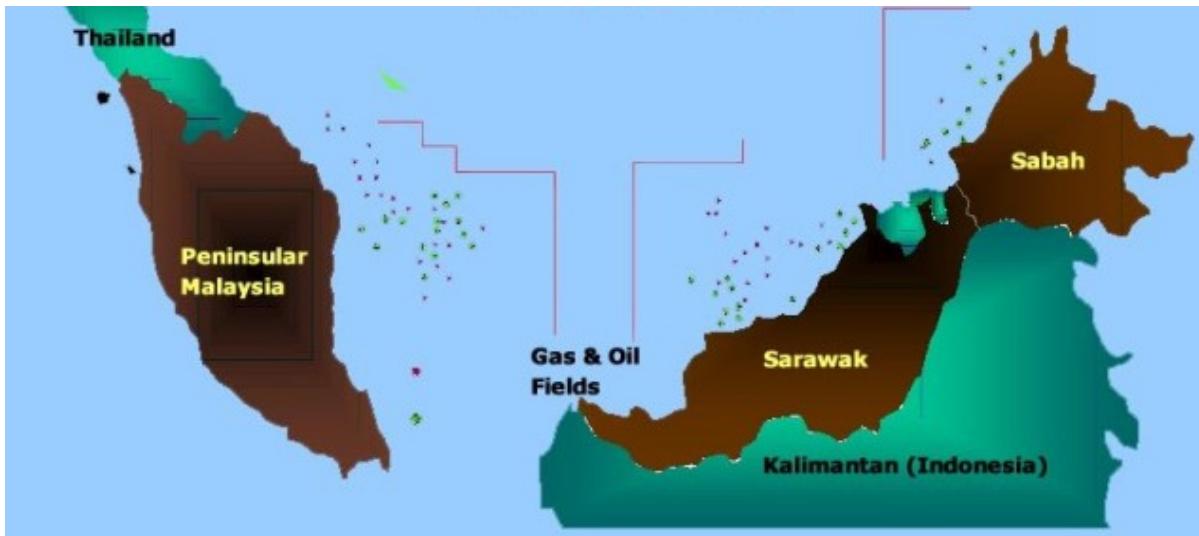


# Malaysia's Oil Royalty Rumble

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Anas Alam Faizli  
One of the issues that are bound to crop up in the 13th general election campaigns is the oil royalty. In the past, many reasons have been

presented by political parties from both sides of the divide on who is entitled to what. Perhaps this article will help shed some light on the issue.

When rulers and representatives of the Straits Settlements, the Federated Malay States and the Non-Federated Malay States signed the Federation of Malaya on the 31st January 1948, nobody imagined the significant petroleum money conflicts that would ensue for the years to come. One component made all the difference; jurisdiction over all areas beyond three nautical miles of the state shores is handed over to the federal government. Section 4 of the Emergency Ordinance 1969 also defines territorial waters as three nautical miles, subject to some exceptions, including the newer states of Sabah and Sarawak.

This is the case against petroleum-related royalty payments from the federal government to some state governments today. For oil found beyond three nautical miles (beyond state territories), no royalty monies are due because they belong within federal government territories.

If we hold that the story ends here, we will conclude that no royalty is due to currently petroleum-producing state of Kelantan, or rightfully, even Terengganu and Pahang. But, the story does certainly did not end here.

## Petroleum Development Act 1974

In 1973, the world witnessed an Oil Shock caused by a six-month embargo on oil supplies by the Arab members of the Organisation of Petroleum Exporting Countries (OPEC). Crude oil prices climbed four-fold overnight causing severe disruptions to many industries. Most developing economies that produce oil, including Malaysia, then began to realize the strategic and economic importance of having national control over this Black Gold.

Malaysia responded by setting up Petroliam Nasional Bhd or Petronas on August 17th 1974, our

home-grown oil giant which we have slowly grown dependent upon, up to 40% of federal government budget. It was oil money that financed the RM6 billion Petronas Twin Towers and the RM22 billion Putrajaya. In fact, oil-generated income, thanks to soaring crude oil prices in the past decade, was the only way we could have afforded the whopping RM135 billion increase in government operating expenditure in 2012 compared to 2000.

The incorporation of Petronas paved the way for another defining milestone in the history of Malaysia's petroleum industry, namely the Petroleum Development Act 1974 (PDA). The PDA is the "antagonist" to the federal constitution, used by proponents of royalty payments to states when it comes to oil exploration beyond three nautical miles of state shores. By section 2 of the PDA 1974, Petronas is vested with the "entire ownership in petroleum lying onshore or offshore Malaysia", as well as exclusive rights, power, liberty and privilege of exploring, exploiting, winning and obtaining them. The generic term "offshore Malaysia" is thus the main contention, since neither specific length from state shores were explicitly stated, nor were references to the Federal constitution "three nautical miles" component, made.

The PDA was a powerful manifestation of Malaysia's control and sovereignty as it essentially made uniform all previously separately standing agreements between the international oil operators and state governments, with regards to Malaysia's hydrocarbon resources. It entailed three major developments; one, that all finding will be under Petronas custodianship; second, that existing concession agreements will be replaced with Production Sharing Contracts (PSCs) where the government via Petronas effectively undertakes expenditure; and third, that there would be an additional five percent royalty payment to the federal government (from Petronas) on top of five percent royalty payment to state governments (also from Petronas). There were monies paid to state governments under the previous concession models but the specific magnitude is not known.

Supplementing the PDA 1974 were 13 identical Assignment Deeds and Vesting Grants, which were also separately signed between each of 13 states and the federal government between 1975 and 1976. All of them vested the rights to "petroleum whether lying onshore or offshore of Malaysia" to Petronas, in return for cash payments in the form of a yearly sum equivalent to 5% of the value of petroleum produced. Again, no length from state shores was specified with the generic term "offshore". Thus, these new deeds only exacerbated the controversy.

## Sarawak and Sabah

Until 2010, Sabah had received a total of RM7.2 billion in oil royalties. Meanwhile, Sarawak is estimated to be receiving about RM600 million per annum currently. Having a federal share of the Sabah and Sarawak petroleum industry was actually the more overbearing intention behind the PDA, compared to the 1973 Oil Shock. By then, the Borneo states Petroleum industry was close to its centennial, with Shell and Esso having fully entrenched production in place in Sarawak (80,000 bpd) and Sabah (5,000 bpd) respectively. However, these operations were under legacy British-granted concession agreements with the state governments, generously skewed in favour of the oil operators. Naturally, the latter were then unhappy to fork out extra petroleum royalties to this new federal government.

The first chairman and chief executive of Petronas, Tengku Razaleigh Hamzah, or fondly known

by Malaysians as Ku Li, took to himself the arduous task of convincing Sabah and Sarawak to agree to the PDA. His job then seemed like a tall order, since the pre-conditions were extremely delicate. First, there were contracts in place between the oil majors and the East Malaysia states, whose sanctity needed to be honoured. Secondly, Malaysia was a federation of previously sovereign states in their own rights, which entailed dues. Recollections of the process spanning 2 years include one where Ku Li was apparently barred from entry into Sabah at the airport!

Today, even though Petronas and its contractors are operating and producing out of more than three nautical miles beyond the coasts of Sabah and Sarawak, both states still receive royalty monies by way of constitution. In addition to royalties, unlike the peninsular states, both states are constitutionally entitled to export duties on “mineral oils”, which petroleum qualifies for. Both royalty and duties total 10 percent.

## **Terengganu**

Terengganu found petroleum off its shores in 1973. From 1978 to 2000, it received a sum of RM7.13 billion in royalties. Not only does the state enjoy tremendous growth from federal government allocations and royalties, it also reaped economic benefits from the formation of petroleum townships. Rantau Petronas in Kerteh is one of the most advanced full-fledged petroleum centers housing a little economy of its own.

However, royalty payments were stopped in 2000 during PAS government’s one term tenure in the state. Under the constitutional clause allowing for discretionary payments from federal to state, a fraction of the due royalties known as the “Wang Ehsan” (goodwill token) was paid instead through government agencies. Royalty payments were only continued in 2009 when Terengganu is back under the Barisan government, even though productions were from areas sitting beyond three nautical miles from the state. This makes the task of concluding whether or not Terengganu should receive royalties a confusing one, considering the payment was not fulfilled the moment it was a different ruling state government.

## **Kelantan**

Petroleum was only found off of the shores of Kelantan in the 1990’s when Kelantan was under the rule of PAS, so the PDA, Vesting Grant and Assignment Deed stood unquestioned until then. As it happens, findings were either 150km (about 81 nautical miles) from Kota Bharu, or within free economic zones where the federal government has joint development agreements with Thailand and Vietnam.

For production coming off these areas, namely from blocks PM2, PM301, Malaysia-Thailand Joint Development Agreement (MTJDA) and PM3 CAA Malaysia-Vietnam, the federal government has received its share of 5 percent in royalties, totaling RM4.59 billion. While the same number is theoretically due to Kelantan state as well, the latter has received no sum, in royalties. Worse still, Kelantan enjoys absolutely no spill over economic developments in the form of a supply base, processing or transportation activities. Gas extracted off of Kelantan’s shores through MTJDA bypasses Kelantan and is directly funneled to Thailand, despite it being less economical to do so.

The federal government maintains that the Federal Constitution dictates for Kelantan to not receive royalties for rights over areas it did not own in the first place. On the other hand, Kelantan bases its claims on the sanctity of the PDA, the Assignment Deed, and the Vesting Grant 1975/1976, claiming that they should not be deprived of royalties since these documents used the generic term “onshore and offshore Malaysia” in the case of petroleum, instead of three nautical miles in the general case of territorial provisions. Experts have clarified that the constitution supersedes any other laws in place, being the supreme law of the land.

In August 2010, the Kelantan state government filed a lawsuit against Petronas for failing to pay the state royalties. The government responded to this with a special study panel, which has yet to come up with a conclusion.

## Substance over Form

We should be able to conclude by now that this is a complicated battle of legal interpretation. Aside from the litany of agreements and documents signed, one cannot help to discard the stark reality that both Kelantan and Terengganu were denied royalty payments during PAS’ rule. It is hard to not label the issue as a politicized one. As members of the public, the continuous debacle leaves us with some pertinent questions.

First, the three nautical miles component in the Federal Constitution articulated the maritime border of states, but what about ownership of petroleum assets specifically? Surely when the relevant preceding documents were enacted, the intention was to designate petroleum and gas as a specially-treated issue given its economic and political importance. Thus, can it be seen lumped together with other maritime border issues under the constitution? If the signing of these documents were intended to cajole previously sovereign and independent states into handing over custody rights of oil blocks to Petronas, is not depriving them of royalties now a blatant dishonouring of past promises?

Second, why is the application of the “three nautical miles” component inconsistent across all peninsular states? Experts go as far as to label the Assignment Deed 1975 unconstitutional and containing serious defects because it failed to specify that Kelantan can only assign to Petronas areas that belonged to it. Even so, why does it apply to Terengganu and now, Pahang who is without question promised the five percent oil royalty for the recent Bertam PM307 discovery 160km (86.3 nautical miles) offshore Kuantan? Terengganu and Pahang too then should rightfully have no claim over portions of gross oil revenues from areas beyond state borders. This is against Article 8 of the Federal Constitution that calls for equal treatment of all and non-discrimination.

Third, what was the initial intention of promising cash payments to the state government? If it was to appease the sovereign states into agreeing to share revenues from their natural resources with the rest of the country, is it fair to dishonour them after making them believe their interests were protected prior to the signing? As it is, annual allocations to state governments are only 8.6 percent of the federal government’s annual budget.

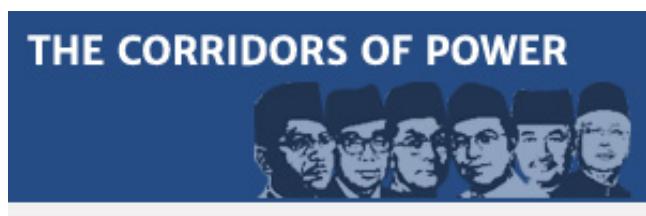
At the end of the day, we conclude that there are two parties using two contending documents; the PDA and the Federal constitution. But what point is there for the claims to be tossed between

legal documents, while the reality is the four producing states are amongst the poorest states in Malaysia? Kelantan sees the lowest household income averaging RM2,536 below national average of RM4,025, while Sabah's incidence of poverty of 19.2% is a stark level above national level of 3.8%.

Have we ever wondered then, if the states would be as willing to sign the PDA 1974 and various petroleum-related agreements vesting rights to Petronas, if not misled into believing that they would be able to enjoy at least some of their natural endowments?

As Plato said, "We deny that laws are true laws unless they are enacted in the interest of the common wealth of the whole state."

*\*\* Anas Alam Faizli is an Oil and Gas professional. He holds a Master's degree in Project Management and is pursuing a post graduate doctorate. He tweets at @aafaizli*



- When Kua Kia Soong speaks

with a forked-tongue

- Why is the MACC following and monitoring me?
- The Malaysian civil service has gone bonkers
- Okay, Mahathir, we accept your challenge
- So, do they or don't they want foreign workers?





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