Petromin PNG Holdings Limited

26 April 2015

The Hon. Peter O'Neill, CMG, MP
Prime Minister
National Parliament House
PO Box National Parliament
WAIGANI
National Capital District
Papua New Guinea

My Dear Prime Minister,

THE PROPOSED ORGANIC LAW TO ENACT THE ORGANIC LAW ON THE SOVEREIGN WEALTH FUND

I wish to bring your attention to the serious implications of the Proposed Bill to Enact the Organic Law on the Sovereign Wealth Fund (SWF) on the proposed Kumul entities which your Government has decided to establish to hold the State's minerals and petroleum assets**.**

The provisions of the proposed Organic Law on the SWF contain a number of terms that are relevant to Kumul Minerals Holding (KMH) and Kumul Holdings Petroleum (KPH) and if passed in its present form, will have a significant impact on the viability and ability of KMH and KPH to carry on commercial activities. Let me at the outset point out that the Kumul entities will become meaningless once the Organic Law on the SWF, in conjunction with the proposed Kumul legislation, have been enacted by Parliament. What this means is that the proposed law will result in all the proceeds of the Kumul entities being directed to the SWF leaving these entities in a financially crippled position and unable to effectively operate as a business or invest in oil, gas and mineral projects.

The proposed Organic Law on the SWF clearly fails to consider the commercial and business realities which is to the detriment of the Kumul entities and should be withdrawn until it is properly thought through, debated with the necessary involvement of the Kumul entities (or their predecessors) and appropriately revised.

A. Issues:

We have identified the following areas of concern which we wish to bring to your immediate attention for consideration and appropriate actions.

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1. The Bill has been Advanced

We understand that the Bill has been advanced to First Reading and Second Reading stages in Parliament and it is expected to reach final reading in May 2015. We have consulted with the Office of the State Solicitor who has indicated that no changes can be made prior to the Third Reading.

2. Interpretations ("Mineral & Petroleum Receipts")

The definition of mineral and petroleum receipts in particular the definition of "*gross public revenues..."* in Section 10 (a) of the proposed Organic Law on the SWF of 2/11/2011 poses concerns for Petromin/KMH on two fronts;

a) All mineral and petroleum revenues directed to the SWF should be distributable profit and dividends and not "gross public revenues". The State owned entities incorporated under the Company's Act are legally obliged to follow accounting and corporate governance practices and procedures before declaring dividend payments to shareholders;

From a commercial perspective, there is no point for the Kumul entities to be established and expect them to operate commercially at arm's length with the State if their "***gross public revenues***" will be directed by law to be channeled directly to the SWF. This will affect the KMH operations and investments. The revenues flow from KML to the Sovereign Wealth Fund needs to be clearly defined and articulated so that the former is not disadvantaged to perform its responsibility as a commercial entity. For example and as you know, both the mining and petroleum industries are cyclical and experience periods of prosperity, followed by low commodity prices and so on. Consequently, KMH and KPH must ensure that they continue to maintain sufficient liquidity levels and manage their finances according to industry forecasts to ensure their longevity for the benefit of the State.

3. State's receipt of dividends

The Fund is constituted as two separate funds:

a) ***<u>Section 10</u>*****: The Stabilisation Fund** – purpose is to manage the impact of fluctuations in mineral and petroleum prices on the economy of PNG, and, to ensure that large foreign currency movements do not affect the competitiveness of the economy.

b) ***<u>Section13</u>*****: The Savings Fund –** to provide a means of preserving the real value of extracted mineral and petroleum resources through long term investment for the benefit of current and future generations of citizens of PNG.

   The Bill provides under section 14(2)(b) that any amount over 1 Billion contributed to the SWF will "spill over" into the Savings fund – the effect of this is that the State will never receive a dividend as it will spill back into the Savings Fund effectively resulting in 100% of any dividend remaining in the SWF.

4. Kumul Holdings Companies inability to liquefy or realize assets

The Bill provides that 100% of the proceeds of any sale of any entity holding interests in Petroleum/Mining assets will go into the SWF. It also provides that the proceeds from the sale of any non-mining or non-petroleum assets be paid into the Savings Fund (s 14(e)).

The effect of this is that the Kumul Holding companies will not be able to realise any assets (shares or otherwise) without losing the proceeds. This will place the companies in a commercial "straight jacket" being unable to trade or realise investments or convert interests into other vehicles – all normal commercial corporate activities – without losing their investment – an uncommercial and restrictive requirement which will place them at a commercial disadvantage against their private enterprise peers in the market place.

Instead, the SWF provisions should allow "trading" in assets by the Kumul entities and their investments. The benefit to SWF is for these entities to create wealth and to then distribute by dividends which should grow with the increased wealth of the Kumul entities. The SWF legislation must be re-framed to accommodate the Kumul Holdings framework of dividend declaration set out in the proposed Kumul legislation.

5. The requirement to pay 100% of all distributions from Holdings Companies to the State

The term "distributions" is defined broadly in the proposed Organic Law on the SWF to mean any direct or indirect transfer of money or property, other than the company's own shares, to or for the benefit of the shareholder, expressly includes dividends.

This can be interpreted to catch all "non-dividend" payments made to the State and operate to make it impossible for the Kumul entities to contribute to any national, social obligations or community facilities.

A possible interpretation of the provision may be to create an obligation on a Kumul Holding Company to pay an equivalent amount of any distribution it has made to the State also to the SWF - effectively a "tax" on such contributions.

Instead, the meaning of the term "distribution" needs to be redrafted for clarity and should allow Kumul Holdings to make tax credit payments, payments to meet social and community obligations etc. Distributions should be limited to dividends or payments of a nature of a dividend.

The definition should also make clear that it only applies to after tax profits.

The payment of 100% of all dividends into the SWF potentially will add pressure for "indirect" contributions by the Kumul Holding Companies (Subsidisation, Tax payment arrangements, community support, etc.)

The SWF needs to be clear on the entitlement to receive dividends – is it correct to interpret the existing sections to mean that effectively 100% of dividends will be paid to the SWF – or – does the entitlement of the Stabilisation Fund to receive dividends cease when the fund is at US$1B?

6. Ability to Procure Financing

KMH and KPH would require substantial investment funds to invest in the emerging mining projects and to meet the company's operational requirements. Considering this, the Kumul entities must be empowered and given the ability to raise their own financing requirements.

A major difficulty faced by Petromin has been lack of ability to arrange required finance due to the Negative Pledge Covenant. This is despite the fact that the Petromin structure was purposely set up to overcome the State's negative pledge obligations in respect of financing its interest in petroleum and minerals projects. Several key reasons underpin Petromin's unique corporate structure (which, we understand, will also underpin the Kumul corporate structure):

- A key issue faced by the State was financing its equity interest in mining and petroleum projects. This issue arose when the State sought to finance its equity interests in resource projects when the contracts for existing loans it has from lenders, such as the World Bank, the ADB and even commercial banks, contain clauses which restrict the State's ability to offer security over its assets to new lenders. In essence, these so called "negative pledge" obligations provide that the State cannot offer security over its assets to any new lender to the exclusion of the existing lender. In other words, the existing lender must have equal security over the asset to that which may be offered to any new lender and precludes project financing of projects;

- The negative pledge obligations are particularly problematic in situations where the State seeks to finance an interest in a resource project by way of "project recourse borrowings" or project finance. Such borrowings, usually from commercial banks or export credit agencies, are secured against the asset being acquired and its associated cash flows. In general, negative pledge obligations effectively preclude the State securing project recourse funds; and

- Legal advice obtained at the time indicated that the negative pledge problem faced in raising project recourse funding can be overcome if the State's interest is acquired and financed through an incorporated company (Petromin) that operates sufficiently at arm's length from the State: that is, a company that cannot be regarded as being "a part of the State." This would work provided the company has the appropriate structure.

However, in reality Petromin's endeavour to avoid the negative pledge obligations has had measured success and is not always accepted, particularly by international financiers. Therefore, Petromin/KMH must be able to fall back on a strong balance sheet in order to successfully finance its participation in emerging mining projects.

The proposed Organic Law on the SWF must be redrafted to facilitate the intention for KMH and KPH to commence operations with healthy balance sheets, in order to achieve their legislated mandate of operating on commercial terms. Failure to do so may have the consequence of the State being forced to assist with financing rather than the Kumul entities operating at arm's length and independently from the State.

7. Dividend alignment with Kumul legislation

The provisions regarding the payment of dividends need to be aligned with the provisions in the proposed Kumul legislation pertaining to the payments of dividends. The latest draft of the KMH legislation provides that dividends must be paid directly into the SWF in accordance with the Organic Law on the SWF in respect of each Accounting Period equal to the amount of available reserves of KMH determined on a consolidated group basis, less any amount required to be held by KMH and its subsidiaries to meet the requirements of the approved Annual Plan, including the amounts to be preserved for future capital expenditure. We take this opportunity to reiterate that the proposed requirement for there to be an 'approved' Annual Plan has significant implications on the Kumul entities and their ability to function on a commercial basis independent of interference by the State.

We suggest that there should be a clearly defined dividend policy that will cater for consumption, support investment and future savings, which is reflected in the proposed Organic Law on the SWF.

Dividend is that part of the after tax profits of a company which is distributed amongst its shareholders. In determining a dividend policy, it is important to consider the amount of profit to be distributed among the shareholders and the amount of profit to be retained in the firm for investment purposes. Dividend policies are required between the State and the respective Kumul entities which would allow flow of dividends to the State and at the same time ensure that sufficient funds are retained by the companies to be invested in projects for revenue generation.

It is in this light that a balanced dividend policy is recommended between KMH, KPH and the State which must ensure project revenues are apportioned for consumption, savings and investment.

The dividend policy should recognise and align with the Kumul legislation as it pertains to the payments of dividends. The latest draft of the KMH legislation provides that dividends must be paid directly into the SWF in accordance with the Organic Law on the SWF in respect of each Accounting Period equal to the amount of available reserves of KMH determined on a consolidated group basis, less any amount required to be held by KMH and its subsidiaries to meet the requirements of the approved Annual Plan, including the amounts to be preserved for future capital expenditure. Again, Petromin reiterates that the proposed requirement for there to be an 'approved' Annual Plan has significant implications on the Kumul entities and their ability to function on a commercial basis independent of interference by the State.

How will this be achieved?

(a) ***<u>Cash flow for consumption</u>***. It is proposed that certain portion of the dividend be directed for consumption. These funds should be directed to the Government Consolidated Revenue (Treasury/Planning Departments) for funding Government activities/projects including infrastructure projects, social welfare and other activities.

(b) ***<u>Cash flow for investment</u>***. It is proposed that certain portion of the dividend be retained by Petromin/KML for investment purposes. These funds to be channeled to the following activities:

- Re-invest in the minerals projects. KMH will be created for this purpose hence sufficient funds should be retained by the entity and invest in mineral projects for revenue generation.

The formula for calculating retained earnings will need to be further discussed between Petromin/KMH and the State/SWF and depends very much upon Petromin/KMH's business plan for the next 12-36 months. It is important to note that to a certain extent Petromin/KMH's business plan can easily be dictated by specific project schedules. For example, Petromin/KML will be the State Nominee in emerging world class mineral projects including the Frieda River and Wafi-Golpu Projects. These projects are envisaged to go into development phase commencing 2016/2017.Petromin/KMH will need to raise 30% of the cost currently estimated at US$1.4 billion.

This is critical in the context of financing the State's share of the project cost. Where will KMH draw funds from to invest in the projects? Will it draw down required funding from the SWF or will it or the State seek to leverage raising its own financing from the financial markets? Further, the structure of financing varies between projects and the financing proposals initiated by each developer of a project. Given such a scenario, the State must have a clearly defined process for funding its share of project cost in each of the minerals projects the State decides to participate through its vehicle.

In the interim, Petromin/KML has overheads and other operational requirements to meet going forward and that need to be maintained and must ensure that it has sufficient liquidity.

(c) ***Cash flow for savings***. It is suggested that certain portion of the dividends should be directed for future savings. These funds should be directed to the Sovereign Wealth Fund (SWF). These funds may be saved in the following ways;

i. Invested within PNG or offshore but it must be PNG based;

ii. Invested in the capital market; and

This will create a future for the next generation of Papua New Guineans

It is recommended that a dividend policy that addresses the issues highlighted above should be put in place between KMH and the State to allow a fair distribution to be made for consumption, investment and savings. We expect Kumul Consolidated and Kumul Petroleum to raise similar issues/concerns. The proposed dividend distribution has been reflected as shown in the diagram below.

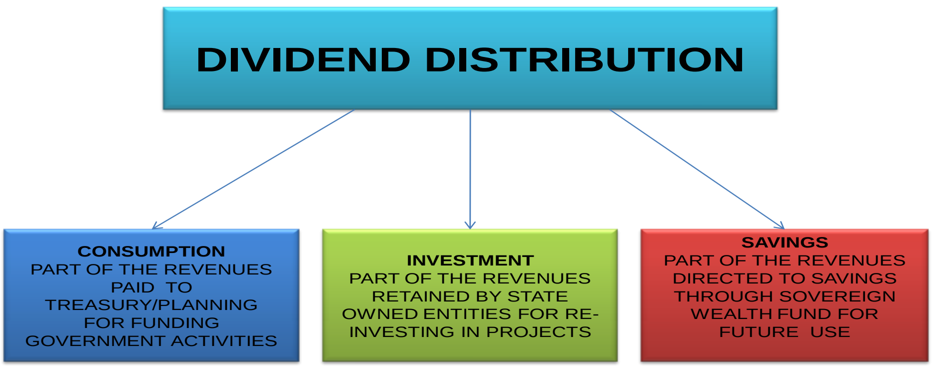

Figure 1: Proposed Dividend Distribution Structure

The proposed dividend distribution structure specific to Petromin/Kumul Minerals Holdings would be as reflected in the diagram below.

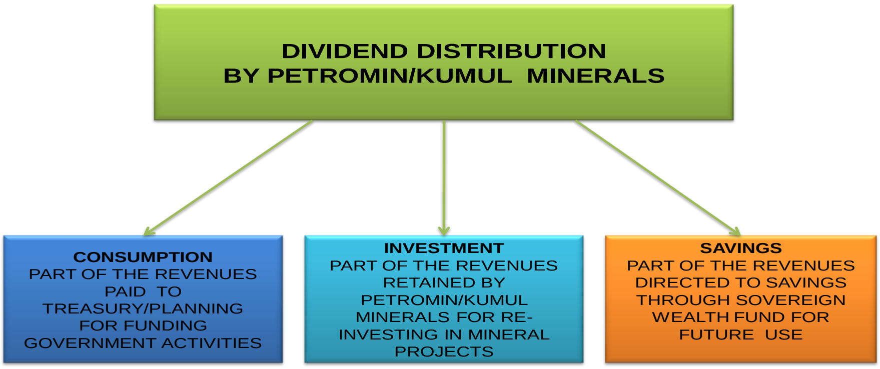

Figure 2: Proposed Petromin/Kumul Minerals Dividend Distribution Structure

8. Receipt of mining and petroleum taxes

The SWF will receive 50% of all Mining and Petroleum taxes – payable into the Stabilisation Fund – which, when the fund is over $US1B will spill over into the SWF Savings Fund.

The combination of all the sections on payment into the SWF has the result that the State will receive:

a. 50% of Taxes,
b. 0% of Dividends,
c. 0% of Distributions.
d. 0% of proceeds for sale of mining and gas assets.

We have been advised by National Petroleum Company of PNG Ltd (NPCP) that a practical flow-on effect of this is that the State has extensive obligations entered into under the Umbrella Sharing Agreement which will now be unfunded, or at least funded out of Consolidated Revenue from other (non mining and petroleum) sources.

It is estimated that at 100% of all Taxes being received by the State it will take a US$70-75 Gas price to enable the State to fund its obligations. At 50% receipt this may well be a figure above the historical high for gas prices.

A full analysis of the States obligations ties/related to Petroleum and Mining needs to be made and the cost of meeting those obligations – State can then decide if the "take" by the State is adequate.

B. Recommendation

Considering the above, we respectively but strongly recommend that the proposed Organic Law on the SWF currently before Parliament be immediately withdrawn in order to allow for comprehensive consultations with the Kumul entities and alignment of the proposed Organic Law on SWF with the proposed Kumul legislation.

If this is not done and the proposed Organic Law on the SWF is enacted as is, it will override the Kumul Acts of Parliament, immediately crippling the Kumul entities.

As always, Petromin acknowledges your continued support in dealing with issues which are critical to the successful creation of the Kumul entities your Government has taken the initiative to establish to hold and manage the State's important petroleum and mineral assets.

Please also be assured that we are working with our sister company, NPCP, to address the issues jointly facing KMH and KPH.

I am available if you wish to discuss, as is our Managing Director, Mr. Thomas Abe. We are available at your convenience.

Yours faithfully,
Petromin PNG Holdings Limited

Sir Brown Bai, Kt, CSM, CBE
Chairman

cc. **Petromin Trust Manager**

Daniel Rolpagarea – State Solicitor

Loi Bakani – Governor, Bank of PNG