Lebanon Oil and Gas: what is on offer?

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It has been said many times that Lebanon is at a crossroads. This has never been truer than now. The Lebanese economy is often associated with banking and tourism. But this perception could dramatically change if Lebanon succeeds in unlocking its oil and gas potential and, more importantly, increases its commitment to transparent and efficient management of the sector.

International Interest

The Ministry of Energy and Water (MoEW) officially launched Lebanon's first ever offshore licensing round in April 2012.

Around 52 international oil companies submitted prequalification applications and 46 companies were shortlisted. These included major oil companies such as Shell and ExxonMobil, which satisfied the country's relatively strict financial and technical prequalification requirements. However, there is a difference between companies that prequalified; those that will actually bid; and the number of contracts awarded – the numbers will shrink as we move towards the latter category.

While such a high level of international interest is surely a positive development, it is also not unusual. Oil and gas companies are constantly looking for new opportunities. Lebanon's key target, however, has to be to capitalize on these expressions of interest, in other words, to lock in foreign capital in a way that maximizes the benefits to the whole nation.

Uncertain Plan

According to the Ministry's original plan, bidding was supposed to start in May 2013 and was expected to continue for six months. Various bid evaluations would then take place between November 2013 and January 2014, with the first exploration and production agreement (EPA) scheduled to be signed in February 2014.

However, the resignation of the Mikati government in March 2013 took many by surprise and left the future of the round in doubt. At the time of writing, no new government has been formed. If the issue is not resolved by September, it is likely that the round will be postponed.

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The problem is that, prior to the government's resignation, two important decrees still had to be approved by the Council of Ministers, as required by the Lebanese Offshore Petroleum Law: first, the model EPA which includes the fiscal terms (which have not been defined in the law); second, the delineation of the 10 offshore blocks in question (out of which four are likely to be offered in the first bid round).

In principle, a caretaker government does not approve such decrees. However, the MoEW has repeatedly said that, under special circumstances, an exception could be made. The robustness of such an option is a question for the legal community to decide – except that it is doubtful whether, in a country where political rivalries are so vibrant, a lasting legal settlement can be achieved.

The late Lady Thatcher once said 'always expect the unexpected and be prepared for it'; her wisdom is particularly pertinent in Lebanon's context.

Fiscal Regime

Meanwhile, the Petroleum Administration (PA) shared the draft EPA with the shortlisted oil companies as part of a closed consultation workshop, and received around 1,500 comments, some of which were incorporated in the preparation of a new draft EPA. The terms are yet to be disclosed to the wider community.

The fiscal regime includes various tax and non-tax instruments that affect both government take and investor return. Getting the regime right is central for Lebanon.

The volatility of oil and gas prices, the large development and operating costs, the high level of uncertainty associated with petroleum geology, the specific characteristics of individual oil/gas fields, and the long-time horizons, all add to the challenge of designing and implementing an appropriate petroleum tax system that can achieve a balance between the interests of both government and industry. This challenging task should not be underestimated.

Striking the right balance is the critical factor. If the government take is too high, it can lead to sub-optimal investment and, therefore, to less tax revenue in the long run. If it is too low, then too much of the nation's resources are given away to the investor. Part of the problem, however, is that the right balance keeps shifting, driven by many factors including price volatility, knowledge of the geology, technological advances, and competitive behaviour.

According to Lebanese officials, the country has adopted a hybrid arrangement which combines a tax and royalty (concessionary) scheme and a production sharing mechanism (contractual). However, it is common to find the former in production sharing arrangements (PSA) where contractors often pay a royalty (as a percentage of revenue or production) in addition to income tax on their share of profit petroleum. Such a model is widespread in developing countries.

The type of regime, whether concessionary or contractual, is not a central issue from an economic point of view since, for a given oil or gas price, the government take can be made equivalent for the different types of regime. Furthermore, judging a fiscal regime from its 'headline tax' rates is very simplistic – the devil surely lurks in the detail and a meticulous assessment of various terms is therefore required.

According to the PA, the royalty will apply at a flat rate on gas (around 4 per cent) and in the case of oil, on a sliding scale (between 5 and 12 per cent), mainly varying with daily production. The attractions of a royalty scheme from a government perspective are that it is relatively simple to administer (especially for oil), predictable (as it varies with production, not profits), and it provides an early revenue stream (as soon as production starts).

However, because a royalty is imposed irrespective of cost (and therefore of underlying project profitability), it has the effect of a regressive tax – one which imposes a heavier burden on the least profitable fields, even if it is imposed on a sliding scale. A sliding scale simply strips royalty of one of its advantages: its simplicity.

A sliding scale royalty scheme also fails to address the fundamental limitation that it is imposed irrespective of cost, knowing that in oil and gas projects, significant cost variations among individual projects do exist. An additional problem with any sliding scale scheme is how to determine the scale. Furthermore, a higher royalty rate reduces the amount of petroleum available for cost recovery, which in turn lengthens the cost recovery period.

Another instrument that a government can use to achieve early returns is one of putting a ceiling on cost recovery. If the ceiling is, say, 70 per cent in any given year, contractors can recover 70 but not 100 per cent of their costs; the rest is carried forward to the following year.

Just like a royalty, a cost recovery ceiling also has a regressive impact. The definition of which costs are recoverable can vary across countries, hence the need to have a clear understanding of recoverable costs.

According to the PA, the cost recovery ceiling will be one of the biddable parameters. Profit sharing will be another, and it will be on a sliding scale related to profitability (R factor). The latter should make the regime more progressive, but the final outcome will depend on the rates and interaction of different instruments, especially if, for instance, in future rounds, the government decides to enact the state participation option which is provided in the law.

Good Practice

While at first sight, there is nothing peculiar about the above terms, one area of concern is the fact that two important instruments that will shape the government take – cost recovery ceiling and profit sharing – are biddable.

According to international good practice, biddable items should be limited. Typically, they include the work programme and signature bonus. The latter does not apply in Lebanon, although if the potential of the country is proven and international interest is high, this could be an option in the longer term.

When cost recovery or profit sharing is used as a biddable item, it is recommended that the government pre-set by law the range within which bids can be placed. The Lebanese government can also consider fixing the lower band of its share of profit petroleum and allow companies to bid for two more upper tiers.

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The advantage of this more prudent approach is that it allows the government to achieve a greater predictability of potential rewards. This in turn helps more generally with budget planning – minimizing discrimination among investors and reducing the administrative burden of managing different fiscal structures – especially important in a country like Lebanon where administrative capacity is very limited.

Furthermore, some companies may offer very generous terms to the government – for instance a higher share for the government from profit petroleum when the R factor exceeds a certain limit. However, cost overruns (very common in the oil and gas industry) would of course imply that the higher tier would never be triggered.

A legislative, contractual, and fiscal framework that is robust and clear remains the main device on which the government should focus to ensure a sustainable development of its oil and gas sector. Building in-house expertise and administrative capacity to manage the sector is essential. Progress has been 'so far, so good', but the remaining to-do list is long and requires close collaboration between various ministries – mainly the MoEW, Ministry of Finance, and Ministry of Environment. The real test will be in the implementation. The coming years will tell whether Lebanon is able to give itself a good deal. ■