer of the interest) is liable to deduct the amount of the withholding tax from the interest payment made, and remit it to the IRC.

### 8.5.2 Interest gross-up clauses

Of course, financiers do not normally accept that their interest payments will be reduced in this way, and it is standard practice for financiers to require the inclusion of a 'gross-up clause' in their finance documents. The effect of such clauses is to increase the amount of the interest payable so that, after the deduction is made, the financier receives the same amount it would have received had the deduction not been made.

However, section 362(1) of the *Income Tax Act 1959* (PNG) renders void a clause 'in a mortgage that has or purports to have the purpose or effect of imposing on the mortgagor the obligation of paying tax on the interest to be paid under the mortgage'.

This clause is almost identical to the old section 261 of the *Income Tax Assessment Act 1936* (Cth of Australia) (*ITAA*) (which was repealed in 1996). For many years, it was believed that it was possible to avoid the effect of section 261 of the *ITAA* by including the gross-up clause in the facility agreement (rather than the mortgage or other security document) and excluding the obligation to gross up from the secured money under the mortgage or other security document.

---

<sup>35</sup> Dicey and Morris, *The Conflicts of Laws* (12th edn, 1993), 1244; *Kleinwort, Sons & Co v Ungarische Baumwolle Industrie AG* [1939] 2 KB 678.

<sup>36</sup> E Sykes and M Pryles, *Australian Private International Law* (3rd edn, 1991), 615.

<sup>37</sup> *Kleinwort, Sons and Co v Ungarische Baumwolle Industrie AG* [1939] KB 678; *The Argo Fund Limited v Essar Steel Limited* [2005] 2 Lloyd's Rep 203.

<sup>38</sup> *Income Tax Act 1959* (PNG), s 186(2).

However, in 1992, in *David Securities Pty Ltd and Ors v Commonwealth Bank of Australia*<sup>39</sup> the High Court of Australia held that section 261 extended to gross-up clauses in facility agreements.

In Australia, various practices developed to try to accommodate the needs of financiers with respect to gross-up clauses following this decision, including the practice of choosing ‘voluntarily’ to make payments under a void gross-up clause (there were various incentives to ensure the correct choice was made!) and undertaking not to seek restitution for those voluntary payments.

Some of these practices were quite blatantly contrived. Given that the Central Bank needs to approve finance documents, both financiers and borrowers are advised to be cautious about how they go about accommodating the needs of financiers in this respect.

#### 8.5.3 Deemed source of income for financiers

Another potential concern for financiers is section 46(2) of *Income Tax Act 1959* (PNG), which has the effect of deeming their income from a loan to be derived from a source in PNG as a consequence of taking security over assets located in PNG.

Section 46(2) of *Income Tax Act 1959* (PNG) provides:

Interest (except interest paid outside Papua New Guinea to a non-resident on debentures issued outside Papua New Guinea by a company) upon money secured by mortgage of any property in Papua New Guinea shall be deemed to be derived from a source in Papua New Guinea.

If this section applies, it requires a financier to lodge a PNG tax return and pay tax on the profit element in that interest (the financier should be entitled to a deduction for their own expenses incurred in earning that profit) at the applicable PNG corporate tax rate.

Read literally, it subjects to PNG income tax the profit in respect of all the interest on the relevant loan (that is secured by the property in PNG), regardless of the fact that the value of the security may be less than the secured money.

All parties to a transaction should look at ways of structuring the transaction so that section 46(2) of *Income Tax Act 1959* (PNG) does not apply.

## 9. CONCLUSION

This article has attempted to summarise some of the more interesting aspects of undertaking oil and gas projects in PNG. It is by no means a summary of all relevant legal or commercial issues.

The large number of stakeholders, and the large number of approvals that might be required might at first glance seem daunting, but it is hoped that, with proper understanding and planning, potential developers can work with, and through, these issues.

---

<sup>39</sup> (1992) 175 CLR 353.