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Legal Review of Tunisia's Upstream Hydrocarbon Framework

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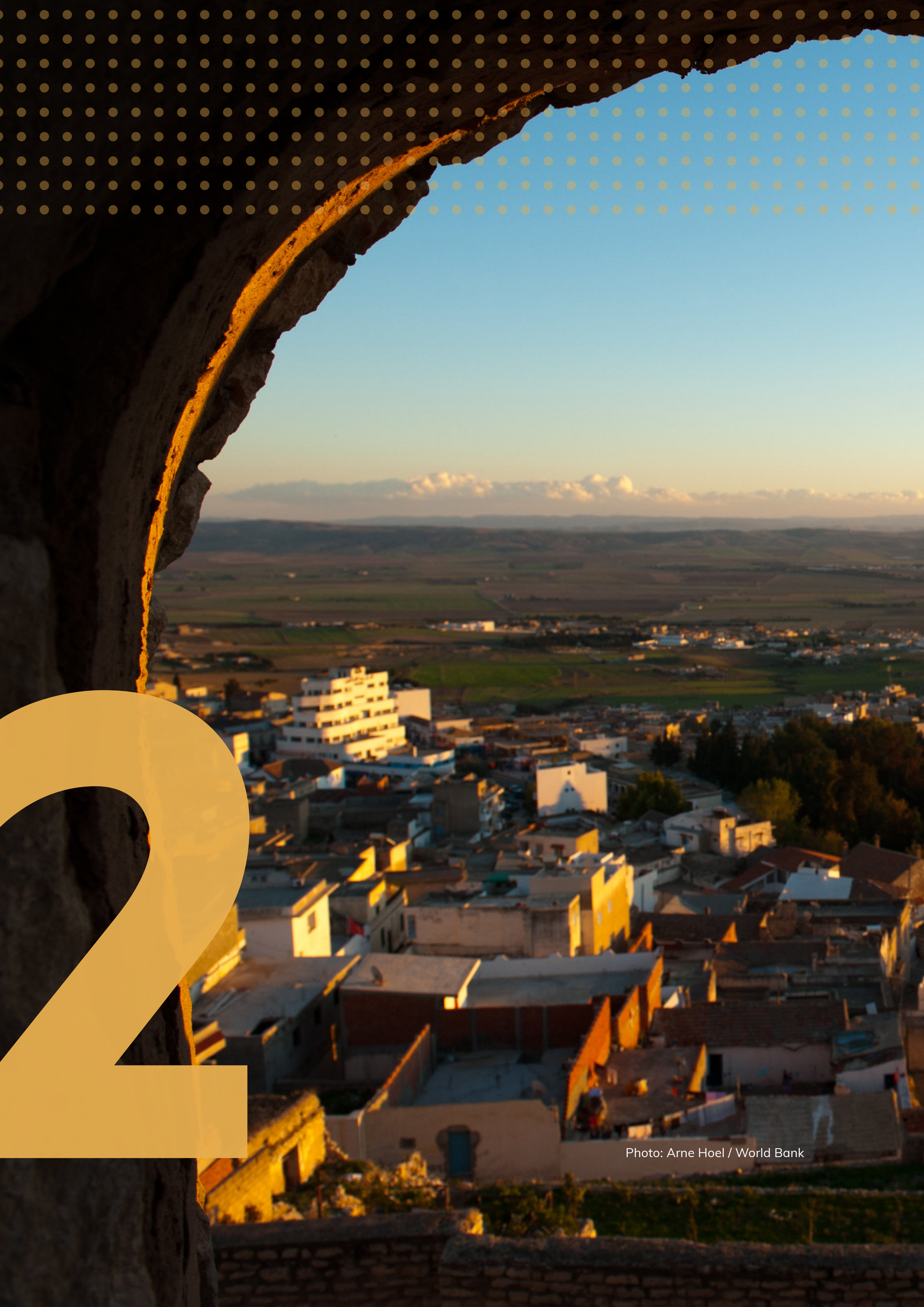
Introduction

This report has been prepared by Sidley Austin, LLP, on behalf of and funded by the World Bank Group. It has not been funded or sponsored by any governmental authority, political party, or another group in Tunisia or abroad. This report attempts to present an unbiased evaluation of current hydrocarbon exploration and development in Tunisia, and to provide recommendations for improvements to benefit of the Republic of Tunisia.

The report proposes changes to the Tunisia Hydrocarbon Code, related laws, and the hydrocarbon contract conventions that Tunisia uses with investors. This report also proposes changes to the role and operations of the Entreprise Tunisienne d'Ac-tivités Pétrolières (ETAP) in order to improve the competitiveness, function, and transparency of the Tunisia hydrocarbon investment regime. The changes and improvements proposed in this report can increase the volume of in-bound investment in the Tunisian oil and gas sector from both existing and new investors. The changes proposed can also help Tunisia achieve more domestic production and a corresponding reduction in the volume of imported oil and gas in order to improve Tunisia's balance of payments substantially.



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Executive Summary

This report is based on a review of relevant codes, regulations, and contracts presently in effect in Tunisia, as well as interviews with both governmental and non-governmental participants in the Tunisian energy sector. This evaluation has also made use of detailed comparisons between Tunisia's hydrocarbon regime and those of various other peer countries. The review process revealed:

- There is a strong need to reverse declining investment in the hydrocarbons sector and increase domestic production to reduce balance of payments issues.
- Tunisia's known prospects are often small and unattractive to investors. However, Tunisia's unconventional resources may seem attractive.
- The sector needs to increase transparency and the trust of the public.
- The legal system for hydrocarbons needs to be clarified and simplified to help the Tunisian government and investors interpret and enforce it.
- The roles of ETAP, the Ministère de l'Industrie (the Ministry of Industry), and its Direction Générale des Hydrocarbures (DGH) must be clarified to permit both entities to work effectively.

The report notes several potential concerns for investors in the present system of upstream hydrocarbon investment in Tunisia:

1. The fiscal system does not offer sufficient returns to investors in smaller fields at low oil prices and similar situations. Yet, Tunisia has faced smaller fields and lower oil prices in recent years.

2. The separate taxation of operations by concession ("ring-fencing") discourages exploration by preventing investors from deducting their losses under some contracts and from their successes in others.

3. The "R" factor, used to determine tax and royalty rates, has several adverse effects:

a. it does not provide Tunisia adequate revenue when oil prices soar;

b. it overburdens the investor when oil prices are low;

c. because it is based on cumulative returns over the life of a concession, it increases tax rates, and discourages new investment at the end of a concession's life. This deterrent means that secondary recovery is usually not pursued.

4. Therefore, reimbursements to investors take many years to process.

5. Approval for new contracts and extensions of contracts often take up to six years for approval. There is no investment activity while the investor waits for approval.

6. It is difficult to build new infrastructure because of opposition by local residents to development and a lack of governmental support in addressing opposition.

7. There have been serious disputes over the interpretation of the tax provisions and tax stability provisions of the Hydrocarbon Code in particular.

8. The hierarchy of laws, regulations, and contracts governing hydrocarbon operations are unclear. Contracts are approved by Parliament, for example, and may contradict the Hydrocarbon Code without any clear indication as to whether the contractual provisions will be enforceable.

This report recommends several significant and important changes that Tunisia can make to achieve better investment prospects:

2.1. Reform the fiscal system to create a tax and royalty structure. It would apply the general corporate tax system on income to create a volume and price-based royalty payment and an uplift on capital expenditures. This would lower taxes and make high cost developments more attractive than an "R" factor.

2.2. Eliminate "ring-fencing" and tax energy investors.

2.3. Eliminate production sharing as a means of fiscal return for the state. Instead, use a higher royalty to enable a significant simplification in an investment.

2.4. Adopt a new form of license contract and eliminate the issuance of a separate license for exploration or a concession for development. All terms that are not set out in the law should be specified in a standard form license contract. Use of a single form of contract would substantially simplify administration by the government.

2.5. Clarify the role of Parliament under Article 13 of the Constitution to enable a much quicker approval process. The role of Parliament should be limited to reviewing whether proposed contracts (a) comply with the law, (b) have acceptable fiscal terms in the bid round, and (c) do not contain any non-standard provisions that raise matters of compelling national interest.

2.6. Replace direct contract awards with a public bidding system to generate an increase in transparency and public trust. Bidding criteria should be as clear as possible to generate straightforward comparisons (for example, signing bonuses). The bidding criteria should be published, all qualified companies should be invited to bid by a published deadline, and the public should see the results of the bids and the award.

2.7. Limit the discretionary decisions made by the Ministry of Industry and implement a rules-based system in which extensions and other benefits are granted based on clear criteria. Allow automatic benefits if the Ministry fails to respond within the permitted time frame. This would increase transparency and reduce delays.

2.8. Restore ETAP to its original a commercial role, and establish a new, independent agency to serve as the hydrocarbon regulator. This would eliminate the conflict of interest that occurs when ETAP regulates its own operations, and it ensures that each organization has only one mission.

Photo by: Gennadiy Kolodkin / World Bank.

2.9. As a “carried” (non-paying) interest during exploration, ETAP’s claim to 50% of the total interest acts as a significant burden on exploration. Make ETAP’s participation more economically effective by either requiring ETAP to bear its share of exploration costs (as shown in the fiscal model in the “Fiscal Review”), or limit its carried interest to a small percentage (with the possible option of acquiring more interest on a pay basis).

2.10. Encourage investors to act quickly by reducing the lengthy periods (potentially for 22–25 years) that enable investors to hold contracts with limited exploration activity.

2.11. Make modifications to the law to permit unconventional resource development. For example, eliminate requirements to relinquish acreage during the course of an unconventional exploration period, and provide more favorable fiscal terms for the investor to recognize the high-cost of unconventional hydrocarbon development.

2.12. Encourage faster exploration by allowing the transfer of remaining minimum work commitments to another contract when the investor has challenged the existence of the geologic prospects that it was pursuing in its work program.

2.13. Take other actions to improve benefits to the public, such as fund distributions to local governments, stronger and clearer local employment, and contract requirements.

2.14. Several other steps are detailed in Section 6 of this report.

These steps will require careful review by the Tunisian Government and Parliament to ensure that they provide the benefits intended.

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Methodology

3.1. This report analyzes Tunisia's current hydrocarbon framework through:

3.1.1. A review of existing laws and regulations;

3.1.2. Interviews with Government officials, members of parliament, civilians, and existing investors to understand perceptions about the strengths and weaknesses of the current system;

3.1.3. A review of secondary sources, such as the draft assessment by the Natural Resources Governance Institute (NRGI).

3.1.4. A review of Tunisia's competitiveness by benchmarking its current system against international practice in the hydrocarbons sector. This would enable an assessment of Tunisia against countries competing for investments.

3.1.5. A review of Van Meurs' economic analysis of the current Tunisian fiscal framework, including sensitivity analysis modeling to determine the impact of different geologic outcomes, different costs, and different oil price scenarios. The economic evaluation includes a comparative analysis of the Tunisian fiscal terms against those of a group of peer countries.

3.1.6. Preparation of a draft report evaluating and making recommendations for proposed improvements to the Tunisian system.

A more detailed discussion of the first two steps is provided below. The fiscal work in the third step is discussed in greater detail in the "Fiscal Review."

Step 1.a – Analysis of Tunisia's Current Hydrocarbon Framework

The report analyzes the following non-fiscal terms:

- The Constitution of 2014 (the "Constitution").
- The current Hydrocarbon Code and supplementary legislation.
- Current forms of concession (convention) and production sharing contracts.
- The law on investment.

- The Tax Code.
- The Code of Exchange and Foreign Trade.
- Expropriations Law and Decree Regarding the Establishment, Installation, and Operation of Public Interest Pipes.
- ETAP statutes and decrees.
- Miscellaneous other statutes.

Non-fiscal commercial and legal terms applicable to petroleum contracts can be as important as fiscal terms in determining whether an investor will choose to invest in upstream opportunities. This report identifies, among other terms, the following non-fiscal commercial terms applicable to concession contracts and production sharing contracts in Tunisia:

- Contract award procedures, including bid criteria and qualification requirements
- Contract terms, including the exploration, appraisal, renewal, and development phases
- Acreage relinquishment requirements
- Minimum work commitments and guarantees to support them
- Participation by the national oil company, ETAP, and the terms of participation
- The role played by ETAP in regulating investment in the sector
- Exploration plans and approval processes
- Development plans and approval processes
- Annual budget approval process
- The rights to utilize land for surface operations, including pipelines for transportation
- Environmental obligations in conducting operations
- Decommissioning obligations on cessation of operations, including the source of funding for decommissioning
- Import procedures and duties applicable to materials and equipment used for oil and gas operations
- Export procedures and duties applicable to exports of oil and natural gas
- Local content requirements for subcontracting
- Local hiring requirements
- Obligations to supply oil and gas to the domestic market
- Requirements benefitting local communities

- The stability of fiscal and non-fiscal terms
- Dispute resolution for government-investor disputes
- Circumstances in which the government is entitled to terminate the contract
- Restrictions on and by the investor

The results of this review are summarized in Section 4.1 below.

Step 1.b Stakeholder Roles

In order to understand the practical efficiency of the current system, Sidley conducted interviews with a range of Tunisian oil and gas stakeholders.

1. The Parliamentary Commission on Industry, Energy, Natural Resources, Infrastructure, and the Environment
2. Ministry of Industry and Small and Medium Enterprises (SMEs)
3. ETAP
4. Ministry of Finance (including the audit team)
5. Ministry of Local Affairs and Environment
6. Ministry of Greater Reform
7. Ministry of Land Use
8. Customs Service
9. Civil society (NRGI, Ridha Bouzouada, and Solidar Tunisie)
10. Large investors (Shell, Eni, and OMV)
11. Small investors (Medco, Perenco, and Topic)

The evaluation is summarized in Section 4.2 below.

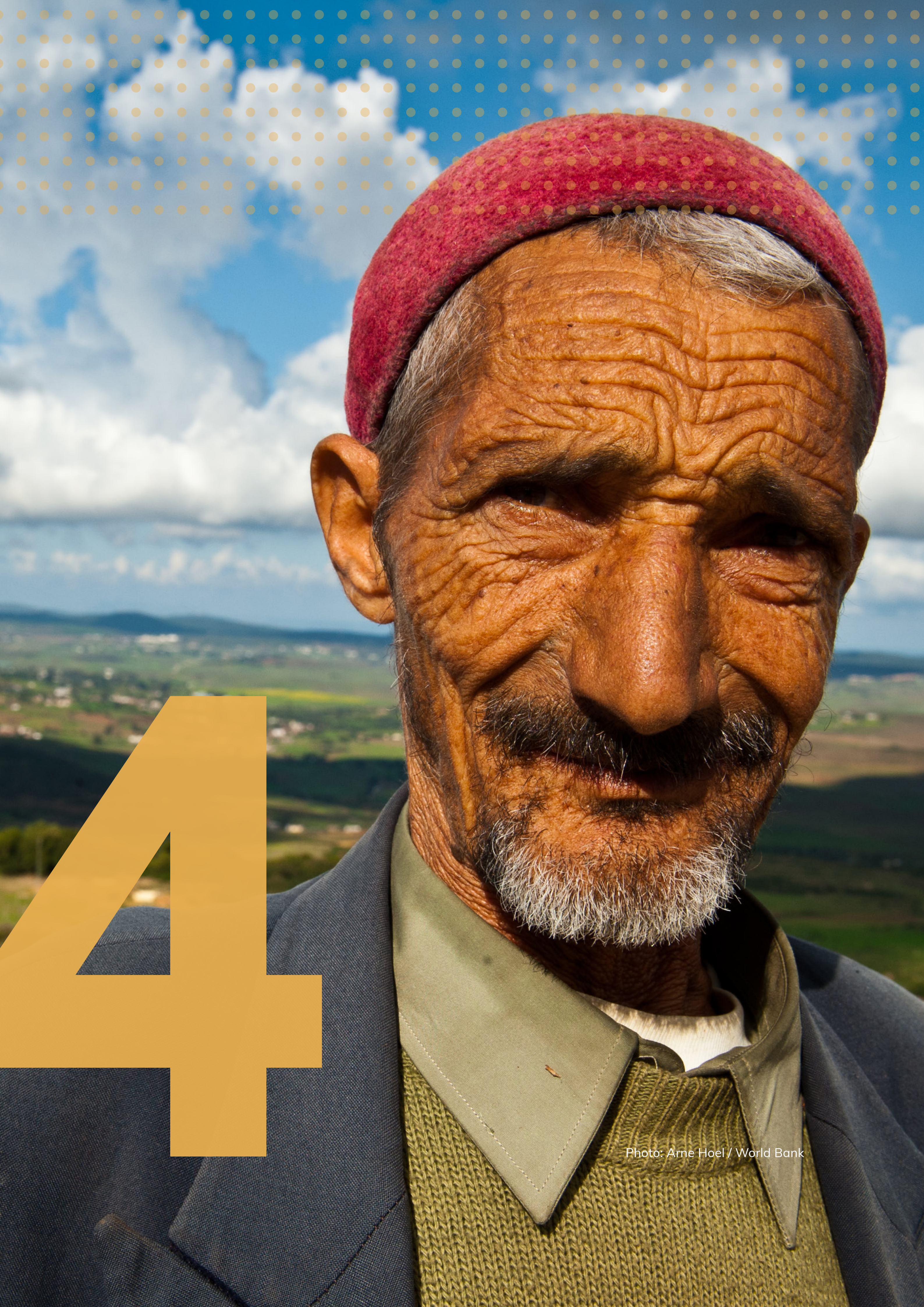
Step 2 – Competitive Benchmarking

In order to meet the goal of attracting investments to oil and gas in Tunisia, the commercial and legal terms should be competitive given the country's resource potential. In order to evaluate competitiveness of the Tunisian commercial and legal terms, a comparative assessment of the terms was undertaken.

This report analyzes the terms for Tunisia in Step 1 against the upstream hydrocarbons framework of nine other countries, selected because they have been successful in improving their attractiveness for foreign investment, and/or they have recently reformed their hydrocarbon systems:

- Morocco
- Lebanon
- Oman
- Ghana
- Romania
- Malaysia
- Mexico
- Argentina (Neuquen Provice – unconventional resources)
- Colombia

A master comparison chart benchmarked the Tunisian terms against those applicable in these reference countries. A distilled version of this chart is included in the Fiscal Benchmarking Table. Based on the outcomes of the review and benchmarking in relation to the other countries, obstacles to Tunisian non-fiscal commercial terms for investments have been identified.



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The Legal Review

4.1. Findings from the Legal Review

Sidley reviewed the Constitution of Tunisia and a few key laws to identify potential problems with the existing legal framework as well as specific opportunities that might be exploited. Highlights include:

4.1.1. Constitutional Mandate for Efficiency in the Development of Natural Resources. Article 12 of the Constitution mandates that the State exploit natural resources in the most efficient way. This mandate guides a portion of the recommendations to expedite the development process and render it more efficient.

4.1.2. Parliament's Role Under the Constitution. The statement in Article 13 of the Constitution asserting that natural resources belong to the people is not unusual; similar concepts appear in constitutions around the world. What is more unusual is the specific constitutional requirement to bring all investment contracts to Parliament for approval:

> "Investment contracts related to these resources shall be presented to the competent committee in the Assembly of the Representatives of the people. The agreements concluded shall be submitted to the Assembly for approval."

While the obligation regarding new investment contracts is clear, the treatment of amendments and extensions, which occur with some frequency, is unclear.

4.1.3. Constitutional Authorization for Allocation of Revenues for Regional Development. Article 136 of the Constitution specifically allows allocation of revenues from natural resource development to regional development if it is applied "throughout the national territory." This guides our recommendation regarding regional development.

4.1.4. Existence of Two Contracting Systems under the Hydrocarbon Code. The existence of two contracting systems under the Hydrocarbon Code causes confusion. Tunisia uses a direct convention award to an investor under Articles 19 – 22 of the Hydrocarbon Code.

However, it also employs an indirect arrangement: the convention is awarded to ETAP, which then enters into a production sharing contract with the investor, pursuant to Articles 97 – 98. The dual contracting systems create a confusing situation with disparate rules that must be enforced separately with different investors. It complicates both the adoption of rules and their enforcement.

4.1.5. Substances Covered by Hydrocarbon Code. The definition of "Hydrocarbon" includes solid hydrocarbons, bitumen, and asphalt. This is somewhat unusual as those substances are exploited in a completely different manner.

4.1.6. Award of Contracts. Contracts are awarded under the Hydrocarbon Code by the relevant ministry rather than through public tender. See Articles 6, 9.1, 10.1, 13 – 15, 17.1, and 39.2. Such a system reduces transparency and trust that the nation is receiving full value on an investment. It also eliminates competition, meaning that the government is unlikely to obtain the best fiscal terms.

4.1.7. Extensions of Contract Terms under the Hydrocarbon Code. The Hydrocarbon Code contains certain extension rights that are discretionary and subject to very few, if any guidelines about when extensions should be granted. See:

4.1.7.1. Extension of Prospecting Permit under Article 10.1.

4.1.7.2. Extra two-year and one-year extensions of Exploration Permits under Article 30.

4.1.8. Other Material Discretionary Decisions under the Hydrocarbon Code. The Hydrocarbon Code contains several other cases where decisions that are significant to the investor are made on a broad discretionary basis. These types of arrangements reduce transparency and increase the risks of actual or perceived collusion:

4.1.8.1. Reduction in the agreed minimum expenditures in Article 25.

4.1.8.2. Changes to the work program (though not the budget) in Article 32.

4.1.8.3. Assignments of interest under Article 34 and Article 55.

4.1.8.4. Reduction of the period during which the investor may not re-acquire interests that it relinquished under Article 38.

4.1.8.5. Extension of the period allowed for commencing development under Article 44.2.

4.1.8.6. Transportation rates for carrying third party production under Article 82.

4.1.8.7. Transfer of tax benefits between permits under Articles 110.2 and 110.3.

4.1.8.8. Authorization of an uplift on exploration costs under Article 112.

4.1.9. The Terms of the Exploration Period and Appraisal Period. The Hydrocarbon Code provides for an unusually long exploration and appraisal period of up to 22 years. It consists of:

4.1.9.1. An initial term of five years (Article 17.2).

4.1.9.2. Two successive renewal terms of four years each (Article 23).

4.1.9.3. A third renewal term of four years if a commercial discovery has been made (Article 28.1).

4.1.9.4. An additional two-year extension (Article 30.1).

4.1.9.5. An additional one-year extension (Article 30.2).

4.1.9.6. For a discovery made toward the end of the exploration period, an additional two-year period may be granted for carrying out the necessary appraisal work, for that discovery only (Article 30.3).

In addition, the investor might obtain a two-year prospecting permit (with a one-year extension) under Article 10.1. That would extend the total exploration time to 25 years. These time periods are unusually long and may allow investors to "bank" their prospects for future drilling, rather than proceed promptly.

4.1.10. Time to Commence Development. Under Article 44 of the Hydrocarbon Code, the investor is given six years from discovery of oil and eight years from the discovery of gas to commence development. These time periods are somewhat long for onshore discoveries and may allow investors to "bank" discoveries without proceeding promptly to development once appraisal is completed. Although the terms of an exploitation concession could shorten these periods, it would be better to have a shorter time frame built into the law. Exceptions might be made in cases where circumstances (such as offshore development, a gas export project, or unconventional resources) require longer lead times. Article 52 of the Hydrocarbon Code provides a shorter period of two years from the granting of a concession to commencement of development. The time periods in Article 44 could be aligned with Article 52, at least for onshore conventional development. In addition, under Article 70.1, the four-year period for a gas development decision could be too short for some large non-associated gas deposits.

4.1.11. Change of Control. The assignment provisions of the Hydrocarbon Code (Articles 34 and 55) do not address change in control. As noted below, in Section 4.2 of this report, that silence has led to disputes and has called into question the government's ability to manage who is holding conventions. Under most legal systems, a change in the ownership and control of a company is not treated as equivalent to the transfer of an asset such as a contract.

4.1.12. Grounds for the Early Termination of the Contract. The Hydrocarbon Code provides for a notice and a cure period if the investor has committed a violation, but the Code does not specify the cure period. See Articles 37 and 57. The Convention form does provide a six-month cure period with respect to Exploitation Concessions, in Article 52 of the Specifications, but six months may be too long. The provision should cover exploration periods as well. Having a known cure period to avoid the risk of a surprise termination is an important factor for an investor considering Tunisia.

4.1.13. Discounted Purchase Price for Domestic Crude Oil. Article 50.1 of the Hydrocarbon Code provides that sales of crude oil to the government for domestic consumption must be 10% below market prices. The price, however, discourages developments, particularly of small fields, which may be better suited for sale in the Tunisian market.

4.1.14. Domestic Gas Price Set by Decree. Under Article 73 of the Hydrocarbon Code, the sale price for domestic gas used in power generation is set by decree, not by the market. This exposes investors to potential changes in the decree price, which may discourage expenditure of significant capital up front to develop gas for the Tunisian market. It leaves investors unsure of their rate of return over 20+ years in the future.

4.1.15. Investor Preemptive Right with Respect to Expired Concession. The investor is given a preemptive right to reacquire an expired, relinquished, or canceled concession in accordance with Article 58 of the Hydrocarbon Code. This may diminish the interest of new investors.

4.1.16. Local Hiring and Training Requirements. The obligations under Articles 47 and 62.2 of the Hydrocarbon Code are very general and high level. This can lead to unsatisfactory results. Article 56 of the Convention provides for an agreement that Tunisians must comprise a percentage of the contractor's total workforce. This number is not known until negotiated and should include skilled and unskilled portions of the workforce to accommodate training new workers.

4.1.17. Use of Local Goods and Services. The obligation to use local goods and services under Article 62.2 of the Hydrocarbon Code only applies in the case of strict comparability between the local goods or services and those that are imported. This means that even if Tunisian goods and services are satisfactory, they do not need to be used.

4.1.18. Rights-of-Ways for Pipelines. The ability to construct infrastructure that brings production to market is a critical factor in making the development of a field viable. Although Article 75.2 declares that the construction of pipelines is in the public interest, later provisions of the Hydrocarbon Code (Articles 85, 86, and 90) indicate that the investor has no ability to pursue acquisition of the land in court but must rely on the government (which is not required to take any action) for this purpose. Where there is permanent occupancy, such as a pipeline, the price paid is twice the market value. These types of provisions encourage landowners to resist negotiation rather than reach a market-based agreement and they delay progress on pipelines.

4.1.19. Rights to Use of Other Producers' Pipelines. Articles 79.2.b, 80, and 82 provide a right for the government to require that an investor carry other investor's production using spare capacity on its pipeline. They do not guaranty that the investor will be able to recover its operating costs, a pro rata share of its capital, and a reasonable profit—the typical standard for pipeline rate-making. Rather, the Articles leave the rate as a negotiation point between the government and the investor. This arrangement does not encourage investment in pipelines with excess capacity.

4.1.20. Distance of Wells from Dwellings. The 50-meter set-back distance in Article 87 of the Hydrocarbon Code is too small, particularly for high intensity unconventional drilling. The public will be dissatisfied with intense drilling close to buildings.

4.1.21. ETAP Participation. Articles 91 – 96 of the Hydrocarbon Code establish mandatory participation by ETAP in each exploration permit. This participation is carried (paid for) by the investor until development. At development, ETAP is given six months to elect to participate on a pay basis. The result is that investors pay the entire cost of exploration and submit development plans without knowing whether they will receive back the carry from the exploration phase or what share of the capital requirements for development they will need to pay. This arrangement makes an investor's decisions about development difficult.

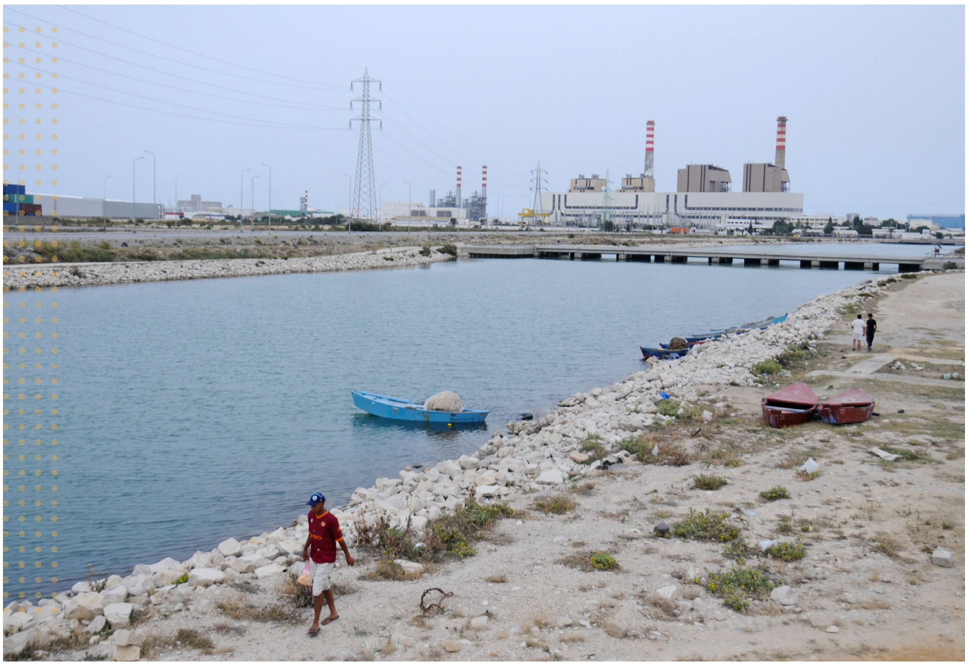

Photo by: Dana Smillie / World Bank

4.1.22. Production Sharing Contracts. The Hydrocarbon Code contains remarkably few details on the contents of production sharing contracts (see Articles 97, 98, and 114), which leaves enormous discretion with the Government to determine the terms of these contracts. This significantly reduces transparency and trust with respect to contracting. There are addi-tional fiscal burden issues related to production sharing contracts, which are addressed in the Van Meurs report.

4.1.23. Stabilization. The stabilization of terms of investment is a key consideration for investors in hydrocarbons. In Articles 105.2 and 105.3 of the Hydrocarbon Code, investors are assured of stability for "taxes, levies, and duties" but they are not protected against changes in other fiscal terms. This is narrower than is typical elsewhere (see discussion in Section 5 of this report below) and has led to multiple disputes with investors in Tunisian oil and gas (see discussion in Section 4.2 of this report below).

4.1.24. Import Duty Exemptions. Articles 116 and 130-4 of the Hydrocarbon Code and the Customs and Taxation Official Bulletin N545/87-08 contain fairly typical exemptions from import duties, but they do not exempt "merchandise and goods available in Tunisia of the same suitability and of comparable price and quality as the ones to be imported" (or, in the case of Article 130-4, "equivalents which are not manufactured locally"). The first exception is vague, leaving wide room for argument between the Government and investors as to whether the investor's imports are exempt from duties.

4.1.25. Decommissioning. Under Articles 118 – 122 of the Hydrocarbon Code, investors are given a right to make an allowance toward decommissioning costs over the last five years of an offshore field and the last the years of an onshore field. If investors relinquish interest prior to the five-year or three-year period, they may be excused from its decommissioning obligation. This arrangement potentially lets original convention holders avoid liability by transferring their interests to another company prior to the five-year or three-year period.

4.1.26. Exchange Controls. Exchange controls apply to foreign investors, including Tunisian local subsidiaries and permanent establishments (branches) of foreign investors, under the terms of Article 127 of the Hydrocarbon Code.

4.1.27. Deemed Approval Under Law on Investment. In the current law on investment, ratified in October 2016, Article 4 asserts that when the deadline for government response expires without approval or rejection, the investment will automatically be approved. This same concept can be utilized to provide a clear path around some of the delays being faced in the hydrocarbons sector.

4.1.28. Imports, Exports, and Land Acquisition under Foreign Exchange and Foreign Trade Regulations. The Foreign Exchange and Foreign Trade Regulations (Decree No. 77-608 of 27 July 1977) allow the Tunisian Minister of Finance to set quotas and to prohibit imports and exports. Similar broad authority applies under Title IV of the Foreign Exchange and Foreign Trade Regulations (Decree No. 76-18 of 21 January 1976) with respect to the treatment of Tunisian assets controlled by foreign entities. Article 20 of the Foreign Exchange and Foreign Trade Regulations requires authorization for acquisition of land that is relevant to oil and gas operations (outside industrial zones and tourist areas). When these activities are conducted in the scope of approved operations under the Hydrocarbon Code, this additional layer of approval and authorization does not seem necessary.

4.1.29. Payment Restrictions. Under Chapter VI of the Foreign Exchange and Foreign Trade Regulations, most payments abroad or between residents and non-residents require authorization, not simply reporting, except where listed in Article 12-bis of the regulations. In addition, under that same chapter, the Central Bank of Tunisia is authorized to fix the currency in which exporters are paid as well as the payment terms for the exports. These are restrictions that normally would not apply to the import of equipment and the export of hydrocarbons.

4.1.30. Authorization of Pipelines. The Foreign Exchange and Foreign Trade Regulations (Decree No. 84-793 of 6 July 1984) authorize pipelines and the use of public lands for the pipelines. It does not, however, authorize the investor to make use of private lands but refers the investor to the general expropriation law (Decree No. 82-60). Obtaining easements under that law (or Decree No. 2016-53 of 11 July 2016, as applicable) has not proven to be effective, as discussed in Section 4.2 of this report.

4.1.31. Existing Local Authorities Support Fund. There is a program in effect to advance funds to local authorities throughout the country under Decree No. 2014-3505 dated 30 September 2014. This may be a mechanism to show more direct benefit to the regions and local governments using a small share of the revenues received by the Government.

4.1.32. Role of ETAP under Relevant Statutes. The law establishing ETAP, Law No. 72-22 of 10 March 1972, notes that ETAP will be "of an industrial and commercial character" and states that the purpose of ETAP is:

- To conduct all oil studies;
- To train Tunisian executives in various branches of the oil industry; and
- To participate in all industrial, commercial, financial, securities, or real estate operations directly or indirectly related to hydrocarbons.

Decree No. 73-173 of 16 April 1973 repeats these principles. There is no suggestion that ETAP is organized as a regulatory body of the state. The commercial role of ETAP is further reinforced by Article 13 of the decree, which indicates that contracts awarded by ETAP are not subject to the general public procurement rules.

However, ETAP has evolved into a regulatory entity, due, in part, to the lack of capacity in the ministry to perform regulatory functions related to petroleum, as discussed in Section 4.2 below.

4.2. Hydrocarbon Focused Critiques

A stable and clear legal framework should be a key priority for Tunisia. Frequent changes within the relevant ministries leads to frequent rule changes. Reform must not result in an overall loss of revenues.

4.2.1. Concerns from State Entities

Energy Commission of the Tunisian Parliament. Members of the Parliamentary Energy Commission ("Commission") represent a diverse set of political parties and interests. The Commission would like to upgrade the Tunisian Hydrocarbon Code and dramatically improve the efficacy of the Tunisian oil and gas sector more broadly. In particular, the current regulatory and legal framework governing the oil and gas sector is not sufficiently attractive to private sector operators.

In general, the Hydrocarbon Code has been assembled piecemeal, which makes it difficult to navigate. The current legal framework for the sector includes multiple laws from different periods, including several different versions of the Hydrocarbon Code, which include contradictory provisions.

The current Hydrocarbon Code was drafted when Tunisia was a net exporter of oil. However, the situation has changed dramatically as Tunisia is now a net importer. This has had a significant negative impact on Tunisia's balance of payments.

The current Tunisian Constitution, adopted after the Jasmine Revolution, provides that natural resources belong to the Tunisian people. As a result, oil and gas permits and contracts must pass through Parliament. There is a concern that the article stipulating ownership by the people, Article 13, has been interpreted too broadly, implying that all major decisions relating to permits and contracts must be reviewed by the Commission. The Commission does not have sufficient knowledge and capacity to assume this regulatory role.

The Tunisian Parliament takes transparency and the fight against corruption very seriously, but there is a lack of trust between the public and the oil and gas sector. The oil and gas sector has been targeted as an area that needs better laws and transparency. The current state of Tunisia's oil and gas sector and reserves is not well-known to Parliament and requires more information. It is not clear to the Commission whether Tunisia's reserves are sufficient to attract investors.

The Commission studied the possibility of developing unconventional resources and renewables, while recognizing the potential social and environmental issues associated with unconventionals. In addition, Parliamentary Commission members noted that secondary recovery from existing fields must also be examined.

There have been recent legal efforts to address the societal responsibility of companies in Tunisia, but local communities are resistant to oil and gas projects and are suspicious of unconventionals. The Commission would like to understand better how the development of the oil and gas sector can help to boost growth, employment, and new infrastructure for the local population.

One challenge to the development of unconventionals is that several prospective areas are already covered by existing concessions. Therefore, new licenses for unconventional development cannot be awarded without cooperation from the existing investor. There is also concern about the ability of ETAP to participate in unconventional development due to the significant capital requirements.

In conclusion, the Hydrocarbon Code needs to be updated to consider the current, unsatisfactory situation, attract private operators to invest in the sector, increase transparency, and address the requirements of Article 13 of the Constitution effectively.

ETAP and SMEs. The development of the energy sector and national resources has become a top priority for the government and Parliament of Tunisia. Investment needs to be encouraged at all levels to improve production and boost revenues. The state entities support the development of unconventionals if due care is given to environmental concerns. In addition, the public needs to be educated about fracking, given the strong opposition by local populations.

The Role of ETAP should focus on the following four objectives:

- **i.** Renew reserves by relaunching exploration activities.
- **ii.** Increase production.
- **iii.** Improve cost efficiency.
- **iv.** Promote sustainable development. The public view of fracking and unconventional development has improved as jobs have become more of a focus for the public. Shale gas potential lies primarily in the south of the country, while there is more shale oil potential in the center. Secondary recovery in existing oilfields is another possibility that ETAP must examine.

Permits. In the current procedures for the granting of all types of oil and gas permits, i.e. prospection, exploration, concession, extension, renewals, etc., applications are submitted to the DGH. Once registered, they are considered by the Consultative Commission on Hydrocarbons (CCH), a multi-ministerial committee that examines all applications and renders a favorable or unfavorable opinion (avis). The final decision is taken by the Minister, who is also the President of the CCH.

Prior to the adoption of the new Constitution and Article 13, oil and gas contracts and permits were approved by simple decree. Since the adoption of Article 13, however, and the related amendment to Article 19 of the Hydrocarbon Code in May 2017, all contracts must be examined by Parliament and approved by law. Only a small number of permits have been approved under this procedure since 2017. Parliament only needs to approve new contracts and amendments, but exploitation concessions in approved contracts do not need to go before Parliament.

ETAP. ETAP holds most oil and gas expertise in Tunisia, granting the entity a disproportionately high role in all decisions. An effective training program for governmental personnel is needed.

ETAP is highly involved in the audit of investors. Under the contracts, a joint management committee consisting of ETAP and the investor approves a final budget every June to close out the year. When it is involved in the relevant concession, ETAP, as a representative of the Tunisian State, audits the final figures and the "R" factor determination. ETAP sets domestic gas price by decree based on a percentage of the low sulfur fuel oil price.

- ETAP may not be sympathetic to investors who want to know the current and future price of gas in order to make judgments about long-term investments.

With respect to pipeline use, there is no formula for compensating the pipeline owner, but the parties must negotiate compensation in every instance. In addition, the land expropriation process for pipelines requires legal action with each owner who disputes the offer for use of his land. This current system might deter investors from building an independently operated pipeline.

In order to make ETAP more efficient, the following amendments to the Hydrocarbon Code are recommended:

- Inclusion of a provision stating that each petroleum contract should include a training component/obligation.
- Inclusion of provisions on unconventionals.
- Inclusion of provisions that clearly define, and not only recommend, how to deal with the use of pipelines (by third parties, for example) and the acquisition of land rights for that purpose.

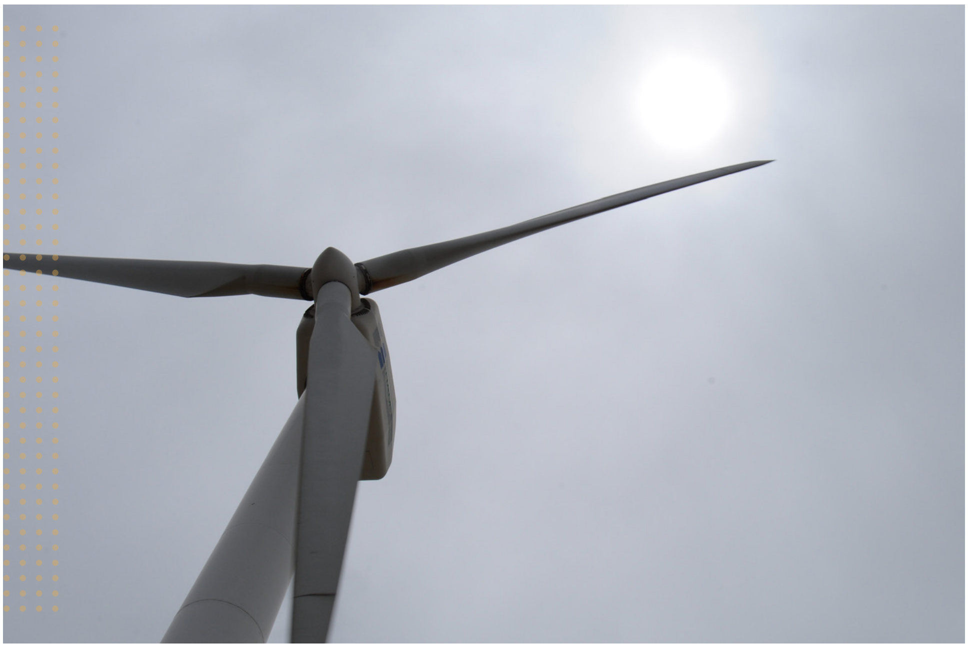

Photo by: Dana Smillie / World Bank

- Inclusion of provisions concerning refinery activities. The fact that the up-stream and downstream sectors are currently held to different legal frameworks is not satisfactory.
- Inclusion of provisions to address inactive concessions.
- Clarifying the roles of the State and ETAP.
- Making contracts simple, transparent, and flexible.

Concession contract enforcement and ETAP's participation in the concessions pose major concerns. When a concession is granted, ETAP has the choice to participate. After the exploration phase of the concession, the operator must submit a Plan of Development (POD), after which ETAP will have six months to determine whether it wishes to participate. If ETAP decides not to participate, the Ministry of Industry (specifically, someone from the DGH) will act as the State regulator for the concession. ETAP or the DGH will audit the expenditures of the concession. When ETAP participates in projects and serves as auditor, a conflict of interest arises. The roles and activities of ETAP and the DGH are not clearly defined in this regard. The government would like recommendations about how to better distinguish their roles to avoid such conflicts of interest.

When ETAP decides to participate in a project, it refunds prior costs only after the start of production and sales have been made. There are no restrictions on prior costs, which include all costs related to exploration, drilling, seismic studies, and costs not yet depreciated. The audit includes all expenditures related to the license. In addition, ETAP provides reimbursement in kind, not in cash.

Although the Hydrocarbon Code includes provisions for the cancellation of permits and concessions, there is no evidence that Tunisia has canceled a permit or concession, even when there has been little activity undertaken by the investors.

On the subject of disputes, Tunisia has participated in investor-state arbitration under the rules of the International Centre for Settlement of Investment Disputes (ICSID) in response to a dispute with Lundin regarding fiscal terms. Lundin prevailed in that arbitration in 2015, and Tunisia made a payment to Lundin to settle the arbitration award.

Ministry of Industry. The Ministry of Industry in Tunisia implements land use restrictions in the oil and gas sector in accordance with geological maps. Local governments are not permitted to pass laws restricting access to land.

4.2.1.1 Reflections and critiques from private sector oil and gas operators present in Tunisia (Shell; ENI; OMV; Medco Energi; Perenco; and TOPIC S.A.)

The operators require a more stable and well-defined legal and fiscal framework. Currently, the oil companies are operating their concessions under a variety of different legal regimes. The fiscal regime requires more stability and transparency as well as better fiscal terms (including, for example, periods when oil prices are low).

New charges must not be imposed on investors without any prior discussion. For example, in 2014/2015, the government imposed an “exceptional contribution” on the oil and gas sector. Similarly, in 2019, the government promulgated a permanent exceptional contribution tax based on 1% of a company’s turnover. These changes in the fiscal system are viewed by the investors as contradicting the tax stability requirements of the Hydrocarbon Code. Furthermore, the tax authorities are not willing to take decisions to settle disputes about taxes. Therefore, the parties must resolve tax disputes in lengthy court procedures.

For operators, ETAP has been a challenging joint venture partner. Government control over ETAP's budget means it struggles to make investment decisions. Contradictory feedback on regulatory matters is often given by different departments within ETAP. Yet, ETAP has become a de facto regulator because the ministry lacks resources. ETAP often operates in conflict of interest situations because it is making determinations about policy matters in which it is interested.

Permit approvals and renewals are difficult to obtain. The criteria applicable to the granting of permit approvals and renewals is not clearly defined. Binding deadlines for permit approval and renewal decisions are needed. The preferential right to match other offers on an expired contract area does not help if no other company makes a prompt offer for the area. In addition, extension requests under the old Hydrocarbon Code must be submitted at least ten years before the expiration of the concession despite the impossibility of planning ten years in advance.

Although the Hydrocarbon Code does not distinguish between treatment of the contract holder and its contractors and subcontractors, the formalities differ depending on whether the company holds an actual concession or is only an oil service company.

Oil and gas operators need incentives to promote new exploration in Tunisia. The current regime is not sufficiently attractive to encourage exploration: the holder absorbs the risks. If nothing is found, all exploration expenses are lost. Due to ring-fencing of tax by convention, exploration costs cannot be recouped from other blocks, thus discouraging exploration. The ring-fence arrangement makes it difficult to build common facilities for use by multiple concessions.

Oil and gas operators face challenges from the local population lodging complaints about alleged environmental violations and seeking compensation for land, agricultural activities, animals, etc. The operators believe that the courts do not address these cases fairly and that they systematically lose their cases. Operators also face difficulties in acquiring land for their projects when there is local opposition. Typically, Tunisia does not exercise its expropriation rights on behalf of operators or assist the private operators in dealing with local land issues. Operators are often forced into extended negotiations with landowners and can be forced to settle property ownership disputes for prices far above market value. As a result, the price of land has skyrocketed where projects are planned.

Operators have expressed interest in unconventionals, but there is strong public opinion against them. Operators believe that a public education campaign about unconventional resources and the possible risks and rewards is needed. The local population attributed a small earthquake in the South to the development of unconventionals, though such development does not exist yet. Similarly, the agricultural ministry rejected a permit for fracking in a conventional vertical well though fracking has been undertaken in Tunisia for decades.

The audit process is too complicated and lengthy. Audits can be carried out by ETAP when it participates in joint ventures. The tax authorities can undertae tax and royalty audits. The required documents and information needed for an audit are uncertain, and Tunisia formulates reserves which take a long time to settle. Audits often take place after a delay of several years and can take many years to complete. Operators would like the government to include binding deadlines for audits in the revised Hydrocarbon Code.

The lack of clarity in the Hydrocarbon Code about whether an approval is needed for the change in control of an investor has led to confusion and disputes with the Government.

The ambiguity in the transition provisions of the Hydrocarbon Code and their impact on the remaining terms of an original concession under the earlier law led to a serious issue for one of the operators. The government attempted to apply retroactively the shorter duration of concessions under the Hydrocarbon Code to invalidate the pre-existing concession. An attempt to resolve this disagreement through administrative channels did not work and resulted in repercussions for personnel in the government who attempted to settle the matter. As a result, government officials are reluctant to make decisions regarding ambiguous provisions.

The government is obliged to reject investor expenses that are not clearly allowed in the law even if they are justified.

Pipeline owners have no guidance about what tariffs they will receive from others using their pipelines. There is no provision in the Hydrocarbon Code for sharing infrastructure such as terminals.

Many incentives in the Hydrocarbon Code require special applications that are discretionary. This is not ideal because it renders decisions arbitrary and opaque.

More generally, no one in the government is empowered to make decisions, there are few fixed deadlines, procedures are complicated, and the authorities often delay in reaching decisions. These are not encouraging conditions for investors.

4.2.1.1. Critiques of the Hydrocarbon Code by Ministers

Ministry of Finance. The terms and provisions of the Hydrocarbon Code must be better defined to avoid strong variations in application and interpretation. When the Hydrocarbon Code was adopted, the perception regarding available oil and gas reserves differed from the actual reserves. As a result, government revenues are lower than expected, and the Hydrocarbon Code does not provide the intended fiscal incentives.

In 2018, a permanent 1% contribution from investments was introduced in the Finance Law, but it does not apply to the oil and gas sector. Yet, the ministry treats the “exceptional contributions” that were introduced in the Finance Law in 2014 (15%) and 2017 (7.5%) not as a tax, but rather as a perfunctory “contribution” that must be paid by all companies.

The ministry does not have a defined audit process for oil and gas companies, despite their general mission to audit public and private companies. When ETAP is not in a contractual relationship with the operator, audits are carried out by committees or departments within the Ministry of Industry or the Ministry of Finance. Audits of major companies are carried out by the “Department for Major Companies” within the Ministry of Finance. The audit cycle reaches each company every four to five years.

Audits should focus on the company rather than the concession. The “R” factor is not dynamic enough. More specifically, the “R” factor does not properly react to changes in oil price, meaning that the investor can have too high a burden during a period of low oil prices due to previous revenues.

In addition, the “R” factor discourages investment later in the life of a field as it is tied to cumulative historic net revenues, rather than current net revenues. A concession can switch from one regime to another at any time if, for example, the proportion of oil relative to gas changes.

In addition, the parliament must stop treating each concession as if it is a separate company, subject to a distinct tax regime and a different “R” factor.

Audit disputes are not related to the applicable tax, but rather to the expenses incurred by the operators during the initial phases of exploration. The applicable rules are unclear, particularly with respect to how to treat expenses in the initial phases of projects. Disputes can take years to resolve and are sometimes only resolved through arbitration. The situation is compounded by the lack of adequate specialized personnel within the audit team. Qualified personnel often take jobs in the private sector.

Concessions in Tunisia need to be clarified. The current Hydrocarbon Code is too complicated with respect to the applicable fiscal terms and the calculation of the “R” factor. The information required to calculate and verify the “R” factor is lacking. The main problems stem from contradictions between the requirements of Article 13 of the Constitution (which requires Parliamentary approval), the Hydrocarbon Code, and the contracts with operators. Confusion dictates which law and provisions should apply. Since the adoption of Article 13 of the Constitution, there have been very few approvals for new concessions.

In general, the fiscal system does not encourage development of smaller fields or additional investment later in the life of a concession.

The Ministry of Local Affairs and Environment, Ministère des Affaires Locales et de l’Environnement. An environmental impact assessment must be carried out for every project. Following an environmental impact assessment, the Ministry and the Agence Nationale de Protection de l’Environnement Tunisienne (ANPE) must issue an approval certificate based on environmental impact. There is no channel for public input about a project's environmental impact statements.

The Ministry of Environment has commissioned studies focusing on the potential for unconventionals in Tunisia and the related environmental impact and risks. The studies are being prepared by two independent consulting firms from Tunisia and Canada. The first part of the study is now finished, and the second part should be finished by the end of 2020. A baseline study would monitor the effects of unconventional development on land use and water supplies.

Tunisia plans to revise its energy mix and expand its share of renewable energy from the current 4% to 30% by 2030.

The Ministry of Great Reforms, *Ministère des Grandes Réformes*. The ministry facil-itated amendments and simplifications to the Tunisian Investment Code and supports a more streamlined Hydrocarbon Code to attract investors and provide a more transparent framework. The reform should also include capacity-building in the energy area for the Ministry of Industry.

4.2.1.2. Comments and critiques by Land and Property Ministries:

Ministry of Land Use, *the Ministère des Domaines de l'État et des Affaires Foncières.* The Ministry of Land Use in the oil and gas sector exists to make land available to operating companies when the exploration of hydrocarbons takes place on state property. The ministry representatives intervene in oil and gas projects in the follow-ing cases:

- If the land is for a concession and it is located on state property, the Ministry of Land Use will provide the operating company with the land under the concession agreement.
- If the land is to be used for a concession and it is owned by private individuals, the operating company must obtain the approval of the landowner. However, if the land is required for a long-term concession, the Ministry of Land Use may resort to expropriation of the land for the benefit of the state and provide it to the operating company.
- If the land is required for a pipeline, then it involves a right of servitude and will be regulated by the law of 1968. An expert from the Ministry of Land Use will intervene to determine the amount of the servitude.

The lease amount is assessed by an expert, who considers the type of land (com-munal, agricultural), its current use, and other factors such as whether the land is fertile, the level of taxes, etc. These factors are considered for both public property and privately-owned land.

According to the Hydrocarbon Code, the government can only purchase privately-owned land if it is in the general public interest. If an agreement to purchase land cannot be reached with the landowner, then the government will apply the provisions of Law No. 53 of 11 July 2016 on expropriation.

Expropriation for public interest must the benefit of the state, but private entities may also benefit from expropriation for public interest. Pipeline projects are treated as public interest projects due to the income that they generate for the Tunisian state.

To access water, sand, gravel and other resources that are relevant for unconventionals, several different Ministries would be involved in the regulatory and approval process, including the Ministries of Agriculture (water), Infrastructure (sand and gravel), and Industry.

Offshore, subsea lands, and ocean bottoms are public property. The public maritime sector is governed by the Ministry of the Environment and National Agency for the Protection of the Coastline, together with the Ministry of Infrastructure.

The expropriation of land for the oil and gas industry is primarily a social and political issue and not a major legal issue in Tunisia. It may be controversial to change the law to allow a private company to expropriate land for purposes of public utility.

In Tunisia, there is great sensitivity to fairness across regions. The government cannot adopt a program of benefits that applies only to the regions that produce oil and gas, but the Constitution requires that the national government provide resources to local governments in a balanced manner.

The Customs Agency, the *Direction Générale des Douanes*. Customs exemptions for the import of oil field equipment apply when there are no comparable goods available in Tunisia. In response to questions about how investors will know whether there are comparable goods available, the customs representatives explained that the investors would need to consult with the General Directorate of Mechanical Industries. There is no published list of which goods and equipment qualify for exemptions. Therefore, exemptions must be addressed on a case by case basis.

To benefit from the customs exemption, companies need to file an application for exemption with the Ministry of Industry. The ministry reviews the application and grants the exemption, which will be included in the application form to import the goods into Tunisia. The office of fiscal incentives within Customs reviews the application and grants the final import declaration. In practice, the Ministry of Industry cannot always process requests for exemptions in time. Therefore, the Customs authority allows companies to file detailed declarations up to 30 days after the import of goods or equipment.

Customs Locations. There are several regional customs offices where operators can clear customs. Operators can choose which customs office they prefer. However, oil companies do not require a customs office on site because they can complete the customs procedures themselves or through a customs agent who can deposit the customs declaration on their behalf.

With respect to the potential abuse from importers who benefit from customs exemptions on goods (like vehicles, for example) and subsequently sell the goods

in Tunisia, the Hydrocarbon Code and the Customs Code are not monitored. The Customs authority must study methods and techniques used elsewhere to monitor and track imported goods (for example, the invisible marking of equipment). The customs authority should also make the import arrangements a “suspension” rather than an “exemption” so that duties would automatically apply if goods were diverted for other purposes or sold.

When an oil company exports crude oil, it must pay a 1.5% fee for customs services on the total value of the export. The value of the fee is assessed by the Ministry of Industry based on the S&P Global Platts price, which is calculated as an average over the entire month.

The Customs authority must improve customs procedures, primarily, by making it digital.

4.2.1.3. Critiques by the Natural Resource Governance Institute (NRGI), an NGO active in the oil and gas sector.

A model contract must be included in the new Hydrocarbon Code. NRGI commissioned Solidar, a Tunisian think tank, to prepare model contracts that mandate transparency and more competition. NRGI made recommendations for the awarding of new oil and gas contracts in collaboration with the legal department of the Ministry of Energy and Mines.

NRGI recommends clarifying the roles of ETAP and of the Ministry of Industry. As stated above, ETAP acts in a regulatory role and invests in projects, which constitutes a conflict of interest. It effectively dominates the entire hydrocarbons sector in Tunisia.

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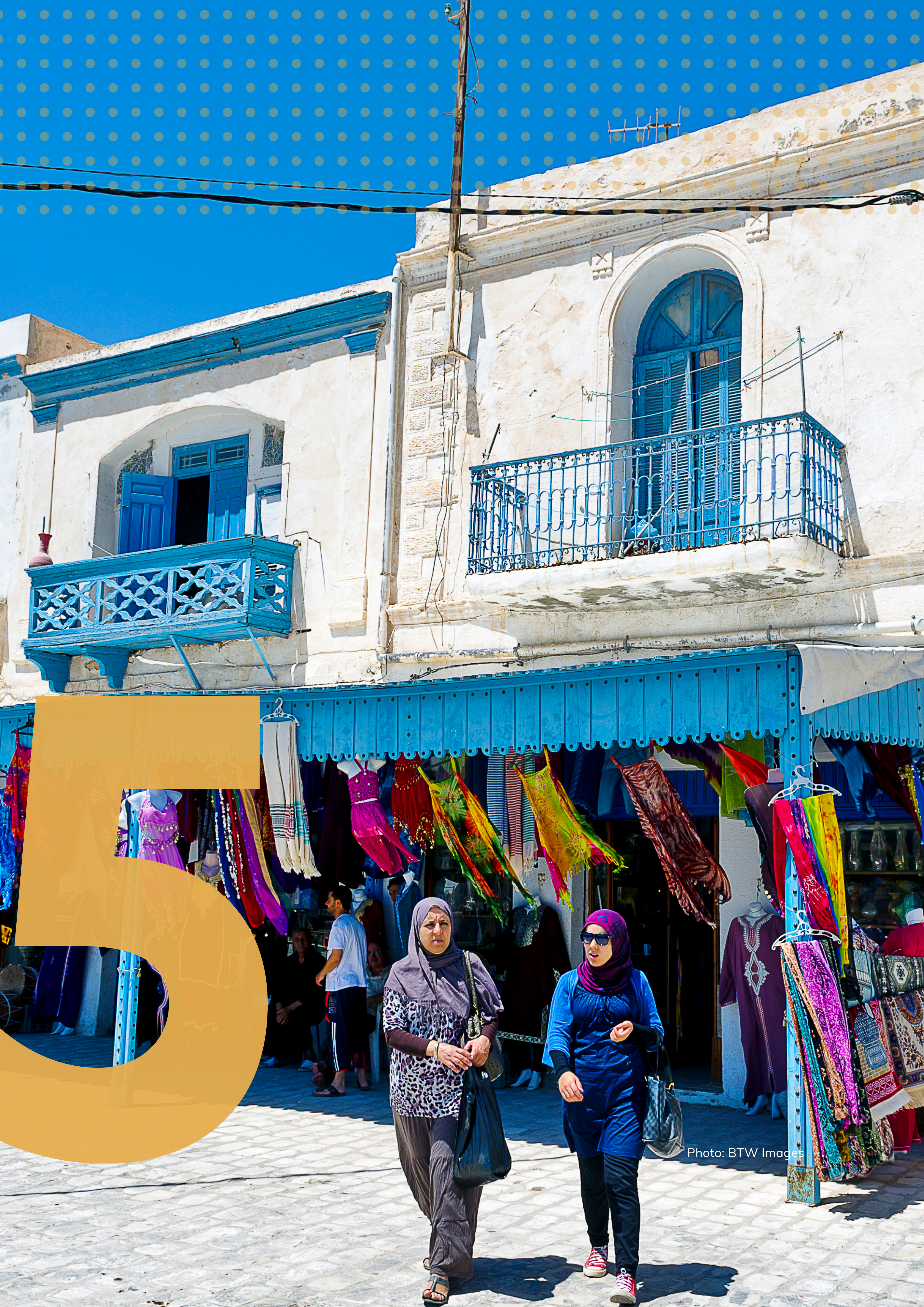

Photo: BTW Images

Comparison of Tunisia and Other Non-OECD Country Hydrocarbon Regimes

A detailed, model-based comparison of the fiscal terms of the Tunisian hydrocarbon regime with competing countries is discussed in Chapters 4 and 5 of the "Fiscal Review." In the Fiscal Benchmarking Table, the Tunisian hydrocarbon regime's commercial and legal provisions are compared to those of nine other countries ("reference countries"), which have implemented successful reforms or have had success in attracting investors. Key commercial and legal comparisons are discussed below. These comparisons reveal that the current Tunisian hydrocarbon regime differs from the typical approach in a variety of ways, outlined in detail below:

5.1. Contract Award Procedures. Tunisia's direct award of contracts by the Ministry of Industry, with approval by Parliament, contrasts with the typical approach in the nine reference countries. Many of the reference countries rely on public tender as the sole or main basis for awarding contracts to investors. Seven reference countries do not require parliamentary approval for individual contracts. Of the nine countries examined in the benchmarking, seven used public tender as the sole basis for contract awardĉ and one used it as one of two rationales. Only Malaysia relies on a direct award based on nominations of interested investors as the primary basis for issuing contracts.

5.2. Contract Term. The 30-year development phase term for Tunisia does not differ materially from the development phase terms for the reference countries (two offer 25-year terms, one offers a 29-year term, five are 30-year terms, and one, 35 years). In the case of exploration and appraisal, Tunisia differed dramatically from the other countries. The Tunisian system allows up to 26 years between the initiation of a prospecting permit and commencement of development, enabling long-term banking of Tunisian prospects. In contrast, the average maximum time allowed by the reference countries (excluding those cases with insufficient data) is just under 8.5 years.

5.3. Right of Renewal at the End of Term. In contrast to Tunisia, which provides a preferential right when the contract area is offered again, seven of the reference countries provide for formal, specified extensions of the development term (ranging from five years to more than fifteen years), on the request of the investor. The decision to approve the application is discretionary with the government.

5.4. Acreage Relinquishment Requirements. Tunisia's reduction in the investor's contract area at the first exploration period renewal accommodates up to 80% of original area, the second exploration period renewal accommodates up to 64% of the original area, and third exploration period accommodates up to 50% of the original area under Articles 26 and 28 of the Hydrocarbon Code. These percentages are more generous to the investor than the average of the reference countries (a common reduction to 50% of the original area at the first exploration period renewal, and an additional 25% at the second exploration renewal period renewal, with the great majority of reference countries having no third exploration renewal period). In all cases, the investor chooses the existing development areas and those to be relinquished. In some cases, discoveries are excluded from the relinquishment calculation.

5.5. Minimum Work Commitments and Guarantees. In both Tunisia and many of the reference countries, the minimum work program is established with both a required program of work and an estimated minimum expenditure. In the event of a failure to fulfill the minimum work program, the shortfall in the minimum expenditure is paid to the government.

5.6. Required Participation by National Oil Company. ETAP has a required participation as specified in each convention. This participation is carried until development, at which time ETAP has six months to elect to continue or decline participation on a paying basis. The ETAP percentage can climb as high as 50%. In contrast, the manda-tory national oil company participation in the reference countries ranges from 0% (in four countries) to 25% (the other four countries).

Of the four countries with mandatory national oil company participation, the national oil company is carried until

i. completion of the minimum work program,

ii. development, and

iii. completion of development. In Argentina, the national oil company must choose between a production fee (royalty) or payment of a working interest at the time of commercialism.

5.7. Regulatory Role of National Oil Company. ETAP has evolved into a significant regulator, conducting audits and carrying out other functions on behalf of the Ministry of Industry. In contrast, in five of the reference countries, the national oil company has no regulatory role, and in four of these five, regulation is handled by an independent agency. Of the other four countries, the national oil company played a limited regulatory role in one (Ghana) and a significant regulatory role in the other three.

5.8. Approval Procedures for Exploration Plans. In Tunisia, the holder of an exploration permit must agree to a program of work for the current term of the permit. Six of the reference countries clearly require separate exploration plans. Of these six, three establish these exploration plans as part of the public tender process for the contracts, two provide for discretionary approval by the government, and in one country, the exploration plan is submitted for informational purposes only, but not for approval.

5.9. Approval Procedures for Development Plan. The development plan is part of the application for an exploitation concession and approved as part of the same process in Tunisia. It must be submitted within 12 months after the end of appraisal operations. In the reference countries, government approval is also required. The deadlines for submission are tied to the declaration of commercialism and range from 90 – 120 days (in two countries) to 180 days three countries).

5.10. Approval Procedures for Annual Budget. Under the Production Sharing Contract (PSC) form, investors in Tunisia submit a proposed annual budget to a joint management committee consisting of representatives of the investor and ETAP for approval. The PSC form allows for a budget overrun up to an agreed amount. Under the convention, investors submit their annual budgets to the Ministry of Industry. In six of the nine reference countries, government approval is required for annual work programs and budgets. The situation in one country was unclear. In Mexico, the budget required approval for PSCs but not for licenses, and in Ghana, the budget served to provide information only during the exploration phase. In three of the countries where approval is required, the investor is authorized to make minor changes (up to 10%-15% of the budget) without government approval.

5.11. Rights to Use Land. As noted above in Section 4, Tunisian law provides that pipelines are part of public utility, but it gives only the government the right of expropriation for purposes of the project. Of the five reference countries, where the treatment of expropriation was clear, three provided for expropriation of necessary land by the government on behalf of the project, Morocco permitted the investor to expropriate land if the government had declared its work to be of public utility, and Romania did not offer specific expropriation rules for the hydrocarbon industry but referred instead to prevailing laws on expropriation. One country, Mexico, gives affected landowners a share of production (0.5% - 3%).

5.12. Environmental Surveys and Other Prerequisites for Conducting Drilling and Constructing Infrastructure. An environmental impact study and agreed measures to protect the environment based on that study are a requirement to carry out operations in Tunisia. Of the seven reference countries for which requirements could be determined, all required similar actions.

5.13. Decommissioning Obligations. Decommissioning requirements under the law in Tunisia are fairly high level, with an obligation to decommission according to the standards required by law, an obligation to present a decommissioning plan in advance, and an entitlement to set aside a cost-recoverable allowance for decommissioning costs starting five years before decommissioning in the offshore and three years before decommissioning in the onshore. A cumulative amount of funds required to be deposited each year is based on the ratio of production to date versus total recoverable reserves.

Of the reference countries, three require a decommissioning plan at the commencement of production and the contribution of funds each year during the life of the field. Three others require a plan three years to five years before decommissioning, but only one country required contributions to a decommissioning fund during this period, which is in line with Tunisian policy. The final three reference countries have decommissioning requirements but details regarding implementation are not available.

5.14. Exemptions from Import Duties. According to Articles 116.1 - 116.2 of the Hydrocarbon Code, an investor in Tunisia can import equipment and materials free from customs duties and VAT, but this exemption does not apply where goods of comparable suitability, price, and quantity are available in Tunisia. Several of the reference countries offer a similar full exemption, though Oman offers only a reimbursement of duties for the first three years, and Colombia offers only a 50% exemption. Others, such as Romania and Malaysia, seem not to offer exemptions.

5.15. Exemptions from Export Duties. In Tunisia, export duty applies to hydrocarbon exports but is considered an advance on the corporate income tax (See Article 100.f of the Hydrocarbon Code. Five of the reference countries provide full exemptions from export duties and VAT on exports. Argentina allows a refund of VAT, while Morocco provides a five-year exemption and reduced rate thereafter. The rules for export duties in two countries are unclear.

5.16. Local Content – Subcontracting. Under Article 62.2.b of the Hydrocarbon Code, investors in Tunisia are required to use materials and equipment made in Tunisia and Tunisian services if the prices, quality and delivery times are comparable. Several of the reference countries had stronger requirements. Mexico and Argentina have specific percentage requirements for local content. Lebanon and Ghana require local goods and services be used even if they are up to 10% more expensive. The others take a comparable approach to Tunisia or have subcontracting laws that are unclear.

5.17. Local Content – Hiring. Tunisia requires that operators hire Tunisian personnel where available and train local workers for specialization in accordance with a training plan approved by the Government (see Article 62.2.a of the Hydrocarbon Code). A recruitment and training program is also required as part of any development plan (see Article 47.e of the Hydrocarbon Code). The relevant contract may also require the utilization and training of ETAP personnel and may require a negotiated minimum percentage of Tunisian nationals. All of the reference countries, except for Romania, have a similar preference for local hiring, but five countries have specified numerical percentage requirements, generally 70% to 100% of positions other than managerial and/or technical/professional. Colombia also requires that at least 30% of managerial and technical/professional staff are local.

5.18. Local Content – Training. Tunisia requires a training plan, as noted above, and may require the training of ETAP personnel in the contract. Five of the reference countries require specific annual training contributions to the government, and two contain requirements for the investor to train national oil company personnel. Two countries have no training requirements.

5.19. Domestic Marketing Obligation. In Tunisia, under Article 50 of the Hydrocarbon Code, investors must supply the local market, if called upon, with up to 20% of their oil production. The production is sold at the normal Free on Board (FOB) export price minus 10%. Under a PSC, ETAP may bear this obligation. For gas, Article 65 of the Hydrocarbon Code gives the domestic market full priority over the export market. The price for local gas sales is set by decree where gas is used as fuel (see Article 73 of the Hydrocarbon Code). Four of the reference countries have no domestic marketing obligation for crude oil and two have no domestic marketing obligation for gas. In three countries, where there are domestic marketing obligations, the investor's obligation may be limited to its pro rata share based on the overall production in the country. Payment for domestic supply, in each reference country, is at market value with the exception of Argentina, which has a temporary above-market guaranteed price to encourage local gas production.

5.20. Local Community/Social Program Requirements. Tunisia does not presently require social actions by investors. Of the reference countries, two have such programs. Argentina offers optional fiscal benefits to investors if they contribute 2.5% of their initial investment amounts to a corporate social responsibility project, and Colombia requires implementation of a community program with a minimum expenditure equal to 1% of the cost of the exploration plan. As noted above, Mexico requires payment to impacted landowners of a share equal to 0.5% to 3%. The other reference countries appear not to have mandatory local community programs.

5.21. Stabilization. Articles 105.2 and 105.3 of the Hydrocarbon Code assure investors of stability of "taxes, levies, and duties." Of the reference countries, Ghana offers stability that covers not only the economic terms of the contract, but the terms more generally. Three reference countries provide general fiscal stability, one provides stability limited to tax, and one authorizes separate tax stability agreements. It is unclear if the reference countries implement these requirements.

In general, parties are obligated to meet and agree on changes to the contract that are required to restore fiscal stability. In two of these cases, the investor is expressly authorized to refer the matter to arbitration or an expert if the parties are unable to agree upon the required changes. Three of the countries do not provide for fiscal stabilization.

5.22. Dispute Resolution. In Tunisia, petroleum contract disputes are subject to international arbitration, under the International Chamber of Commerce (ICC) rules in Paris (in French, or French and English). This is a very typical approach, with seven of the nine reference countries using international arbitration for dispute

Photo by: Curt Carnemark / World Bank

resolution. Of those seven, three use ICC rules and two use the International Centre for Settlement of Investment Disputes (ICSID) rules with ICC as a backup if ICSID jurisdiction is not available. Two of the countries that offer arbitration, Colombia and Malaysia, require that arbitration be held in the country; the others provide for arbitration in London or Paris.

5.23. Government Right to Terminate the Contract. In the event of violations, each country's government holds a right to terminate a contract early, though the terms differ from country to country. The chart below shows the basis for terminating a contract in Tunisia under Hydrocarbon Code Articles 37 and 57 in comparison to the nine reference countries:

Basis for Terminating Contract Early	Tunisia (Yes or No)	Reference Countries (number including)
No longer technically or financially qualified	Yes	0
Provided false information	Yes	4
Failure to fulfill the minimum work program	Yes	2
Failure to commence work in a timely manner	Yes	0
Transferred interest in violation of restrictions	Yes	3
Failure to submit an abandonment plan, etc.	Yes	0
Failure to assume the interest of a withdrawing co-owner	Yes	0
Failure to provide required information	Yes	0
Refusal to follow government orders	Yes	0
Failure to pay	Yes (just royalties)	5
Abandonment or suspension of operations	No	5
Failure to comply with an arbitral or court ruling	No	2
Violation of law or permit requirements	No	3
Bankruptcy	No	1
Extraction of unauthorized minerals	No	1
Violation of confidentiality obligations	No	1
Serious accident or misconduct	No	1
General breach of the contract	No	7

As the chart shows, Tunisia's terms differ significantly from more common international procedures because they lacks a "catch all" clause that allows for termination in the event of any violation, even if it is not otherwise listed. With the exception of the exploitation period, Tunisia does not provide a stated period in which the investor can cure a default before the contract is terminated. Most of the reference countries provide such a period for the contract: three countries provide 90 days, three provide 30 days, and three could not be determined.

5.24. Restrictions on Assignment and Change in Control. In Article 31 of the Hydrocarbon Code, Tunisia matches the approach taken by the reference countries, which is to require government consent for an assignment of an interest in the contract, except in the case of an assignment to affiliates. The Hydrocarbon Code states that it covers assignment "in whatever form" the government has interpreted as covering changes of control by the contract-holder. In contrast, five of the reference countries expressly require consent in the case of a change in control. One country, Argentina, required consent for both "direct and indirect" assignments.

6

Photo: Aurore Kervoern

Recommended Changes to the Tunisian Upstream Framework

6.1. Alter Fiscal Terms to Make Tunisia Competitive

6.1.1. The first key recommendation is to eliminate the "R" factor to help the investor receive a higher share of return in the event of a high cost structure. Due to its cumulative nature, the "R" factor discourages investment late in field life. It does not adequately capture benefits from higher oil prices and it is complex to administer. There are several replacement options for income taxes and royalties:

6.1.1.1. The general corporate income tax under the Tax Code would apply to earnings. According to Article 49 of the Tax Code, a fixed rate of 35% would be applicable to hydrocarbon income. The use of a single fixed rate simplifies tax calculations significantly. It also reduces the incentives for disputes between the government and investors. In contrast to an "R" factor environment, costs would matter only for purposes of deductions, and they would not affect tax rates. As a result, the incentive for investors to cut costs aggressively would be reduced.

Specialized provisions of the Hydrocarbon Code (other than tax rates) dealing with hydrocarbon taxation that are still applicable after the changes would be moved from Articles 101 through 113 of the Hydrocarbon Code to a section of the Tax Code. Taxation of hydrocarbons would be treated like taxation of any other specialized industry.

6.1.1.2. An uplift would be applied against capital expenditures to allow larger deductions and incentivize more drilling and development. The uplift would not apply to operating expenses. Therefore, costly operators would not be rewarded. Adding the uplift would make the rate of return for investors sensitive to development costs, providing an incentive for investors to develop more expensive fields. This concept already exists as a discretionary option for certain types of fields in Article 112 of the Hydrocarbon Code but would become standard to encourage activity across the board. The recommended uplift is 30% for conventional hydrocarbons and 50% for unconventional hydrocarbons.

6.1.1.3. Certain additional provisions unique to hydrocarbons (such as the deductibility of certain exploration dry hole costs in the year incurred) would also be included in the new section of the Tax Code, as described in detail in the "Corporate Income Tax" section of the "Fiscal Review."

6.1.1.4. For conventional resources, royalties would be revised to enable a volume-based component with higher rates for more productive fields. Royalties would also be revised to enable a price-based component to increase the royalty rate at higher price levels. In contrast to the "R" factor, these changes would allow smaller fields and investments made later in field life, such as enhanced recovery, to be more attractive to investors and to encourage more immediate interest in several of Tunisia's known prospects. In addition, unlike the "R" factor, this approach would yield a higher share to the government as soon as prices rise.

6.1.1.5. For unconventional resources, the base royalty would not fluctuate, but it would be fixed. Every well in an unconventional field is a separate profit or loss center, as there is generally no pressure connectivity between wells. As a result, a successful unconventional project will need to have many wells. The high volume well requirement results in very high costs due to the amount of drilling and the cost of each well. A fixed royalty is used because volume-based royalties do not work well in a high volume and high cost environment.

6.1.1.6. A relatively low fixed royalty rate is recommended to attract investors to Tunisia's unconventional environment because it is not proven for investment. A relatively low fixed royalty rate also recognizes the very high rates of return earned on some shale investments in the United States, which compete for investment dollars with shale projects elsewhere. In Tunisia, there would still be a price-based component, enabling royalty rate increases at higher price levels. If the government wishes to incentivize development of unconventional resources to an even greater extent, it could eliminate this price-based royalty for unconventional resources as well.

6.1.1.7. The royalty could be in kind or cash. The license would describe in detail the procedures for determining the royalty. The total royalty rate would be the sum of the rate based on the daily production plus the rate based on the value (price) of the oil and gas.

6.1.1.8. Royalty rates for different classifications of conventional fields should be calculated based on the following sliding volumetric scales. A linear interpolation should be used to determine royalties for production rates falling between those levels shown on the chart below. Royalty at production rates below the lowest volume shown would be fixed, and royalty at production rates above the highest volume would be fixed at those rates.

(a) For onshore areas, the royalty rates would be based on the average daily production of each development area for the previous month, based on the following table:

Oil and Condensates		Gas (including natural gas liquids)	
Barrels per day	Royalty Rate	MCF per day	Royalty Rate
5,000	5.00%	50,000	5.00%
10,000	12.50%	100,000	12.50%
20,000	22.50%	200,000	22.50%
50,000	27.50%	500,000	27.50%

(b) For shallow water areas with water depths of less than 400 meters, the royalty rates would be based on the average daily production of each development area for the previous month, based on the following table:

Oil and Condensates		Gas (including natural gas liquids)	
Barrels per day	Royalty Rate	MCF per day	Royalty Rate
10,000	5.00%	100,000	5.00%
20,000	12.50%	200,000	12.50%
40,000	22.50%	400,000	22.50%
100,000	27.50%	1,000,000	27.50%

(c) For deep water areas with a water depth that exceeds 400 meters, the royalty rates would be based on the average daily production of each development area for the previous month, based on the following table:

Oil and Condensates		Gas (including natural gas liquids)	
Barrels per day	Royalty Rate	MCF per day	Royalty Rate
20,000	5.00%	200,000	5.00%
40,000	12.50%	400,000	12.50%
80,000	22.50%	800,000	22.50%
200,000	27.50%	2,000,000	27.50%

(d) Where a development area is located partially onshore and partially in shallow water, the royalty rates for onshore would be used. Where a development area is located partially in waters shallower and deeper than 400 meters, the royalty rates for shallow water would be used.

6.1.1.9. The royalty rate based on daily production of unconventional hydrocarbons is recommended to be 5%.

6.1.1.10. The royalty rate for conventional and unconventional hydrocarbons (assuming the government applies the value royalty to unconventional resources) would be based on the value of the measurement point at each development area for the previous month. The following table provides the values:

Oil and Condensates		Gas (including natural gas liquids)	
$ per Barrel	Royalty Rate	$ per MMBtu	Royalty Rate
40	0.00%	4	0.00%
70	3.00%	7	3.00%
100	10.00%	0	10.00%
120	15.00%	12	15.00%

- The interpolation procedure for price levels between those listed in the chart would be similar to the scale based on daily production.
- The value at the measurement point(s) for Oil and Condensates would be tied to an international benchmark index price for crude oil, minus transport costs from the benchmark measurement point(s) to the market in Tunisia based on a relevant transportation index.
- The value at the measurement points for gas would be based on a formula related to the value of low sulfur heavy fuel oil established in the License Contract, minus transport costs from the measurement point(s) to the market in Tunisia or to the export point.
- The value numbers ($ per Barrel) indicated in the royalty table above would be adjusted for U.S. inflation on a yearly basis.

6.1.2. A second key fiscal recommendation is that Tunisia should provide for the consolidation of income and expenses at the company level for income tax purposes. The ring-fenced system currently in use discourages investment in exploration, as investors can never recover dry hole costs in unsuccessful contracts from their successful contracts. It will not provide an incentive for investors who only seek a single contract, but provides increasing incentive for investors with multiple contracts, yielding a higher probability that one of them will be successful.

6.1.3. A third key fiscal recommendation is the elimination of production sharing. A higher royalty rate, as noted above, is used to ensure sufficient government revenues while being sensitive to field size and oil prices.

6.1.4. A fourth fiscal recommendation is to exempt petroleum service company income with unconventional hydrocarbon operations from withholding tax. As noted earlier, unconventional operations can be very costly. This will make such operations in Tunisia more feasible.

6.1.5. As a fifth fiscal recommendation, the current provisions of Hydrocarbon Code Articles 101.1.1 and 101.1.2 (payments based on contract area) could in principle be maintained. It is, however, recommended that references to minimum salaries should be eliminated. Instead, figures should be provided that are internationally understandable. In order to stimulate exploration, fees and taxes during the exploration phase should be modest. For instance, the surface fee per hectare per year could equal five Tunisian Dinars for the exploration area and 500 Tunisian Dinars for the exploitation area. These amounts could be increased with inflation on a yearly basis.

6.1.6. In connection with the implementation of a public bidding system as described below in 6.4, a signing bonus may be introduced, as an additional fiscal term on which interested investors base their bids. Signing bonuses are very transparent for the purposes of comparing bids and provide immediate cash to the national treasury.

6.1.7. The existing fiscal terms would continue to apply to existing contracts in order to avoid impacts on projected revenues from existing fields unless they are converted to the new system on an agreed basis. For existing contracts without commercial discoveries, conversion could be permitted based on specified value offered to the government. These include:

6.1.7.1. Relinquishment of portions of the existing contract area and/or commitments to conduct new exploration operations on undeveloped areas; and

6.1.7.2. Relinquishment of unconventional resources unless commitments are made to develop these resources.

For existing contracts with commercial discoveries, the government may also encourage conversion where further investment in enhanced recovery or additional exploration is desired. In these cases, it is possible to apply a system of different treatment of old oil/old gas and new oil/new gas. The old oil/old gas production would be determined based on the proven developed reserves and independent engineering studies. Alternatively, one might simplify the definition of the old oil/old gas as the existing level of production less a general decline rate, which could be the same for all producing concessions. A comprehensive methodology would have to be adopted after more is known about the details of the remaining anticipated production.

Assuming an acceptable methodology can be developed for old oil/old gas determination, the following conversion concept could be applied:

(a) The levying of an additional royalty on the old oil/old gas, over the basic royalty, in order to compensate for the lower tax rate under the License Contract.

(b) Applying the new corporate income tax to both old oil/old gas and new oil/new gas.

(c) Maintaining the level of participating interest of the national enterprise.

(d) Obtaining the new fiscal terms for new oil/new gas, and

(e) The presentation of an updated development plan or a new development plan for the increase in production and maximum economic recovery of existing fields.

6.2. Replace the Use of Multiple Forms of Contracts with One New Form

6.2.1. It is relatively unusual for a country to offer two forms of a contract at the same time, as noted above. This adds significantly to the administrative burden of the government without clear benefit. A "general form of contract" is low on investors' list of priorities because similar fiscal results can be achieved with numerous types of contract.

6.2.2. However, one form of contract simplifies evaluation for investors as well.

6.2.3. In part, production sharing contracts (PSCs) were implemented in Tunisia because they were viewed as a more modern approach to structuring the government's revenue from the hydrocarbons project. In contrast, they have been viewed as less successful experiments since the 1970s. They have proven to have several drawbacks, including the undesirable impact of cost oil calculations in the face of volatile commodity prices. Lower commodity prices can lead to cost oil claiming a large share of production.

When commodity prices rise, the reduced share of cost oil forces public oil companies to write down their associated reserves, a strange trick of accounting in a rising price environment. PSCs also require extensive government involvement, both in auditing costs used for cost oil purposes and, potentially, in marketing the government share of production.

6.2.4. The more recent trend has been to abandon PSCs in favor of simpler tax/royalty arrangements such as licenses. PSCs rely on gross royalties and the regular corporate income tax mechanism to provide government revenue, which substantially reduces the audit and monitoring role required of the ministry in charge of hydrocarbons. We recommend moving to a single form of contract in the future, like a license.

6.2.5. The proposed license, in contrast to the current Convention form, would not require issuance of separate exploration permits and exploitation concessions. Instead, advancement through stages of the contract would take place in accordance with the terms of the Hydrocarbon Code and license, subject to the Minister's confirmation that the stated conditions have been satisfied, as described in Section 6.5.4.2 below.

In contrast to PSCs, the government's income would not be based on a calculated share of profit oil or gas but would be all received in the form of royalty, tax, and certain other fiscal charges such as bonuses and annual rentals on acreage held, as discussed in Section 6.1 above. Other characteristics of the license would be similar to the Convention, with those changes recommended elsewhere in this Article 6. Except for the fiscal arrangements, which require a significant change, the changes should be evolutionary in nature.

6.3. Clarify the Role of Parliament

6.3.1. It is evident from the review described in Article 4 that the lack of clarity about the meaning of Article 13 of the Constitution has caused some confusion.

6.3.2. While a law cannot change the Constitution, it should clarify the interpretation of the Constitution's precepts.

6.3.3. Given the fundamental challenges of Parliament seeking to act as a technical body, and the lack of detailed industry expertise available to Parliament, it would be beneficial for the Hydrocarbon Code to clarify that:

6.3.3.1. The matters that must go before Parliament pursuant to Article 13 are (i) new contracts, (ii) substantive amendments to contracts (not merely name changes, transfers, etc., and (iii extensions of the final terms of contracts that are not provided for in the contract as originally approved.

6.3.3.2. Parliament reviews the contracts to determine whether it is satisfied that: the fiscal terms are acceptable, the award process follows Tunisian law, the contract form complies with Tunisian law, and matters of compelling national interest are raised only by standard terms included in the form of contract. This provision will avoid any implication that Parliament should determine whether every individual term of the contract is good or bad.

6.3.3.3. An investor should be entitled to withdraw a contract and receive a return of any application payment if Parliament does not act within a specified period.

6.3.4. This report also recommends that the Parliamentary Commission claim a small number of professional staff with expertise in this area to help perform its functions in this area.

6.4. Use a Public Bidding System for Contract Awards

6.4.1. There is significant concern in Tunisia about the integrity of the contract award system. The public both mistrusts the motivations for awarding contracts to particular companies and questions the fairness of the terms that are granted.

6.4.2. Contracts with many negotiable issues are more likely to be subject to questions. In addition, if there are many variables, it is difficult to see how much benefit the country has received from any one contract, and very difficult to compare contracts.

6.4.3. Contracts awarded through private direct negotiation are inherently more susceptible to both real and perceived corruption issues.

6.4.4. The private award of contracts potentially overlooks other interested investors who may be willing to offer better terms.

6.4.5. In contrast, any company meeting the technical qualifications can participate in public tenders, which are announced in advance. They generally involve publication of all bids, avoid risk of an unfair deal, and allow the public to see that the best offer was taken.

6.4.6. Private negotiations are inferior to competition. Public bidding processes push each potential investor to make the best offer in fear of losing the bid.

6.4.7. This report recommends that Tunisia move to a public tender system for all contract awards.

6.4.8. The best public tender processes use only a single variable for bidding (for example, a bonus or a royalty rate). With a single variable, it easy to compare bids and allows the public to see that Tunisia received the maximum available value by picking the highest bid.

Although some bidding systems use the proposed minimum work program or local content shares as elements for bidding, it may be harder to compare a work program or local content bids. Instead, a minimum work program that the government wants conducted and the local content requirements that need to be achieved can be included as a requirement for all bidders in the tender process. This would eliminate bidders offering unrealistic local content percentages from winning a contract and negotiating a correction to reflect the actual market availability of goods, services, and personnel.

6.4.9. If bid rounds are held on a regular basis and announced in advance, companies are more likely to review the blocks on offer on a regular basis than if the bid rounds are held on an irregular basis. Tunisia would be well-served to establish a regular program, perhaps once per year or twice per year.

6.4.10. In connection with the tender planning process, Tunisia will need to review which areas to offer and the size of each contract area. Ideally, contract areas should be large enough to contain at least a few prospects of interest but not so large that they place many prospects in the hands of one investor who may not have the interest or capability to pursue them all.

6.5. Reduce Discretionary Decisions and Increase Transparency

6.5.1. Decisions that are based on the discretion of a particular person or organization are inherently less transparent and prone to generate concerns about collusion.

6.5.2. Discretionary decisions also burden administrative agencies, leading to paralysis in decision-making. An agency may find it easier to make no decision than make a potentially incorrect decision.

6.5.3. Investors generally are not fans of discretionary decisions because they destabilize future outcomes and create the potential for unscrupulous officials to demand some type of consideration in exchange for granting the authorization.

6.5.4. Tunisia should adapt a rules-based set of decisions in the Hydrocarbon Code to facilitate the process for government agencies and investors.

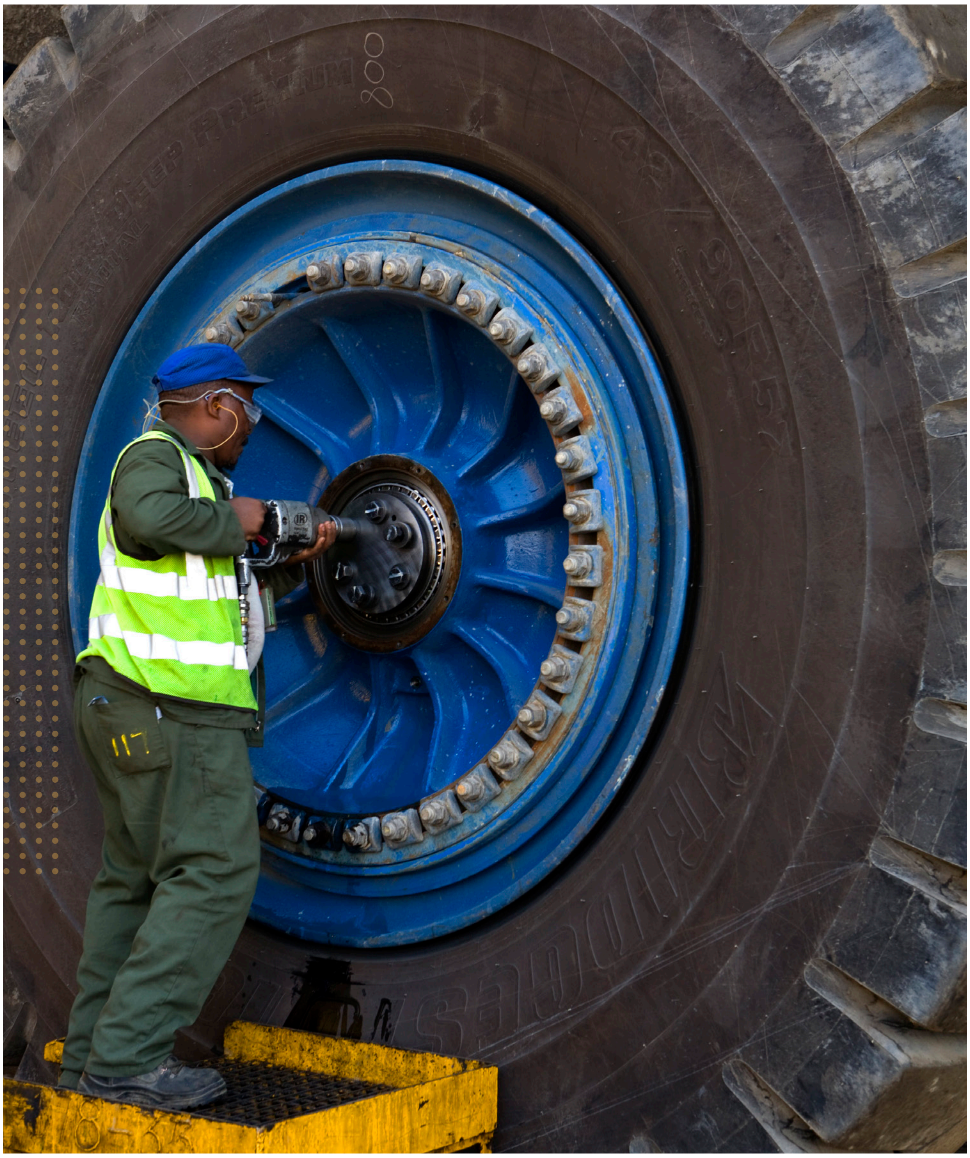

Photo by: John Hogg / World Bank

Key considerations include:

6.5.4.1. Hydrocarbon Code Article 10.1 – A one year extension for a prospecting permit would be available if the investor performs its obligations, is in compliance with the terms of the contract, and presents a specific program of geological and geophysical studies in the same area.

6.5.4.2. Hydrocarbon Code Articles 23 – 30 – The investor would be entitled to authorized extensions if it performs its obligations and is in compliance with the terms of the contract. The additional work to be performed with each extension would be spelled out in the contract with no negotiation at the time of extension. This would speed the approval process, though Section 10.9 of the Hydrocarbon Code that the ministry may not be able to respond within the allowed period. If enforceable under Tunisian law, it would be most effective to provide that the ministry would automatically granted the extension if it does not reject the application within a stated period of time (for example, 60 days). This type of automatic approval would be consistent with the principles already found. Currently, ETAP requires 30 days to exercise its preferential right under Article 55.4 of the Hydrocarbon Code or lose that right.

6.5.4.3. Hydrocarbon Code Article 25 – Eliminate this article, which allows discretionary reduction of the agreed minimum expenditure commitment. Alternatively, the law could be amended to allow the transfer of any additional drilling commitment to another contract area if the investor has already drilled two dry holes.

6.5.4.4. Hydrocarbon Code Article 32 – This article, which allows discretionary modification to the agreed minimum work program, could also be eliminated. However, the law might be useful if the geology turns out to be different from the investor's initial expectations. Tunisia could allow the investor to modify work locations within the contract area, but not the number of wells and kilometers of seismic data. This latter approach would not require approval, only notification.

6.5.4.5. Hydrocarbon Code Article 38 – This article allows for the reduction of the period during which the investor may not reacquire an interest in the same contract area after expiration. It could be simplified by setting a single shorter period, such as two years, during which the investor can not acquire the same block to give the government an opportunity to offer it to others. Alternatively, the article could be deleted entirely if the government feels that it discourages the most likely bidder, in this case, the prior owner, from pursuing the contract area.

6.5.4.6. Hydrocarbon Code Article 44.2 – This article sets minimum time periods for the initiation of development. It allows discretionary extension of an initiation. This article should be revised but, with respect to the discretionary extension, it could be changed to a right by the investor, especially if a force majeure has prevented the investor from proceeding with development. This would not require any governental decision.

6.5.4.7. Hydrocarbon Code Article 82 – This article indicates that the Ministry must approve proposed rates for carrying third party production on pipelines. It would be best to define a rate-making formula. The investor would be entitled to recover: its capital for the pipeline, amortized across production during a defined amortization period, its annual operating expenses, and a specified rate of return. This would expedite the process of agreeing on a rate and would reduce the amount of discretion that needs to be exercised.

6.5.4.8. Hydrocarbon Code Articles 110.2 and 110.3 – These articles allow transfer of tax benefits between permits. If ring-fencing of taxes is eliminated, taxes can be calculated on a corporate basis rather than on a contract basis. The related discretion will no longer be required.

6.5.4.9. Hydrocarbon Code Article 112 – This article allows the minister to grant uplift on exploration costs to encourage exploration in remote areas on a discretionary basis. Instead, these areas could be defined by regulation and the benefit fixed. Therefore, any investor that acquires a contract in the designated area would be entitled to a benefit.

6.6. Situate ETAP in its Intended Commercial Role. Enhance ETAP's Capacity to Serve Tunisia

6.6.1. As noted in Section 4 of this report, ETAP has played a significant regulatory role in hydrocarbon matters, in part, because it possesses the main pool of trained and experienced hydrocarbons professionals.

While this has been a practical solution to resource challenges within the government, ETAP as regulator has raised numerous issues. First, it has exposed a major conflict of interest: as one of the oil and gas companies, ETAP is regulating itself. The public is understandably concerned about whether regulation, audit, and enforcement is pursued rigorously and objectively, even if, in practice, it is.

Secondly, having a secondary role in regulation serves to distract ETAP management from its primary goal of developing oil and gas for Tunisia and training Tunisians in the oil and gas field. Likewise, it takes resources that could be devoted to commercial purposes. An organization can rarely perform two completely different functions well; typically, separate organizations are set up for separate functions, with each having a clear primary mission.

ETAP should not serve a regulatory function.

6.6.2. In fact, as noted in Section 4 of this report, Law No. 72-22 of 10 March 1972 states that ETAP will be "of an industrial and commercial character," and that the purpose of ETAP is:

-To conduct oil studies.

-To train Tunisian executives in various branches of the oil industry.

-To intervene in all industrial, commercial, financial, securities, and real estate operations directly or indirectly related to hydrocarbons.

6.6.3. The modern trend for good governance in hydrocarbons extraction is to abandon regulation by national oil companies. As Section 5.7 discusses, five of nine reference countries that were examined did not assign a regulatory role to the national oil company, and four of those countries, which have undergone reforms, have placed regulation in the hands of an independent agency.

6.6.4. Despite certain protections in Decree No. 73-173, such as exclusion from general public procurement requirements, ETAP appears to be hamstrung as a commercial company by some of the internal approval processes to which it is subject. ETAP is challenged by formulating responses within normal commercial time frames. This harms ETAP's abilities to take advantage of opportunities and makes it a less desirable partner for potential investors.

6.6.5. This report recommends several important changes, and further reviews with respect to ETAP, recognizing that the details will require thoughtful additional study:

> **6.6.5.1.** A new independent national agency should be established to regulate the hydrocarbon sector. Like ETAP, that agency could fall under the broad umbrella of the ministry that addresses energy matters.
>
> **6.6.5.2.** ETAP should be subject to a streamlined set of internal procedures, in which decisions that must be directed to the board of directors or a government agency more closely resemble the decisions that would be presented to the board of a commercial oil company. A formally approved delegation of authorities could establish the authorities of various senior managers within ETAP.
>
> **6.6.5.3.** ETAP's budget and policy regarding dividends to the government should be examined to ensure that ETAP has sufficient resources to perform its commercial role.
>
> **6.6.5.4.** Finally, as a long-term goal, the government should reevaluate equipping ETAP to secure resources for Tunisia overseas. Tunisia is a net oil importing country. Many oil importing countries do include, as

part of the mission of their national oil company, an entity to import resources at more attractive prices. Although overseas investment does require expenditures of hard currency, resources shipped to Tunisia from abroad, without additional payments, would not harm Tunisia's balance of payments in the same way that cash purchases do.

6.6.6. One concern about changing the role of ETAP has been the salary scale necessary to attract trained and experienced professionals needed for regulation. The use of an independent agency separate from the ministry, with a salary structure in line with the private sector, offers a potential means to solve that challenge.

6.6.7. Regarding ETAP's funds for investment, please see the separate discussion of the ETAP carry in the Van Meurs report and below in Section 6.7.

6.6.8. The recommendation to equip ETAP to invest overseas should be taken in context: that a national oil company investing overseas will be in a very different position than a national oil company investing in its home country. There is a risk of making mistakes or bad investments when investing in a different hydrocarbon regime in unfamiliar geology. Any program designed to advance such an investment should look for ways to mitigate these risks, such as co-investing with trusted partners from Tunisia. For example, Qatar Petroleum has co-invested with Exxon and Shell in overseas enterprises.

6.7. Make ETAP's Participation Economical for Investors

6.7.1. As discussed in Section 4.1.21 above, ETAP's participation in domestic investments can have a serious negative impact on the economics of a potential investor.

6.7.2. ETAP's participation in Tunisia is significantly higher than the average required participation of national oil companies in the reference countries examined and discussed in Section 5.6 of this report.

6.7.3. Nonetheless, ETAP's participation in petroleum projects is important for Tunisia. ETAP has knowledge about operations, participates in decision-making, employs Tunisian workers, and develops fields in the national interest that are not attractive to private investors.

6.7.4. The most attractive arrangement for encouraging investors would be to allow ETAP to participate for a fixed percentage, such as 20%, from the beginning. In this way, the interest would be known and understood to the investor. ETAP would pay its own share of exploration costs rather than disproportionately assign the risk of unsuccessful exploration to the investor. In addition, a lower ETAP interest (compared to the 50% interest rate) would leave greater interest for investors and encourage investment.

6.7.5. However, due to funding deficiencies, ETAP may need to participate in investments without sufficient funds.

6.7.6. Though not as competitive financially for investors, an alternative would be to give ETAP a small carried interest of 5% or 10% in each contract area. ETAP would have an option at the time of contracting to assume additional interest, not to exceed 20% in total interest. ETAP would elect to participate in development at the time a plan was submitted for approval. All participants would understand how the costs of development are to be shared before a requirement to commit.

6.8. Shorten the Prospecting and Exploration Term in order to Require Timely Operations

6.8.1. As discussed in Section 4.1.9 above, the current Hydrocarbon Code permits investors an unreasonably long time to explore their contract areas. Investors do not feel pressure to explore their blocks well or lose them.

6.8.2. Based on the comparative analysis referenced in Section 5.2, this report recommends shortening the available exploration period for all but unconventional resources to a maximum of eight years. This could consist of an initial three-year exploration period with extensions of three years and two years. Alternatively, a simple two period system with one four-year exploration period and one four-year renewal term could be employed.

6.8.3. Unconventional resources require a longer pilot project period to determine whether they are economic after experimenting with different development techniques. The initial period of investment, which would only include geological and geophysical work and drilling of a vertical test well(s), could be set at three to four years. The extension term for pilot horizontal drilling could be five years or six years.

6.9. Shorten the Time to Develop Discoveries

6.9.1. As discussed in Section 4.10 above, Article 44 of the Hydrocarbon Code gives investors a long time to initiate development, particularly for onshore conventional projects. This can allow investors to "bank" prospects to develop later.

6.9.2. This report recommends shortening the period from discovery to commencement of development by (i) limiting the appraisal program as described in Article 40 of the Hydrocarbon Code to a maximum of two years, (ii) limiting the period for submission of a development plan to 12 months after the completion of the appraisal program (as already established in Article 44.1 of the Hydrocarbon Code), and (iii) requiring the commencement of development within 12 months after granting a concession (not two years as provided in Article 52 of the Hydrocarbon Code). The lengthy six-year and eight-year periods in Article 44.2 of the Hydrocarbon Code could be eliminated.

6.9.3. As an exception to the shorter appraisal periods in Section 6.9.2, a longer appraisal period of three years would be appropriate for an offshore discovery. A longer period to submit a development plan (perhaps two years) and commence development (perhaps two years) would be appropriate for offshore development.

6.9.4. Another exception to the shorter period in Section 6.9.2 would apply to non-associated gas development projects. Due to the need for a pipeline or significant infrastructure, a longer period (perhaps three or four years from discovery as provided in Article 68.2 of the Hydrocarbon Code) could be allowed between completion of appraisal and submission of a development plan which assesses commerciality. In addition, the Hydrocarbon Code could state that development need not commence until necessary land use rights for a pipeline have been obtained, provided that the investor is diligently pursuing those rights.

6.10. Alter the Relinquishment Requirements to Encourage Exploration of Conventional Resources and to Permit Unconventional Development

6.10.1. To encourage exploration, investors must explore or lose their acreage. Based on the international comparative analysis presented in Section 5.4 of this report, increase the relinquishment requirement for conventional resources at the end of the initial exploration period in Article 26.1 of the Hydrocarbon Code to 50% of the original area (instead of 20%) and alter the requirement for the end of the first extension period under Article 26.1 of the Hydrocarbon Code to relinquish an additional 25% of the original area (for 75% total relinquished instead of 36%).

6.10.2. For unconventional resources, the opposite approach is needed. Unlike conventional development, unconventional development does not require a one- or two-phase development plan implemented over a short time and produced for many years. Unconventional wells drain limited areas around each well and deplete rapidly. Therefore, unconventional resources require continuous drilling of new wells throughout the life of the project. The “fields” are not a bounded reservoir but a widespread layer of shale or another tight rock that typically extends across an entire block. As a result, there are often no unproductive areas that can be relinquished, and development is expected to continue for many years.

6.10.4. To permit unconventional development, Articles 26 and 28 of the Hydrocarbon Code should be modified to prohibit relinquishment of the contract area for unconventional resources unless the investor has declared a non-prospective. At the end of the exploration period (including any extension), the investor should be entitled to include as much of the contract area in the exploitation area as is desired, provided that the development plan considers eventual development.

6.10.5. To prevent undeveloped areas, the law could provide that areas not developed would be relinquished during exploitation if the investor ceased development operations for a period in excess of one year for reasons other than force majeure or restrictions placed by applicable law or g overnment order.

6.11. Allow Transfer of Remaining Minimum Work Commitments to Other Contracts in Cases Where Geological Prospects Have Been Disproven

6.11.1. Investors will be reluctant to spend exploration funds on a block in which they have disproven their geological theory. As a result, they will put off expending additional funds and pay only the short-fall in the minimum exploration program and relinquish the block. It would be preferable to transfer the unsatisfied commitment to another active block where productive additional exploration can be conducted.

6.11.2. This report recommends that when the investors in a contract reasonably demonstrate that they have disproven the prospects that they had proposed to drill under the terms of the contract, they be permitted to transfer the remaining work obligation and expenditure commitment to another contract held by them.

6.12. Make Oil and Gas Development a Net Benefit for Local Communities

6.12.1. Local communities in Tunisia see oil and gas development as a burden without any direct benefit, as fiscal benefits go to the national government.

6.12.2. The public is generally suspicious of oil and gas activities, as noted in Section 4.2 of this report.

6.12.3. Tunisia has an existing mechanism under Decree No. 2014-3505 dated 30 September 2014 to provide funding from the national government to local communities across the country on an equitable basis.

6.12.4. This report recommends that a portion of the royalty received by the national government pursuant to the new contracts provide additional funding to local communities through Decree No. 2014-3505.

6.12.5. Oil and gas operations have direct negative impacts on their immediately surrounding areas. These impacts must be mitigated.

6.12.6. Restrictions in connection with drilling operations should be reinforced. As noted in Section 4.1.20 of this report, the current Hydrocarbon Code only requires a set-back of 50 meters from dwellings. This is too close for intense drilling and fracking operations as part of unconventional resources development.

6.12.7. A second form of mitigation could mandate that investors spend a minimum amount each year on corporate social responsibility projects in their operational areas. ETAP and some operators have already undertaken such operations voluntarily. However, some countries are starting to require such expenditures as noted in the comparative analysis in Section 5.20. Given the need to develop public support for hydrocarbon development, this report proposes that such annual expenditures by investors be made mandatory in Tunisia.

6.13. Increase Local Employment and Training

6.13.1. (i) The Production Sharing Contract (PSC) requires use of ETAP staff with required experience and qualifications "as far as possible," and the preparation of a training program. (ii) The Convention requires an agreed minimum proportion of Tunisian nationals in the investor's workforce, and (iii) the Hydrocarbon Code in Articles 47 and 62.2 contain very general and high level hiring and training obligations. However, there are no specific targets provided by law or fixed in the contract form.

6.13.2. There appears to be general dissatisfaction with employment benefits from oil and gas development.

6.13.3. As noted in Section 5.17 of this report, many of the referenced countries examined for purposes of international comparison had a specific percentage hiring obligations.

6.13.4. To increase transparency and ensure maximum use of Tunisian personnel, this report recommends that the Hydrocarbon Code be amended to require a minimum percentage of labor. A minimum percentage of technical and managerial personnel should be Tunisian nationals.

6.13.5. Tunisia could push for more technical skills training by giving extra credit to investors for each Tunisian national trained and employed in Tunisia in certain roles. For example, double credits could apply to training obligations.

6.14. Increase Local Business Opportunities from Oil and Gas Operations

6.14.1. As observed in Section 4.1.17 of this report, the current Hydrocarbon Code requires that local goods and services be used only if they are strictly comparable, or better, in terms of price, quality, and delivery time.

6.14.2. Based on a review of the laws and contracts of the reference countries as summarized in Section 5.16, some countries have stronger requirements to encourage the use of local contractors and suppliers.

6.14.3. This report recommends that comparability on price be limited to no more than 10% above imported prices.

6.14.4. This report further recommends the establishment of a minimum percentage local content (by expenditure) for onshore operations. It will need to be based on local conditions, but we note that Mexico has used a 15% figure during the exploration phase and 26% - 35% during development and production. Employment percentage obligations would allow the public to see that a specific benefit will be provided. Exceptions to the mandatory targets would be expected for offshore operations and major gas infrastructure.

6.15. Ensure Reasonable Market Prices for Production Destined for Local Markets

6.15.1. Tunisia disadvantages the local markets by pricing oil sales below export prices, as noted in Section 4.1.13 above.

6.15.2. Though gas prices for power production are not fixed below market prices, they are regulated by decree rather than set by the market. Producers are not guaranteed that they will not be changed, as discussed in Section 4.1.14 above.

6.15.3. These mechanisms may be designed to support domestic price subsidies. However, they distort incentives for investors, who would rather export than sell in Tunisia. It would be better to give attractive prices to producers to encourage production, collect a general tax or royalty from producers—regardless of whether production is imported or exported—and to use the proceeds from that tax or royalty to subsidize domestic prices.

6.15.4. This report recommends the elimination of the 10% discount on oil prices under Article 50.1 of the Hydrocarbon Code. In addition, the pricing mechanism for natural gas should be fixed at a fair level (which may be tied to an international index, as is the case presently) in the law to inform investors that it will not be changed easily.

6.15.5. This report also recommends that the government consider a special incentive price for gas from unconventional resources. It would only apply to early production to encourage rapid development of this resource. A similar approach has been successful in Argentina.

6.16. Provide More Effective Rules to Permit the Development of Hydrocarbon Infrastructure

6.16.1. We have discussed in detail in Sections 4.1.18, 4.1.19, 4.1.30, and 4.2 some of the issues facing development of necessary oil and gas infrastructure in Tunisia.

6.16.2. It seems important to separate the government from the role of expropriator in necessary but unpopular projects.

6.16.3. There is no Constitutional prohibition against expropriation by privately-owned companies if it is a matter of public utility.

6.16.4. To facilitate infrastructure development, this report recommends that companies willing to develop pipelines, terminals, and other energy infrastructure available for use by others based on an approved tariff should be authorized to initiate expropriation proceedings in the appropriate court.

6.16.5. To allow effective use of energy infrastructure, this report recommends that the law define which rates are established for use of infrastructure based on a formula for amortization of capital investment, annual recovery of operating costs, and a fixed percentage of profit. Standard utility rate-making provisions should be adopted to provide the necessary legal infrastructure to allow for effective implementation of such a pricing formula.

6.17. Make Stabilization More Effective for Investors

6.17.1. As discussed in Section 4.2.1.2, the so-called "exceptional contribution" has become a significant issue for investors. Unfortunately, the perception that Tunisia did not honor its stabilization commitment (though that view was successfully disputed by the Tunisian Government) can tarnish the country's image as an oil and gas investment destination.

6.17.2. Investors do not like fiscal risk, but in Tunisia, investors can be charged addi-tional contributions that they did not anticipate.

6.17.3. As noted in the international comparison in Section 5.21, it is more common, where stability is offered, to provide full fiscal stability.

6.17.4. This report recommends that the terms of Articles 105.2 and 105.3 of the Hydrocarbon Code are revised to make clear that all fiscal charges, not just the named taxes, are stabilized for the particular contract. the only exceptions should be (a) changes in minor registration or use fees and similar charges contained in Article 100 of the current Hydrocarbon Code, and (b) changes in environmental fees or charges of general application.

6.18. Simplify the Audit Process

6.18.1. As noted in Section 4.2, both current investors and the government complained about the difficulties of the current audit process.

6.18.2. The audit process will be simplified by a clearer, simpler fiscal system as described in the "Fiscal Review."

6.18.3. The government could adopt guidelines for the settlement of audit disputes that would help give audit teams confidence that they would not be criticized for settling in appropriate cases.

6.18.4. This report also recommends that the Ministry of Finance work to develop a small group of auditors with expertise in this area. Auditor expertise could be added to the training obligations investors are required to fund under their contracts.

6.19. Adopt Reasonable but Effective Environmental Protections Relating to Unconventional Development

6.19.1. The public will expect regulations addressing basic matters such as how close to an aquifer fracking can occur and proper methods of treating and disposing of frack flow-back water. Unconventional development cannot receive public support unless the public sees efforts to ensure that it is done safely. Clear rules also allow investors to make investments decisions based on solid information regarding the measures they will need to follow.

6.20. Allocate Funds for Public Education

6.20.1. In addition to other steps taken to encourage unconventional development, the government should consider allocating funds for public education about hydrocarbons development in the areas where they are likely to occur.

6.21. Miscellaneous Reforms

The following reforms will make the Tunisian system more transparent and would increase the attractiveness of Tunisia as an investment destination:

6.21.1. *Scope of Substances Covered by the Hydrocarbon Code*. The Hydrocarbon Code is not suited for handling solid hydrocarbons. This concept should be removed from the "Hydrocarbons" definition.

6.21.2. *Change in Control*. Articles 34 and 45 of the Hydrocarbon Code should be modified to make clear that a change in control of the investor requires an approval.

6.21.3. *Early Termination of Contracts*. Articles 37 and 57 of the Hydrocarbon Code should be clarified by adding a stated cure period, such as 30 days for payments and 90 or 120 days for other violations. Otherwise, investors are unsure if they will lose their contract over an inadvertent violation.

6.21.4. *Effectiveness of Import Duty Exemptions*. The Customs service should either publish a list of items that are clearly entitled to import duty exemption or tie the exemption directly to the local content obligation. The exemption applies except that the investor is required to purchase local goods or services under Article 62.2 of the Hydrocarbon Code. In addition, the exemption process should be automated to avoid delays between the Ministry of Industry and the Customs service in processing of imports.

6.21.5. *Exchange Control Risks*. Exempt oilfield equipment and materials from the potential prohibitions, quotas, and other restrictions under the Foreign Exchange and Foreign Trade Regulations and Code of Exchange and Foreign Trade Law in order to reduce potential risks to investors planning a new development.

6.21.6. *Exchange Control Risks (2)*. Tunisia should consider whether payments relating to imports of oilfield equipment and materials, and exports of hydrocarbon production, should be exempted from the restrictions in Article 127 of the Hydrocarbon Code and Chapter VI of the Foreign Exchange and Trade Regulations.

6.21.7. *Clarify Tax Code Provisions Regarding Oil and Gas.* Even if the general corporate income tax will be applied to oil and gas income, it will need specialized provisions dealing with oil and gas matters. These should be examined considering experience over the last 20 years and clarified where the government has previously had disputes with investors.

6.21.8. *Decommissioning*. Tunisia can reduce the risk that investors will not have sufficient funds set aside to provide for decommissioning of oilfields by requiring the investors set aside funds for decommissioning each year starting with first commercial production, rather than just in the last three or five years of field life as in Article 118 of the Hydrocarbon Code. Provisions of Article 123.1 of the Hydrocarbon Code, which allow an earlier holder of a concession out of liability for the ultimate decommissioning can also be eliminated.

6.22. Exclusions

6.22.1. This report does not propose additional special incentives for deep prospects in remote areas or other specialized types of prospects with the exception of royalty rates for unconventional and offshore resources. Given the extensive nature of the fiscal changes that are proposed, and the desire to incentivize all types of exploration, the results of a new fiscal regime in the first bid rounds should be evaluated before adding more incentives and complexity. If some types of prospects require additional incentives, royalty rates can be adjusted, or other changes made for those prospects through a relatively simple future amendment.

6.22.2. Amendments addressing downstream refining, marketing, and renewable power are not necessary for this particular reform process. They would be appropriate subjects for a later reform effort.