Practical Implications of East Timor’s Transition to the Timor Gap Treaty

Jim Godlove*

SUMMARY

The Timor Gap Zone of Cooperation is an intriguing legal and political phenomenon borne out of a long-standing dispute over the maritime boundary between East Timor and Australia. It provided a practical solution that was intended to and has indeed fostered substantial investments in petroleum exploration and exploitation without jeopardising the positions of the States in reaching a final delimitation agreement over the seabed.

This paper examines briefly the history of this area and the opportunities that exist to establish a significant new petroleum province that will provide meaningful economic benefits to East Timor and Australia. It focuses primarily on the issues related to East Timor’s transition to an independent nation and the effect this change will have on the future of the Timor Gap Treaty and those petroleum operations that are founded on its terms.

Phillips Petroleum Company (91-12) Pty Ltd, as operator of the Bayu-Undan project, has undertaken extensive consultations with East Timor, the United Nations Transitional Administration in East Timor (UNTAET), and Australia in regard to the future of the Treaty and the security of its investment in the project. Maintaining the current legal, fiscal and administrative regime applying to Bayu-Undan is fundamental to the interests of project participants, financiers and potential markets.

The paper describes the transitional process as it coincided with decisions taken during the past eighteen months to advance development of Bayu-Undan and the steps Phillips undertook to assure that project development was not adversely affected. Based upon first hand experience, Phillips is confident that practical solutions in relation to the Timor Gap Treaty will continue to prevail to support

* BS MS Civil Engineering (USA); Phillips Petroleum Company, Darwin, NT.
project development and to realise its substantial value to East Timor and Australia.

BACKGROUND

Matters relating to maritime borders within the Timor Sea have been the subject of intense negotiations and debate for several decades. Through a series of individual treaties, Australia and Indonesia have defined their maritime boundaries in this region. Delimitation of the seabed boundary between Australia and East Timor, however, has never been resolved. This gap of 129 nautical miles, over which boundaries have not been agreed, is known as the “Timor Gap”. It remains one of the most intriguing topics in the interrelated world of maritime law and offshore petroleum exploration and development.

Following Indonesia’s annexation of East Timor in 1975, negotiations commenced between those two nations to establish a single seabed boundary in this long disputed area. In December 1989, the Timor Gap Treaty was signed establishing an area of approximately 60,000 square kilometres known as the “Timor Gap Zone of Cooperation”. The Treaty focused solely on the exploration and exploitation of the petroleum resources in this area. It provided a practical, if interim, solution to petroleum development in this area and established an innovative approach to sharing revenue and other benefits from such activities within the Zone of Cooperation.

The Treaty entered into force in February 1991 for an initial term of 40 years that, in the absence of an intervening boundary agreement, was renewable for successive 20 year terms. It established a provisional, legally binding regime for administering petroleum operations in this area pending a final decision on the seabed boundary in the Timor Gap area. It preserved, without prejudice, the claims of both States (and now, those of East Timor) in relation to delimitation of the continental shelf. Three geographically and legally distinct areas were established within the Zone of Cooperation with Area A (ZOCA) subject to joint administration on behalf of the two States. The other two areas to the north and south of Area A were subject to administration by their respective State and to specific revenue sharing arrangements between the States.

Under the 1989 Treaty, the States transferred their sovereign rights over petroleum resource development within Area A to a Joint Authority, subject to instruction from a Ministerial Council composed of an equal number of ministers from each State. Exploration and development operations within Area A are administered by and
proceed only with the approval of the Joint Authority. The Treaty established individual Production Sharing Contracts (PSC) and a Petroleum Mining Code that govern all petroleum operations within Area A. In addition to this solid legal and administrative framework, the Treaty also established a secure and equitable fiscal regime involving production sharing arrangements between the contractors and the States and a code relating to double taxation issues.

The Joint Authority awarded the first Production Sharing Contracts (PSC) over Area A in 1991. PSCs are enforceable, private law contracts between the contractors (or group of contractors) and the Timor Gap Joint Authority. Each PSC is offered on a 10-year term during which period the contractors must undertake a specific, approved work programme. If by the end of year 10, a commercial petroleum discovery is not declared and a development programme approved, the balance of the PSC area, not previously relinquished during the term of the contract, would be forfeited. This practical process of relinquishment and forfeiture according to a strict schedule assures that investigation and development of petroleum resources within ZOCA is thorough and proceeds without undue delay.

VIEWS ON THE TIMOR GAP

The Timor Gap Treaty has been successful in facilitating significant investments in petroleum exploration and development despite the lack of resolution on a seabed boundary within the Zone of Cooperation. It was an innovative, if controversial, approach to further such developments. Considering the recent emergence of East Timor as an independent state, investments in petroleum operations over the past eight years as a consequence of the Treaty have been well timed and will assure a significant and stable source of internal revenue for decades for this new nation. These revenues are expected to become significant soon after their independence is declared.

The level of proven reserves identified within ZOCA is sufficient to encourage and sustain robust exploration and development activities for years to come. The area provides a good mix of near-term and long-term development prospects. As these developments progress, significant employment and economic opportunities will be created within the region for all stakeholders.

ZOCA holds a central position in a world-scale gas province in the Timor Sea. Two major discoveries, Bayu-Undan on the west and Greater Sunrise on the east, provide the catalyst for other
developments within and outside of ZOCA. These field’s large reserves are sufficient to support a major regional gas gathering and transportation infrastructure that will encourage development of smaller fields that may otherwise be marginal or undeveloped. Markets for Timor Sea gas are available and these resources are well situated to capture a major share of recovering gas markets in Asia, including the possibility of liquified natural gas (LNG) exports.

The prerequisite to maintain the momentum that has developed over the past decade is a stable and secure legal, fiscal and administrative regime that continues for the full life of each project. Large resource developments require equally large financial commitments by developers and financiers. Long-term security for those investments is fundamental to their success. The ongoing Treaty transition process is a bellwether to demonstrate that those critical factors will be sustained. Without such security important gas marketing opportunities, and the significant value they represent, would be lost to other regions.

THE OPPORTUNITIES

Investments within ZOCA over the past eight years have been significant and fruitful. Despite its immaturity as a petroleum province, crude oil production within ZOCA has already commenced and several other major petroleum projects are in varying stages of approval and/or development.

The Elang-Kakatua field, comprising two small crude oil accumulations, was discovered by the BHP Petroleum led PSC 91-12 joint venture in 1994 and has been producing since August 1998. In April 1999, Phillips Petroleum (91-12) acquired the BHP subsidiary holding interest in PSC 91-12 and assumed operatorship of the fields at that time. Developed at a cost of approximately US$100 million, oil production from these small fields peaked at 40,000 barrels per day shortly after startup and is currently producing approximately 16,500 barrels per day. This field is expected to continue crude oil production until at least mid-2001 generating revenue for both Australia and East Timor.

The larger Bayu-Undan field was discovered by the Phillips’ led PSC 91-13 group in 1995. It is situated approximately 500 kilometres northwest of Darwin and 250 kilometres south of Suai and straddles PSC blocks 91-12 and 91-13 in Area A. The field covers an area of 160 square kilometres and is located in approximately 80 metres of water. Since 1995 a total of 10 discovery and appraisal wells have been
drilled. Independent estimates of the recoverable reserves from this world scale gas and gas-condensate resource are 400 million barrels of condensate (a light oil) and liquefied petroleum gas (LPG) and 3.4 trillion cubic feet of natural gas.

Phillips is the operator of the Bayu-Undan unit development. The project co-venturers (Contractors) and their current participating interests in Unit operations, are:

<table>
<thead>
<tr>
<th>PSC 91-12 (Undan)</th>
<th>PSC 91-13 (Bayu)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Phillips Petroleum 91-12</td>
<td>23.4%</td>
</tr>
<tr>
<td>Santos</td>
<td>11.8%</td>
</tr>
<tr>
<td>Inpex</td>
<td>11.7%</td>
</tr>
<tr>
<td>Petroz/Emet</td>
<td>8.3%</td>
</tr>
<tr>
<td>55.2%</td>
<td>44.8%</td>
</tr>
</tbody>
</table>

Bayu-Undan is being developed in two distinct phases with the first phase of the project, known as the “Gas Recycle Project”, estimated to cost US$1.4 billion.

The first phase has been approved and involves the installation of facilities offshore to produce and process natural gas to recover gas liquids (condensate and LPG). During this phase, dry gas (following liquids extraction) will be recycled back into the reservoir. Bayu-Undan represents the first commercial development of gas resources within the Timor Sea, reversing almost 30 years of delay since discovery of the first large gas fields in this area. It is ironic that a field within the long disputed Zone of Cooperation is responsible for this change of fortune.

The second phase of development at Bayu-Undan will involve gas export by subsea pipeline from the field to a destination near Darwin. Phillips is actively pursuing a number of commercially attractive gas markets in the Northern Territory and interstate in addition to potential liquefied natural gas markets in Asia. The decision and timing of the second phase will be driven by the availability of sufficient markets to enable approval and construction of an export pipeline.

Another significant gas resource, collectively known as the Greater Sunrise field, is located to the northeast of Bayu-Undan. This resource is located in 160 to 500 metres of water and includes the Sunrise and Troubadour fields located in Australian waters adjacent to the Zone of Cooperation (including NT/RL-2 and NT/P55). Approximately 20 percent of this resource area may lie within ZOCA (including PSC 95-19 and PSC 96-20). The estimated recoverable reserves in these fields exceed 8 trillion cubic feet of gas and 280 million barrels of condensate. Phillips, through various subsidiary
companies, holds interests ranging from 8.3 to 33.3 percent in these Woodside-operated fields.

Without the Treaty, the progress currently being made to develop each of these fields would not have been possible. Investments that have been made to explore for other fields in this area would likely have been deferred as well. Clearly the Treaty has worked well and to the mutual benefit of East Timor, Australia and the PSC contractors.

THE TRANSITION – A PRACTICAL SOLUTION

During the past year, development of the Bayu-Undan project has been inextricably linked, both privately and publicly, with the evolution of an eventually independent East Timor. This situation provides a good example of how parties with mutual interests can work cooperatively, against seemingly impossible odds and regular predictions of failure from various skeptics, to achieve a solution that fulfills the needs of each.

Over the past 18 months many important milestones for Bayu-Undan have coincided with equally important events in the evolution of East Timor as a sovereign nation. This made consideration of the fate of the Treaty a paramount concern for the co-venture. The following briefly summarise a few of those events.

- The transition from the Suharto to the Habibie government in Indonesia, which accelerated long delayed discussions on the future status of East Timor, coincided with Phillips’ acquisition of the BHP Petroleum’s assets in PSC 91-12.
- The United Nations negotiated “Agreement between the Republic of Indonesia and the Portuguese Republic on the Question of East Timor” of 5 May 1999 coincided with the finalisation of unitisation discussions between the PSC 91-12 and PSC 91-13 co-venturers.
- Approval of the Bayu-Undan Gas Recycle Project by the unit participants coincided with the UN Security Council Resolution implementing a transitional administration in East Timor.
- Approval of the Bayu-Undan Gas Recycle Project Development Plan followed closely the exchange of diplomatic Notes in which the United Nations Transitional Administration in East Timor (UNTAET), on behalf of East Timor, assumed the rights and interests previously held by Australia’s former partner in the Timor Gap Treaty.

These examples demonstrate how closely related important project decisions have been to the changing status of East Timor and its decisions regarding the Treaty.
Investment in the Bayu-Undan project involves major commitments by each of its co-venture participants. Due to the size of the resource, the project will have an economic life in excess of 20 years. These investments require the confidence and support of international financiers, risk management organisations, and the markets. Without the security of a stable legal, fiscal and administrative regime covering investments within the Zone of Cooperation for their full life, such commitments and support would not be possible. Development of the project would have been deferred.

To advance the project it was critical to remain informed on matters relating to potential changes in the sovereign status of East Timor, to assess the consequences of such changes on the Bayu-Undan project and to advocate sensible solutions consistent with our legal and fiduciary responsibilities.

Just as the original Timor Gap Treaty provided a practical solution to an intractable dispute over the seabed, an equally practical solution was needed to accommodate the transition to an independent East Timor. There would be no easy answer. Such a situation had never been addressed in practice. It was a challenge requiring international diplomacy, creativity and confidence that an acceptable solution could be achieved within a relatively short period of time.

As with all such problems, it was important to focus on the interests of the parties in crafting a solution to address those interests. Continued development of petroleum resources within the Zone of Cooperation was of paramount importance. The imminent development requirements of the Bayu-Undan project provided additional motivation to achieve a suitable outcome. The following summarise some of those key interests.

The Bayu-Undan participants had made significant investments in petroleum exploration and appraisal, conceptual and preliminary engineering studies, the preparation of development plans for the project, and gas marketing investigations. Any delay in moving ahead with procurement and construction would have an adverse economic consequence of the project. The terms of their PSC agreements also required that decisions regarding field development be approved by the Joint Authority before the end of 2001. Financial commitments, however, required the participants’ legal rights under the PSCs and the fiscal terms applicable to the project to be assured for the full term of the development. Such commitments were critical to secure commitments from the financial community and customers for Bayu-Undan gas.

The Commonwealth of Australia was facing the emergence of a newly independent neighbour whose success was strategically
important for regional stability and potential petroleum resource and related economic development. Decisions regarding its maritime boundary with East Timor would be an eventual topic of negotiation and success in addressing the future of the Timor Gap Treaty would be a bellwether to its future relations with the new nation. Due to the depth of the Timor Trough, located north of ZOCA, the only viable destination for natural gas transported by pipeline from central Timor Sea fields was northern Australia. Consequently, to maintain existing and encourage new investments in the gas-oriented Zone of Cooperation, agreement on the future of the Treaty was critical.

East Timor was engaged in a process that would move it closer to achieving its long desired goal of independence. Agreement on the Timor Gap Treaty would be among the first acknowledgements of its sovereign rights as an independent nation. To assure the evolution of a robust and self-sustaining economy, they would need to maximise the development of their natural resources. The Timor Gap area represented a major near-term opportunity to capture significant revenue, provide for both direct and indirect economic growth, and create high valued employment prospects for East Timorese citizens. However, to achieve these goals, continued investments by the PSC contractors would be required. Providing a reasonable level of assurance to investors consistent with East Timor sovereign interests was needed.

There were two principal challenges relating to the Treaty. Who would speak for East Timor during its transition to independence and how could the PSC contractors be assured that their rights would be maintained during and following the transition process?

The answer to the first question was facilitated when the UN Security Council approved Resolution 1272 on 25 October 1999 which established UNTAET and endowed it with full legislative, regulatory and diplomatic powers in relation to East Timor. On 10 February 2000 UNTAET and Australia exchanged diplomatic notes wherein UNTAET, in consultation with East Timorese leaders, assumed the rights and obligations under the Treaty previously held by Indonesia. This agreement constituted yet another practical arrangement that provided for the continuation of the terms of the Timor Gap Treaty during the transitional period. UNTAET would speak for East Timor during this period in all matters, including those relating to the Timor Gap. Within two weeks, on 23 February 2000, the Joint Authority approved the Bayu-Undan Gas Recycle Development Plan allowing that phase of the project to continue without delay.

In the intervening months Australia and UNTAET, in consultation with East Timor, have worked cooperatively to maintain an effective
and efficient Joint Authority. In April 2000, Australia enacted the Timor Gap Treaty (Transitional Arrangements) Act, which ratified the exchange of Notes and validated all administrative actions taken in relation to ZOCA during the period from 25 October 1999. This legislation and recent actions by those associated with administering ZOCA have assured a smooth and seamless transition for the Timor Gap Treaty and continued progress for Bayu-Undan.

As important as maintaining a credible administrative authority is, assuring continuation of the legal and fiscal regime affecting the project is crucial to progressing the project. The diplomatic Notes specify that the position of an independent government in East Timor is not prejudiced by this transitional arrangement. How is Phillips addressing this uncertainty which cannot be removed until a fully-sovereign East Timor takes a final decision on the Treaty? What are the practical implications for Bayu-Undan and other near term investments in ZOCA?

KEEPING THE FAITH

The Timor Gap Treaty, while innovative, has been the subject of controversy since its inception in 1989. Several legal challenges questioning its validity were lodged during the past decade. While it is fair to observe that these challenges were directed more at the authority of the parties to enter such an agreement, rather than to the substance of the agreement, nevertheless East Timorese have consistently disavowed a willingness to “succeed” to the Treaty.

What was needed was a practical process to assure the terms of the Treaty continued during the transitional period, to allow Australia and East Timor to initiate discussions on sustaining resource development in the Zone of Cooperation, to demonstrate that the rights of the PSC contractors would be preserved, and to encourage the PSC contractors to progress individual projects and demonstrate the value associated with resource development in this area.

Well before the Notes were agreed, it was obvious that Phillips and the East Timorese leadership needed to reach an understanding regarding the Treaty and its critical role in advancing the Bayu-Undan project. The Timorese were adamant they were “not going to be a successor to an illegal treaty”.1 They were equally as forthcoming, however, with their support for the project and continued petroleum development within the Zone of Cooperation. While legally binding commitments were not possible in this circumstance, both parties

---

exchanged assurances and agreed to act accordingly in all future matters relating to the ZOCA.

The East Timorese acknowledged the importance of the legal and fiscal terms of the current Treaty to the PSC contractors. There was an undertaking that these terms would continue for the full term of the project and that East Timor's tax policies applicable to the project would be no more onerous than those prevailing prior to the transition period. In recognition of these commitments, the contractors undertook to conditionally move the Bayu-Undan project forward and to cooperate in the timely development of the human and physical resources of East Timor.

Now, nine months on from the Security Council Resolution, those understandings still guide the actions of all parties. The diplomatic Notes assured that the terms of the Treaty continue during the transitional period. Commitments to and approvals of the first phase of development for Bayu-Undan have been given. Discussions regarding East Timor's taxation policies are proceeding based on the "no more onerous" philosophy. These are very positive developments.

It has been reported in the media that UNTAET, on behalf of East Timor, has initiated negotiations with Australia regarding the Zone of Cooperation. These reports suggest that UNTAET is seeking to conclude a boundary agreement that would maximise long-term revenue for East Timor and that Australia is "willing to negotiate a new agreement in time for independence, but unlikely to concede ground on the boundaries of the Zone of Cooperation". It has been further reported that such an agreement would proceed "without prejudice to the companies" regarding their rights and interests within ZOCA.

So long as the rights of the PSC contractors are not disturbed, agreements relating to seabed boundaries and/or the distribution of government revenues derived from the Zone of Cooperation among the States are matters solely for the States to decide. With regard to delimitation of the seabed, Art 34 of the Treaty, whose terms are still in effect, provides that PSCs shall continue to apply under a regime that is no more onerous than set out in the Treaty and the relevant PSCs. With regard to fiscal terms, Phillips has been reassured that negotiations are limited to matters between the States and will not change either the current terms of the production sharing contracts or the economic effect of taxation policies applicable to the contractors.

As recent events demonstrate, the East Timorese have an understandable desire to assure that petroleum resource development within the Zone of Cooperation continues unimpeded. This view has

been applied equally to both liquid and natural gas resources. While liquid projects, such as Elang-Kakatua and the first phase of Bayu-Undan, can be fully developed within the boundaries of ZOCA, for economic reasons natural gas will need to be exported by subsea pipeline from ZOCA to various gas utilisation customers located in Australia.

While the Treaty establishes a firm fiscal regime relating to sales of crude oil from ZOCA, its treatment of gas exported from the area is not as clearly defined. The key fiscal outstanding issues relating to gas are the point of valuation and the method of valuation. Phillips has discussed this critical matter with both UNTAET and East Timorese representatives and Australia. They are aware of its importance in relation to concluding gas sales contracts. Despite a history of difficult discussions on this longstanding matter, Phillips is confident that a binding gas fiscal arrangement between East Timor and Australia can be concluded soon.

In keeping faith with our commitments to East Timor, the Bayu-Undan project participants are working diligently to demonstrate its value during the transitional period so that final decisions relating to the Treaty can be made as quickly as possible and based upon proven results.

The advanced status of the project is the most obvious proof of its value. By the end of calendar year 2000, commitments for approximately US$1 billion of equipment and services will have been issued and fabrication on numerous major facilities will have commenced. In early 2002 drilling of 16 production wells and initial installation of the offshore facilities will have commenced. By early 2004 the Gas Recycle Project will be producing over 100,000 barrels per day of condensate (a light oil) and liquefied petroleum gases (propane and butane). It is our goal to initiate export and sales of Bayu-Undan gas shortly after the liquids facilities commence operation, which will add further to the value of the project.

But our contribution to the future of East Timor is about more than generating production and tax revenues. The Bayu-Undan participants are committed to being a good neighbour and a good corporate citizen as well.

Offshore petroleum operations in general, and the Bayu-Undan facilities in particular, are technologically advanced and require highly experienced operational staff. Working with an international group of companies and governments, progress is being made to develop and implement a comprehensive training and education programme so that the people of East Timor will be able to qualify for employment in their country’s petroleum operations. The long-
term nature of most of the developments in the Zone of Cooperation means there will be significant direct and indirect employment opportunities. The project is also working closely with East Timor and UNTAET to develop a taxation system applicable to ZOCA that will assure the continued economic viability of our project and encourage additional investments in the Zone of Cooperation.

Our commitment extends to community development as well. Phillips recently donated several trucks to the East Timor Development Agency to support agricultural redevelopment programmes in each of the country's 13 provinces. The Elang-Kakatua joint venture also provided a 4-wheel drive vehicle to the Sisters of Saint Paul for use as a mobile medical clinic in the Suai area of East Timor. Santos, a co-venturer in Elang-Kakatua, has provided school supplies to support efforts to rebuild the educational system in Dili. And shortly, in cooperation with the East Timorese and UNTAET staff, a targeted programme to provide English language instruction will be initiated. Understanding English is essential to working safely in the offshore petroleum industry. Developments within ZOCA will also require a wide variety of logistical support facilities and services, some of which may be suited for East Timor. Phillips and other Timor Sea petroleum developers are investigating such opportunities that will provide further direct and indirect benefits.

These and other programmes, made possible as a result of petroleum development within the Zone of Cooperation, will contribute measurably to the economic security and the quality of life in East Timor. They reflect the mutual goodwill and respect that have developed from ongoing communications among the parties, which have produced timely and important agreements relating to the Treaty. These efforts represent a range of practical solutions that, taken as a continuum, justify our confidence that an independent East Timor and Australia will conclude negotiations relating to the future of the Zone of Cooperation in a manner that fulfills our legal, fiscal and administrative requirements.

CONCLUSION

Petroleum development is primarily an exercise in risk assessment and management. While recent changes in the political status of East Timor involve a measure of uncertainty in relation to the Bayu-Undan project and others founded upon ZOCA resources, Phillips considers these risks to be both reasonable and manageable. These risks are generally no greater than the risks typically associated with investments in most emerging countries. The next few years will see
significant changes in the individuals and the circumstances associated with East Timor's independence. However, in view of the particular significance of this resource to the economic future of East Timor, it is reasonable to conclude that all parties will continue to exercise caution and good judgment in maintaining a regime within ZOCA that provides stability and security for investors and markets.

Based upon our experience during the past few years, Phillips is confident that practical solutions, which have typically characterised discussions relating to the Timor Gap Treaty and have nurtured development of a potentially significant new petroleum province in the Zone of Cooperation, will continue to be agreed and applied by all parties. It is on that basis that we can predict with equal confidence that the practical implications of East Timor's transition to the Timor Gap Treaty will be positive for the East Timor, Australia and the PSC contractors.


The contents of this document contain forward-looking statements made by or on behalf of, Phillips Petroleum Company and other Unit Participants. Neither Phillips nor other Unit Participants undertake to update or revise any of these forward-looking statements. These include, without limitation, statements relating to operations, plans, strategies, objectives, expectations and limitations. These statements are not guarantees of future performance or results. Rather, due to risks, uncertainties and other factors, actual results may differ materially from those expressed in any such forward-looking statement. The following are certain (but not necessarily all) important risk factors that could cause actual results to so differ:

Plans to drill wells and develop Bayu-Undan are subject to: the ability to obtain agreements or consents between or from co-venturers and/or governmental authorities; engaging drilling, construction and other contractors; geological, land or sea conditions; world prices for oil, natural gas and natural gas liquids; applicable treaty, law or regulatory requirements; and the availability of economical financing.

Estimates of proved reserves, raw natural gas supplies, and project cost estimates have been developed using the latest available information and data and recognised techniques of estimating, including those prescribed by the US Securities and Exchange Commission, generally accepted accounting principles and other applicable requirements.

return to AMPLA 2000 Table of Contents