

THE LAW OF PETROLEUM EXTRACTION



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Introduction to the Laws of Timor-Leste

The Law of Petroleum Extraction

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Preface to the Series: *Introduction to the Laws of Timor-Leste*

Timor-Leste has enjoyed a decade of formal independence. The country's democratic institutions have grown during this period. But, as thoughtful Timorese are quick to point out, much remains to be done. Building viable and professional state institutions takes time. And growing the human resource capacity within those institutions is always a major challenge to new states.

The capacity building imperative in Timor-Leste is both striking and compelling. Establishing state agencies in the first instance is relatively much easier than filling those agencies with effective professionals that uphold their duties and responsibilities. Building the capacity of a pool of Timorese who hold, or may hold, positions within legal and other state institutions is crucial. Likewise, building an educated understanding and awareness of the obligations and responsibilities of key actors within legal institutions, and government institutions more broadly, contributes to setting demands and expectations for performance among the polity. Encouraging professionalized capacity within state institutions, on the one hand, and thoughtful and calibrated demands for performance by citizens, on the other hand, are essential dynamics for the development of the rule of law and a democratic state in Timor-Leste. Institutions of higher learning, such as universities and professional training centers, can and should play a key role in stimulating and sustaining this dynamic. Indeed, education is foundational.

This paper is part of the *Introduction to the Laws of Timor-Leste* series of papers produced by the Timor-Leste Legal Education Project (TLLEP). This series seeks to critically engage the reader in thinking about the laws and legal institutions of Timor-Leste, and is based on a model of educational writing first introduced in TLLEP's *Introduction to Professional Responsibility in Timor-Leste* textbook, published in 2011. Founded in March of 2010, TLLEP is a partnership between The Asia Foundation and Stanford Law School. Working with local actors in the Timor legal sector, the project's goal is to positively contribute to the development of domestic legal education and training in Timor-Leste. USAID provided funding for this series through its Timor-Leste Access to Justice Program.

The authors of the legal working papers focused on writing in clear, concise prose, and on using hypothetical legal situations, discussion questions, and current events. Through this style of writing and pedagogy, the aim is to make these texts accessible to the largest possible audience. The texts are designed to be broadly accessible to experienced Timorese lawyers and judges, government officials, members of civil society, Timorese students in law, and the international community. They cover topics ranging from constitutional law to inheritance law to the Petroleum Fund Law.

These working papers represent the dedicated efforts of many individuals. Stanford Law School students authored the texts and subjected each working paper to an extensive editing process. The primary authors for this series were Peter Broderick, Daniel Cassman, Margaret Hagan, Brian Hoffman, Lexi Shechtel, and Anne Johnson Veldhuis, all Class of 2013, Jessica Fox, Hamida Owusu, and Samuel Saunders (all Class of 2014) edited the series under the guidance of Stanford Rule of Law Fellow Megan Karsh ('09). The students benefitted from the substantial and extensive guidance provided by Brazilian lawyer Dennys Antonialli (LLM '11) and Geoffrey Swenson ('09), TLLEP's former in-country director and legal advisor to the Asia Foundation's Dili office.

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The program has also received extensive support from Kerry Brogan, previous Country Representative Silas Everett, current Country Representative Susan Marx, Juliao de Deus Fatima, and a host of other Asia Foundation staff. USAID Timor-Leste provided vital financial and programmatic support to the program. We especially thank USAID Director Rick Scott and USAID staff Ana Guterres and Peter Cloutier. The US Embassy in Dili, especially Ambassador Hans Klemm and Ambassador Judith Fergin, have been incredibly supportive. I would be remiss if I did not thank the former and current deans of Stanford Law School, Deans Larry Kramer and Liz Magill, for their unwavering support of this project.

Finally, this series of papers simply would not have been possible without the many thoughtful and critical insights from Timorese judges, educators and lawyers, and those who work within Timorese institutions. Prosecutor General Ana Pessoa, Public Defender General Sergio de Jesus Hornai, and President of Court of Appeals Cláudio Ximenes were extremely gracious in clarifying issues related to their respective organizations and offering constructive suggestions. The textbooks received vital input from National University of Timor-Leste (UNTL) faculty and staff throughout the drafting and review process including comments from Rector Aurelio Guterres, Law Deans Tome Xavier Geronimo and Maria Angela Carrascalão, Professor Benjamin Corte Real, and Vasco da Cruz of the Portuguese Corporation. Feedback from UNTL students themselves on draft text was immensely helpful for the final text. The Judicial Training Center (CFJ) has also been a source of wisdom throughout the drafting process, particularly CFJ Director Marcelina Tilman, Erika Macedo, and Bernardo Fernandes. The text benefited as well from the contributions of Charlie Scheiner and La'o Hamutuk, the staff of the Ministry of Justice Legislation Unit, AALT Executive Director Maria Veronika, Judge Maria Netercia, Judge Jacinta Coreia, JSMP Executive Director, Luis de Oliveira, JSMP Legal Research Unit Coordinator, Roberto da Costa, ECM director Lino Lopes, and Sahe Da Siliva. We are also grateful to Gualdinho da Silva, President of the National Petroleum Authority, for two wonderfully engaging meetings.

In addition to this series and the already-published texts on professional responsibility, constitutional rights, and contracts, TLLEP has plans to complete the first edition of a new textbook in 2013 entitled *An Introduction to Criminal Law in Timor-Leste*. All texts are updated as the legal landscape changes. The most recent versions of all published texts are always available for download online free of charge on TLLEP's website: www.tllep.law.stanford.edu.

To the students, educators, legal and government professionals that use this book, we sincerely hope that it sparks study and debate about the future of Timor-Leste and the vital role magistrates, prosecutors, public defenders, private lawyers, and government officials will play in ensuring the country's future is bright.

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CHAPTER OBJECTIVES

- To gain a general understanding of the legal regime that regulates the ownership, exploration, development, extraction, and taxation of petroleum resources in Timor-Leste.
- To learn about and become familiar with the different sources of law that govern various aspects of the legal regime on petroleum extraction and the dispensation of the wealth that it generates.
- To develop an awareness of the economic and policy considerations that underlie and inform the legal regime on petroleum extraction in Timor-Leste.

CHAPTER OVERVIEW

- The State holds ownership of all subsurface petroleum resources according to the Constitution.
- There are numerous sources of law that govern petroleum extraction in Timor-Leste, including the Constitution, Laws of the National Parliament, Decree Laws, and Treaty Agreements.
- Timorese law establishes a domestic regime governing petroleum extraction, but many offshore activities are governed by international agreements between Timor-Leste and Australia.

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I. INTRODUCTION

SECTION OBJECTIVES

- To provide a general overview of the nature of petroleum resources, and to introduce the sources of law that we will be consulting during the course of this chapter.
- To outline the importance and centrality of petroleum resources and law to the Timorese people and economy.

This chapter serves as a very basic introduction to the law and principles of petroleum extraction activities in Timor-Leste. It is not meant to be a comprehensive guide, which, given the complexity of the government's involvement in petroleum extraction and the abundance of legislation addressing the matter, could easily fill an entire volume. Instead, this introduction seeks to highlight the applicable legal regimes and sources of law, examine the policy decisions and goals that underlie them, and raise points of tension or ambiguity in the law.

Part of the complexity in Timor-Leste's oil and gas extraction legal regime stems from the multiple sources of legal authority that interact and together make up the law. Additionally, the subject raises several complicated issues of legal theory, implicating international law, constitutional law, the separation of powers between the branches of government, and the appropriate relationship between government entities and private enterprises. These issues are at the center of the public debates surrounding oil and gas law, and they are of key importance for Timor-Leste's future success. This makes it an exciting topic to be studying!

1. What Are Petroleum Resources and Why Are They Important?

Petroleum is a naturally occurring mixture of organic hydrocarbons that can occur in a gaseous state (known as natural gas), or liquid state (known as crude oil). It is formed when organic sedimentary deposits are buried for several thousands of years and subjected to heat and pressure below the earth's surface. Oil and gas deposits form between layers of rock in pockets of various sizes. Reservoirs can be anywhere from hundreds to thousands of meters deep, and can be found below dry land or beneath the sea floor. The exact location of oil and gas reservoirs cannot be perfectly determined simply by examining the earth's surface; prospectors must drill test wells into the earth to determine the size and extent of the reservoir. This process is called "exploration." If the exploration phase indicates that there are commercial quantities of oil or

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gas, a permanent structure is assembled above the well, and oil and gas reserves are pumped to the surface where they are collected. The exploration and production phases of petroleum extraction are known as the **upstream** phases. After the oil or gas is collected, it is transported via pipeline to a processing facility, where it is refined. Then it is shipped to distributors and sold. Processing, transporting, and distributing are the **downstream** phases of petroleum extraction. Refined petroleum serves as fuel in addition to being a key ingredient in many industrial products such as plastics and fertilizers. Petroleum accounts for roughly 35% of the world's energy consumption. It is one of the world's most valuable global commodities.

Timor-Leste has extensive offshore and some terrestrial petroleum deposits, which form its principal national asset and are vital to its economy. Some of the most extensive deposits lie below the Timor Sea and are jointly managed by Timor-Leste and Australia. Timor-Leste has entered into binding **International Treaties** with Australia, which lay out the terms of ownership and management of revenue between the two countries. We will discuss the laws governing joint management of offshore petroleum resources in Section Three of this chapter, below. Other deposits lie below Timorese soil and have not yet been explored or developed. The **2005 Law on Petroleum Activities, Law No. 13/2005 (23 Aug. 2005)**, governs the ownership, exploration, and development of these domestic resources. In addition, as authorized by the Law on Petroleum Activities, the 2005 Decree Law on **Public Tenders in Respect of Petroleum Contract Awards, Decree No. 7/2005 (5 Oct. 2005)** establishes the general procedures for private oil development companies to enter contracts with the government of Timor-Leste to carry out petroleum extraction activities. In addition, the 2011 Decree Law Establishing Timor-Leste GAP, **Timor GAP – Timor Gas & Petroleo, E.P., Decree No. 31/2011 (20 July 2011)**, creates a nationally owned company authorized to carry out upstream and downstream business activities.

The Government of Timor-Leste relies heavily on revenue from petroleum extraction to fund its budget. For example, in 2011 the government's domestic revenue target, generated from taxes, user fees and charges, and revenue from autonomous agencies, but not including revenue from the Petroleum fund, was approximately \$110 million. In comparison, government revenues from petroleum were almost \$800 million. The government does not spend the revenues generated by petroleum extraction directly. Instead, all Timorese petroleum revenues are collected in the Petroleum Fund, which was established by the **Petroleum Fund**

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Law, Law No. 9/2005 (July 13 2005). The Petroleum Fund is invested and revenues are generated by returns on the investments. The Petroleum Fund is currently valued above \$10 billion. A detailed examination of the law regarding the Petroleum Fund and the dispensation of petroleum wealth can be found in another paper in this series.

As you can see, petroleum law and policy is complex and involves many actors. Stakeholders include private oil companies, investors and financial consultants, the national governments of Timor-Leste and Australia, various government officers and ministry officials, and the people of Timor-Leste. As you read through this chapter and grapple with the sources of authority in this arena, keep in mind the number of parties that have a stake in the process and outcomes. Ask yourself what each party stands to gain or lose by reading the law one way or the other, how those parties were represented (or not) in the lawmaking process, and how they might be better served through an alternative interpretation or redrafting of the laws.

2. Sources of Law on Petroleum Extraction and Related Activities in Timor-Leste

The following table provides a simple overview of the sources of legal authority that control petroleum activities in Timor-Leste Leste. We will cover some of these authorities in more depth in subsequent Sections.

Sources of Law

Constitutional Law

Constitution of Timor-Leste Leste establishes that the natural resources of the soil and subsoil belong to the state and should be used in accordance with the national interest.

Treaties

Timor Sea Treaty Between the Government of Timor-Leste and the Government of Australia establishes a Joint Petroleum Development Area (JPDA) in the Timor-Leste Sea, with revenues from Petroleum activities there shared between the countries.

Certain Maritime Arrangements in the Timor Sea (CMATS) provides for the equal distribution of revenue generated in the (disputed) Greater Sunrise Oil Field in the Timor-Leste Sea.

International Unitization Agreement for Greater Sunrise provides for the development of the Greater Sunrise oil field, which crosses the boundary of the JPA, under a single legal regime.

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Laws of Parliament

Law on Petroleum Activities affirms the State's title to all Petroleum resources in its territory, establishes the State's authority to authorize, oversee, and regulate all Petroleum activities in its territory.

Petroleum Fund Law establishes the Petroleum Fund and implements procedures for managing petroleum revenues, providing for accountability and oversight, and regulating transfers from the Fund to the State budget.

Petroleum Taxation Law establishes a specific taxation regime for all petroleum related activities regulated under the Law on Petroleum Activities.

Decree Laws

National Petroleum Authority Decree Law establishes an independent public regulatory body to act as the regulatory authority over the petroleum industry.

Public Tendering in Respect of Petroleum Contract Awards Decree Law authorizes the Government to enter into contracts with private oil and gas companies to carry out petroleum operations in specified areas.

Timor-Leste GAP –Timor-Leste Gás & Petróleo, E.P. Decree Law establishes a State-owned oil company to manage the assets owned by the State in the oil and gas sector.

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II. THE DOMESTIC LEGAL REGIME

SECTION OBJECTIVES

- To provide an understanding of the Production Sharing Agreement regime that governs petroleum activities within Timor-Leste's territorial waters and exclusive economic zone.
- To explore the theoretical legal implications of Timor-Leste's Constitutional mandate of state ownership of all subsoil resources.

1. The Constitutional Foundation of State Ownership

Any discussion of natural resource extraction must begin with the issues of ownership and property rights over the resource, and for that we turn first to the **Constitution of Timor-Leste**. The Constitution of Timor-Leste is a foundational document that establishes the basic rights of the citizens of Timor-Leste, and identifies the obligations and duties of the government. It reflects the values, beliefs, and history of the Timorese People as well as creating and defining the structure of government. The Constitution of Timor-Leste specifically addresses ownership of subsoil resources in Section 139.

Constitution of Timor-Leste

Section 139: Natural Resources

- (1) The resources of the soil, the subsoil, the territorial waters, the continental shelf and the exclusive economic zone, which are essential to the economy, shall be owned by the State and shall be used in a fair and equitable manner in accordance with national interests.
- (2) The conditions for the exploitation of the natural resources referred to in item 1 above should lend themselves to the establishment of mandatory financial reserves, in accordance with the law.
- (3) The exploitation of the natural resources shall preserve the ecological balance and prevent destruction of ecosystems.

Article 139 says that resources of the subsoil (that is, natural resources found below the surface of the earth) "shall be owned by the State." What does state ownership of subsoil resources

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mean, exactly? Many other countries' constitutions do not explicitly address natural resources or their ownership at all—evidently, it is not strictly necessary for Constitutions to include provisions addressing natural resource ownership and use. Consider what the benefits of inclusion in the Constitution.

Question

Can you think of alternative property-rights regimes for ownership of subsoil natural resources?

Answer

Some other countries operate on a theory of private ownership of subsoil resources. Under this theory, subsoil resources may be owned by private entities before they are extracted. Private ownership can take many forms. Most commonly, ownership of the subsoil rights is attached to ownership of surface rights, whether those rights are held by the state, a corporation, or an individual. In other words, if an entity owns a parcel of land, it also owns all of the resources extending below that parcel. This is called “absolute ownership.”

Sometimes, subsoil rights are severable from surface rights—that is, a surface property owner can sell the right to own and extract the subsoil resources beneath his parcel to another party without relinquishing his surface rights. Alternately, an owner of surface rights may have to exercise his right to retain it. This is called “the rule of capture.” Under the rule of capture, oil reserves beneath one surface plot may be extracted from a well drilled on a nearby surface plot. Private ownership rights to subsoil resources are prevalent in the United States and a minority of countries.

Although Article 139 awards ownership rights to the state, it also places restrictions on those rights: the resources must be used “in a fair and equitable manner in accordance with national interests.” What is “in accordance with the national interest” in the context of petroleum extraction? On the one hand, this could be read to require the state to maximize the aggregate economic wealth from those resources. Another reading might take a more nuanced approach and consider that “national interest” has many overlapping meanings. Obviously, the State considers that granting contracts to investors for the extraction of petroleum is within the meaning of use “in accordance with the national interest.”

But is choosing to leave petroleum resources in the ground ever consistent with the national interest? That is to say, “national interest” might not always be synonymous with extraction—if the social or environmental costs were very high. This might be the case if there

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were a commercially viable petroleum deposit below a sacred religious site, or a village, or an environmentally sensitive area, and it could not be extracted without disruption to surface activities. Is the government *obligated* under the Constitution to allow for development if it is commercially feasible? What if information about the reserves is unclear, but an entity wants to conduct harmful exploration activities on the site? These examples question what the Government's constitutional obligations are. A more expansive reading of "the national interest" might find that there are occasions or circumstances in which extraction of resources is not appropriate. It might be relevant whether disallowing development would advantage a few, but allowing development would provide a small benefit to all. The questions posed have no easy answers. The interplay of development interests and other interests like environmental protection or protection of private property rights is an important one and is sure to arise as Timor-Leste seeks to encourage and expand oil and gas development over the next several decades.

2. Production Sharing Agreements versus Licenses or Concessions

Asserting State ownership over subsoil resources is only a legal starting-point. The State must develop administrative and regulatory structures that allow it to implement its Constitutional mandate. Broadly speaking, there are two different but related regimes by which states regulate the extraction of subsoil minerals and petroleum. They are: **Production Sharing Agreement (PSA) Regimes** and **Licensing or Concessionary Regimes**.

Licenses or Concessions

Many countries use a licensing scheme to regulate the extraction of subsoil natural resources. Under these schemes, the State legislatively establishes an administrative system of licenses and permits that is overseen by a government agency. Parties who wish to engage in extractive activities on state-owned land must apply for and receive a license for the exclusive right to use a subsoil area for a particular extractive purpose. In granting a license, the state conveys its ownership rights to the investor (this is the "concession"), who bears all costs and risks of extraction. The State secures its share of revenue from the activities by building compensation into the cost of the license, and also by levying taxes on the profits realized by the licensee. A license is a civil agreement, rather than a contract, and operates within the context of a fixed regulatory framework. The exact conditions of the license, (with the exception of the geographical location covered by the license) are not subject to negotiation between the state and

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the investor, but are fixed and standardized. Usually, an investor may give up the license at will, with no adverse consequences, if it decides that petroleum activities in the area covered by the license are no longer feasible or cost-effective.

Production Sharing Agreements

In contrast, most non-Western countries with large oil reserves use the Production Sharing Agreement (“PSA”) model, which is based on contracts between the State, as owner of the resource, and an investor—or group of investors (such groups are called **Joint Operating Agreements**)—as the party that will conduct the work necessary to complete the extraction of the resource. Generally, under a PSA regime the legislature grants authority to the State to enter into individual contracts with private parties. These contracts grant the investor parties various individual rights related to petroleum extraction. As contracting parties, the State and the investor(s) both undertake binding legal obligations that are specified in the agreement. The State receives compensation by retaining ownership over a certain percentage of the petroleum extracted by the investors.

Agreements under the PSA model are much more flexible than under the licensing model; the possible terms of each contract are limited only to the extent that the legislature chooses to do so in its authorizing statute. Beyond these constraints, the State and the investor may bargain. Often, the bargaining process results in agreements that *require*, instead of allow, investors to conduct upstream activities and to pay penalties or relinquish their claims for failure to do so. Note that in a PSA regime, a license may be required in addition to the contract. This can be confusing, but simply put, the license in this instance is simply a document that serves to formalize and register the rights determined in the contract.

Questions

1. Can you identify some advantages relevant to Timor-Leste that a Production Sharing Agreement regime may have over a Licensing model?
2. Conversely, what are some advantages of using the Licensing model instead?

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Answers

1. Proponents of the PSA model point to several advantages over the licensing model:
 - PSAs can give the state certainty; by establishing long-term contractual agreements (instead of licenses which may be given up at the whim of the investor), the state can more easily predict future revenues.
 - PSAs can also allow the state the flexibility to change its position and reevaluate its bargaining power with every contract it enters, instead of having to overhaul the entire legislative and administrative scheme. Accordingly, PSA models can be more flexible and adaptive to the changing needs of the State over time.
 - By electing to retain ownership over a fixed percentage of the extracted product, the State can avoid the burden of collecting and enforcing tax payments from investors.
2. Conversely, critics of PSAs point to some advantages of the Licensing model:
 - Under a PSA model, States often exercise less public control over agreements with investors because the contract negotiations may be undertaken out of the view of the public. Additionally, it may be the case that appointed, rather than elected and democratically accountable, officials represent the government in the contract negotiating process. In comparison, licensing is a public administrative process that does not involve negotiation. This would seem to provide fewer opportunities for corruption.
 - Licensing can provide certainty to the State because compensation is provided up front, in the cost of the license, and does not depend on the subsequent commercial feasibility of the petroleum activities licensed.

3. PSAs and Timor-Leste: The 2005 Law on Petroleum Activities

In 2005 the National Parliament passed the **Law on Petroleum Activities, Law No. 13/2005 (23 Aug. 2005)**. The objective of the law is contained in its Preamble:

The Law on Petroleum Activities

Preamble

...

The objective of this Law on Petroleum Activities (the Law) is to provide as many benefits to Timor-Leste and its people as possible by establishing a regulatory regime that will allow petroleum companies to develop such petroleum resources.

...

Examine this language closely. The law seeks to provide the maximum benefit to the Timorese people by allowing *petroleum companies* to develop the resource. An alternate approach might have been to allow the *State* itself to develop the resource. Timor-Leste does not currently have the technological capacity to develop its petroleum resources without the expertise and

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experience of private petroleum companies. However, improving the State’s technological capacity could have been but wasn’t articulated as an object of the Law. The Preamble specifies additional goals of the Law, including attracting investment, maximizing oil revenues, and achieving the country’s broad development goals (including speeding up and sustaining economic growth, reducing poverty, and improving the well-being of the Timorese people). A final objective of the law, as stated in the Preamble, is to “ensure stability and transparency in regulating the development of petroleum resources.”

Generally, a preamble sets out the broad policy objectives and goals that the law aims to achieve. It also establishes the intent of the lawmaking body that enacted the law, and provides guidance to those that will interpret the law in the future, including the courts, the government officials who are charged with duties and responsibilities under the law, and the private entities whose activities will be constrained by the law. As we examine specific provisions of the Law on Petroleum Activities, you should be thinking about which of the goals and objectives set out in the preamble these provisions seek to advance, and whether they do so successfully.

The Regulatory Body

The Law on Petroleum Activities vests regulatory authority over petroleum development in the “Ministry.” “Ministry” is defined in Article 2:

Law on Petroleum Activities
Article 2: Definitions
...
“Ministry” means the ministry or other agency to which responsibilities and competencies in respect of the application of the present Law are assigned;
...

This language is exceedingly broad. No agency or ministry is mentioned specifically by name. In point of fact, the Agency with oversight is the National Petroleum Authority, established by a separate Decree Law in 2008, entitled **National Petroleum Authority, Decree No. 20/2008 (19 June 2008)**. This is the body responsible for managing and regulating petroleum activities in the exclusive economic zones and the Joint Petroleum Development Area (see below), in accordance with the relevant legislation and treaties.

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Contracts for Exploration

Article 9 of the Law on Petroleum Activities authorizes the Ministry “to grant a prospecting Authorization, in respect of a specific area, to a Person or group of Persons.” “Prospecting Authorizations” are effectively contracts allowing investors to carry out geophysical testing within a specific area to determine whether there may be commercially feasible petroleum reserves below the surface. Article 13 specifies the procedures that the National Petroleum Authority must follow when inviting applicants for Authorizations:

Law on Petroleum Activities

Article 13: Invitations to Apply

1. (a) The Ministry shall invite, by public notice, applications for Authorizations.

(b) Notwithstanding paragraph 13.1(a) above, the Ministry may choose to award Authorizations through direct negotiation without issuing such invitations:
 - (i) in the case of Access Authorizations; or
 - (ii) in the case of all other types of Authorization where it is in the public interest to do so
- (c) If the Ministry awards an Authorization without inviting applications as set forth in paragraph 13.1(b) above, it shall provide substantiated reasons for so doing.

There are currently three Prospecting Authorizations that have been granted by the National Petroleum Authority and are in operation in the offshore waters under the jurisdiction of Timor-Leste’s domestic legal regime.

Question

You are the chief executive officer of PetroMax, a multi-national petroleum resources development corporation. You are interested in extending your operations to the Timor-Leste Sea. You have looked into entering a Joint Operating Agreement with other corporations who are currently operating wells, but you have turned down that option in favor of conducting your own exploration and development. The area you are interested in exploring is in the exclusive economic zone. What is your first step?

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Answer

You must secure a Prospecting Authorization with respect to the area that you would like to conduct exploratory activities in. If the Ministry (National Petroleum Authority) has extended invitations for applications for Authorizations, under Article 13 of the Law on Petroleum Activities, you may submit a bid for the exploration rights. In order to remain competitive you will have to think about offering concessions in the form of technology sharing agreements or commitments to hiring a certain percentage of your workers from Timor-Leste. If there is no auction pending, you may attempt to secure an Authorization through direct negotiation with the Ministry. However, under Article 13.1, Section (b), the Ministry must provide substantial reasons for awarding the Authorization, and it must accord with the public interest. For a list of what your application must include, examine Article 13, Subsections 2 and 3, not excerpted above. (Hint: it must include proposals for the health and safety of workers, protection of the environment, and preference given to hiring and purchasing from Timor-Leste).

Environmental Considerations

While petroleum extraction brings innumerable benefits to countries with petroleum resources, extraction is not without costs. Extractive activities, especially those conducted offshore, can be dangerous and risky, and come with the threat of environmental catastrophe. For example, in 2009, the Montara wellhead near Australia in the Timor Sea malfunctioned, developed a leak, and generated an oil slick estimated to be 11,000 square kilometers. The attendant impacts on the marine ecosystem are still being evaluated. While not all environmental accidents related to petroleum extraction can be prevented, strong regulation encouraging or mandating state of the art practices, environmental reporting, cleanup readiness, and liability insurance are invaluable in minimizing the economic and ecological harms from accidents.

Note that the Law on Petroleum Activities only addresses in detail fines and penalties for environmental accidents.

Law on Petroleum Activities

Article 35: Danger to people, property and the environment

Whoever, through any conduct contravening the provisions of this Law or the Code, endangers the life or physical integrity of another person, endangers property of high value, or seriously endangers the environment, shall be punished with:

- (a) One (1) to eight (8) years' imprisonment or a fine of no less than two hundred (200) days, where the conduct and the creation of danger are malicious;

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(b) Up to five (5) years' imprisonment or a fine of no less than one hundred (100) days.

Notice that the law provides for fines and/or imprisonment, but it does not make violating parties responsible for paying the costs of environmental damage that may result from their activities, by imposing *liability*. Liability laws are important for ensuring that the economic damage resulting from an accident or oil spill is compensated, or at least mitigated. Liability also serves a deterrent function—parties will proceed more cautiously and invest in preventative measures if they expect to be held liable for costs associated with accidents.

But liability laws are only one piece of the puzzle and are limited in scope. For example, although damage awards may compensate people from the harms they have suffered as a result of a spill, they may not address things like repairing ecosystems or wildlife restoration efforts. This is in part because it is difficult to quantify in monetary terms the ecological damage that results from industrial accidents. Another way in which liability is of limited effectiveness is in addressing environmental harms that result from day-to-day petroleum activities, even when there are no accidents. Deep sea wells, for example, can interfere with marine mammal habitat, and processing facilities can affect air quality. Finally, liability rules can be difficult to enforce, and, in cases where the potential for large-scale environmental hazards exist such as petroleum extraction, the costs of an accident can sometimes exceed the net worth of the responsible party.

Generally, liability only applies where there has been a showing of negligence. One way to encourage preventative measures is to apply strict liability, under which parties responsible for large-scale environmental harms are held liable independently of any showing of negligence.

What approaches to minimizing environmental harm, besides liability laws, are available? An alternate or additional approach is regulatory. Regulatory agencies may establish baseline standards for best practices and best technologies. One problem with this approach is that it is inflexible; requiring oil companies to take certain precautions may not make sense in every instance—for example, if cheaper and more effective solutions become available. The adaptive response to this problem is to tie regulations not to specific practices but instead to industry standards. A downside of a regulatory approach is the cost of enforcement. Laws requiring certain practices are not effective if they are not enforced.

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4. Summary

Under Article 139 of the Constitution of Timor-Leste, ownership of all subsoil natural resources belongs to the State, and must be used in a manner consistent with the national interest. The government has interpreted this Constitutional grant as authority to create a regime under which it may grant contracts to private investors to extract and sell petroleum. The Law on Petroleum Activities governs the tendering and establishment of these contracts between the State and investors. The National Petroleum Authority Decree Law grants regulatory authority to the National Petroleum Authority to administer all petroleum activities within exclusive Timorese jurisdiction.

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III. THE INTERNATIONAL LEGAL REGIME

SECTION OBJECTIVES

- To develop an understanding of the current and historical context of the shared legal authority over petroleum extraction activities in the Timor Sea between Timor-Leste and Australia.
- To provide familiarity with the sources of international law that govern petroleum activities in the Joint Petroleum Development Authority region in the Timor-Leste Sea.

Until now, we have been discussing the legal regime that applies to territory that is unambiguously within the sovereign control of Timor-Leste. But what law or laws apply in instances where Timor-Leste's territorial boundaries are unclear or disputed? In fact, all of the oil and gas *currently* being produced in Timor-Leste is derived from offshore deposits in the Timor Sea between Timor-Leste and Australia. The sovereign ownership of the resources of the seabed in this geographical area is a matter of dispute between the two nations. The National Parliament has used the authority granted to it under **The Constitution of Timor-Leste, Section 95(3)(f)** to enter into binding international treaty agreements with Australia that address this issue.

1. The Maritime Border Dispute

Recall that **Section 139 of the Constitution of East Timor-Leste** establishes state ownership of subsoil resources and resources of "the territorial waters, the continental shelf and the exclusive economic zone." Under the international law of the sea, a nation's territorial waters extend 12 nautical miles from its shoreline seaward. Nations may exercise territorial control over these waters to the same extent that they exert territorial control over land. The **exclusive economic zone**, however, extends beyond territorial waters up to 200 nautical miles from the shoreline and represents the area within which countries may claim a right to all resources derived from the sea or the seabed. Additionally, nations may claim rights to the seabed up to 350 nautical miles from their shoreline where the seabed remains part of the continental shelf. The Constitution of Timor-Leste asserts these rights to their fullest extent. However, where, as with Timor-Leste and Australia, nations are separated by less than 400 nautical miles of ocean, exclusive economic zones will necessarily overlap, and must be delimited by a **maritime boundary**.

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The proper location for an international maritime boundary between Timor-Leste and Australia is contested. In 2002, Australia withdrew its recognition of the existing maritime boundary in the Timor Sea, established during the Indonesian occupation, shortly before Timor-Leste's independence. Since ownership and control of subsoil resources is constitutionally grounded in claims of sovereign control within a country's boundaries, it would appear that the boundary dispute between Timor-Leste and Australia would need to be resolved in order for Timor-Leste to assert full control over its share of oil and gas resources in the Timor Sea, and to bring them within the jurisdiction of its laws, including the 2005 Law on Petroleum Activities. There are many factors that make resolution of the maritime boundary dispute difficult, however.

First, international border disputes are often highly contentious and protracted; resolution often involves arbitration and extensive negotiations taking years. While a resolution is pending, sovereign ownership rights in the contested area are unclear.

Also, uncertainty over ownership and the applicable legal regime represent increased risks for investors, who may be less likely to continue exploration or expand development until the territorial claims are resolved. Moreover, extraction activities have been taking place in the Timor Sea oil fields since before Timor-Leste's independence. Assuming that Australia and Timor-Leste could come to an agreement over the geographical location of the international boundary, any such geographical demarcation could negatively affect the existing operators. For example, an operator could find that it was subject to two different legal regimes for its operations in the same oil field if it had wells on either side of the new boundary, making legal and regulatory compliance difficult, and potentially slowing production. Instead, Timor-Leste and Australia entered into treaty agreements that did not delineate the maritime boundaries, but took another approach.

2. The Timor Sea Treaty

Upon Timor-Leste's independence in 2002, Timor-Leste and Australia entered into the **Timor Sea Treaty Between the Government of Timor-Leste and the Government of Australia (20 May 2002)** (the "Timor Sea Treaty"). The Treaty does *not* establish a maritime boundary between Timor-Leste and Australia in the Timor-Leste Sea:

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Timor Sea Treaty

Article 2: Without Prejudice

- (b) Nothing contained in this Treaty and no acts taking place while this Treaty is in force shall be interpreted as prejudicing or affecting Australia's or East Timor-Leste's position on or rights relating to a seabed delimitation or their respective seabed entitlements.

Instead, the agreement defers the establishment of a maritime boundary without prejudice, meaning that nothing in the treaty or the negotiations that preceded it may be used by one party to assert that the other party has ceded any of its legal claims regarding the future location of the boundary. In lieu of fixing a maritime boundary between Timor-Leste and Australia, the Timor Sea Treaty established the **Joint Petroleum Development Area (“JPDA”)**:

Timor Sea Treaty

Article 3: Joint Petroleum Development Area

- (a) The Joint Petroleum Development Area (JPDA) is established. It is the area in the Timor Sea contained within the lines described in Annex A.
- (b) Australia and East Timor-Leste shall jointly control, manage and facilitate the exploration, development and exploitation of the petroleum resources of the JPDA for the benefit of the peoples of Australia and East Timor-Leste.
- (c) Petroleum activities conducted in the JPDA shall be carried out pursuant to a contract between the Designated Authority and a limited liability corporation or entity with limited liability specifically established for the sole purpose of the contract. This provision shall also apply to the successors or assignees of such corporations.
- (d) Australia and East Timor-Leste shall make it an offence for any person to conduct petroleum activities in the JPDA otherwise than in accordance with this Treaty

The JPDA is geographic area in the Timor Sea placed under the cooperative control of both East Timor-Leste and Australia, who share a limited and exclusive sovereignty within the JPDA’s boundaries. Notice that Subsection (b) addresses the joint control over “exploration, development, and exploitation” of petroleum resources in the JDPA. These are all **upstream** activities; the Treaty does not address control over **downstream** activities, such as refining or distribution. Downstream activities are lucrative too and produce jobs, driving economic growth and generating tax revenue for the state. Currently, Australia enjoys most of the downstream

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benefits from the activities in the JDPA, in part because it already has the infrastructure necessary to support these activities. Is this fair? It is extremely difficult to regulate downstream activities by Treaty since market forces (in addition to geographical location) play a large role in guiding the development of downstream infrastructure, like pipelines, ports, and processing facilities.

Illustration: The Woodside Project

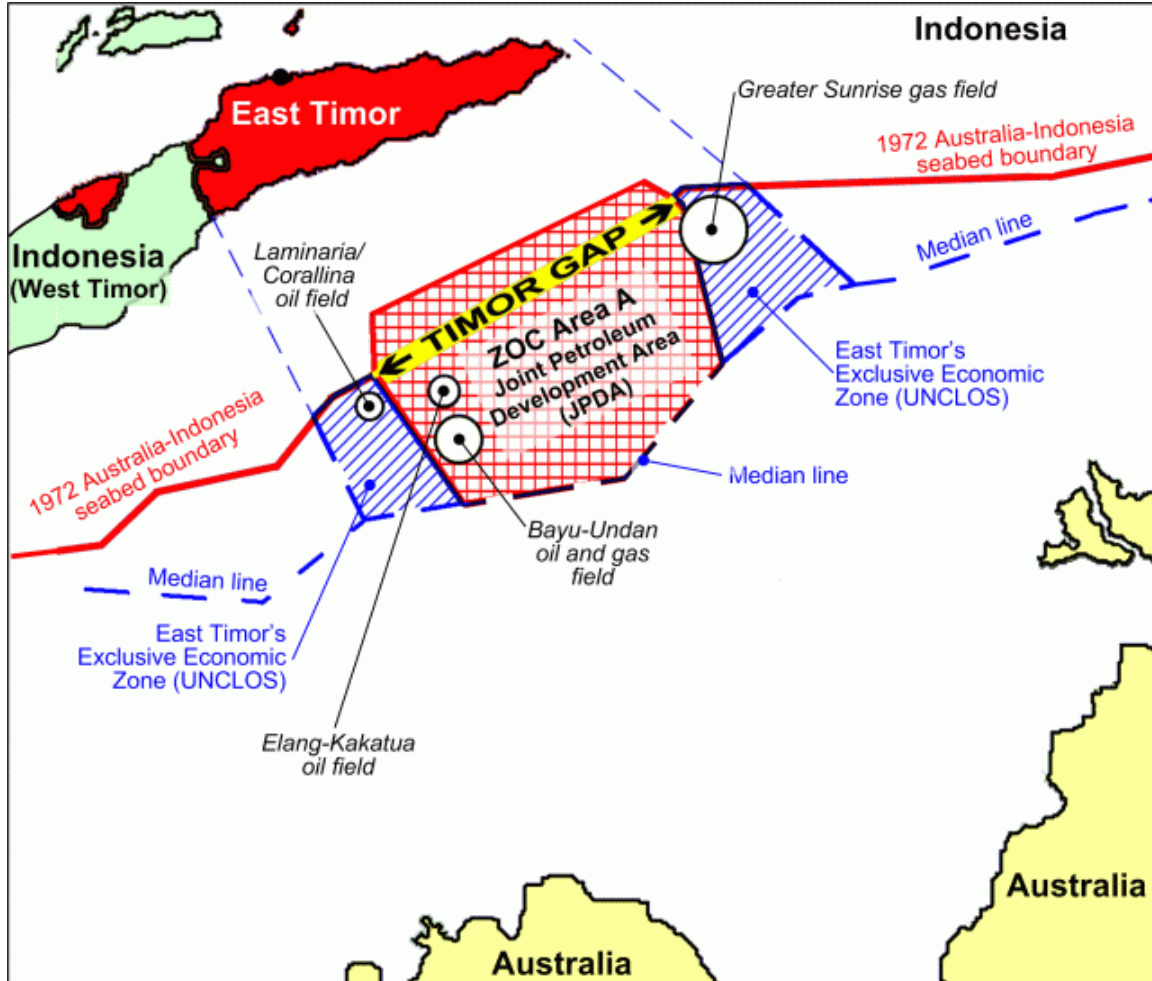
Although Timor-Leste's treaty agreements do not address downstream activities or apportion them between the two countries, Timor-Leste has nonetheless used its bargaining power as a contracting party to negotiate with private operators for a share of these activities. The Sunrise Project is operated by a consortium, of which Australian petroleum company Woodside is the largest partner. The Sunrise field contains natural gas, which must be transported to a processing facility for refinement and liquefaction. During the exploratory phase of development, it became apparent that the consortium would be required to build a new processing facility. Timor-Leste's Secretary of State for Natural Resources encouraged Woodside to consider locating the processing facility near Beacu, Timor-Leste.

Woodside concluded, based on studies that it conducted, that a Timor-Leste-based processing facility was less technologically and commercially feasible than either a floating processing facility or a pipeline to existing facilities in Darwin, Australia. Estimates of the downstream revenues that Timor-Leste would earn from hosting the processing facility are upwards of a billion dollars. The National Petroleum Authority has exercised its regulatory authority as the Designated Authority within the JPDA and the Greater Sunrise Area, to decline to award a Production Contract to the Woodside consortium unless Woodside agrees to locate the processing facility on Timorese soil. To date, negotiations are ongoing, and no development of the field has taken place.

Subsection (c) of Article 3 establishes the regulatory framework *within* the JPDA. As within the domestic legal regime in Timor-Leste, petroleum activities are regulated through production sharing agreements, whereby investors enter into contracts with the Designated Authority for exploration and development. Article (7) incorporates the **Petroleum Mining Code**, which authorizes and governs the formulation of these contracts. We will not examine it in detail here; however, conceptually, the Petroleum Mining Code can be understood as an analogue to Timor-Leste's Law on Petroleum Activities that applies only within the JDPA. In fact, the two documents are similarly structured and contain similar language.

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INSET: Map of Timor Sea and JPDA.



Source: La'o Hamutuk website, available at: <http://www.laohamutuk.org/Oil/course/OilInTLOilwatch.htm>

Regulatory Bodies

Article 6 of the Timor Sea Treaty provides for a three-tiered structure for administering the JPDA, composed of a Designate Authority, Joint Commission, and Ministerial Council.

Designated Authority: for the first three years of the treaty period, the Designated Authority was appointed by the Joint Commission. After the three year period, the Designated Authority became “the East Timor-Leste Government Ministry responsible for petroleum activities or, if so decided by the Ministry, an East Timor-Leste statutory authority.” Article 6, Section b, Subsection ii. As you have seen above, the 2008 National Petroleum Authority Decree Law established the National Petroleum Authority as the ministry with regulatory authority over

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petroleum activities within Timor-Leste. Accordingly, it functions as the Designated Authority within the JPDA. Section b, Subsection iv lays out its duties:

Timor Sea Treaty

Article 6: Regulatory bodies

(b)(iv) The Designated authority shall be responsible to the Joint Commission and shall carry out the day-to-day regulation and management of petroleum activities.

“Day-to-day regulation and management” is not further defined. It appears that the National Petroleum Authority’s regulatory authority in the JPDA is coextensive with its regulatory authority over activities in the Timorese territorial areas and undisputed EEZ. These activities include soliciting contract bids, negotiating and entering into contracts with producers, and enforcement and compliance. **Annex C** of the treaty specifies further duties, such as controlling movement in and out of the waters of the JPDA, filing annual reports to the Joint Commission, and issuing regulations pertaining to health, safety, and environmental protection. Note that the National Petroleum Authority is answerable only to the Secretary of State for Natural Resources in matters within Timor-Leste’s territory and the EEZ. However, in matters arising under its jurisdiction over the JPDA, it is answerable to *both* the Secretary of State for Natural Resources and the Joint Commission. This gives rise to a potential conflict. What if the Joint Commission and the Secretary of State for Natural Resources issue incompatible directives pertaining to the JPDA? Which authority will control? This question remains unanswered, and neither the Timor Sea Treaty nor the National Petroleum Authority Decree Law addresses it.

Joint Commission: The primary responsibility of the Joint Commission is to oversee the Designated Authority. The Joint Commission consists of commissioners appointed by Australia and Timor-Leste. The Commission has one more Timorese commissioner than Australian commissioners. Its duties are listed in **Annex D** of the Treaty. The treaty does not itself establish the procedures by which the Commission must arrive at decisions. Do you think that a majority is sufficient to ensure that Timor-Leste’s interests are sufficiently protected when the Joint Commission is deliberating?

Ministerial Council: the composition and duties of the Ministerial Council are specified in Section d, of the Treaty. It is composed of an equal number of Timorese and Australian Ministers. Its primary function is to adjudicate or resolve issues brought to it by the Joint

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Commission, and serves as a last stop before the issues are subjected to formal dispute resolution procedures specified elsewhere in the Treaty.

Revenue assignment

Under the Treaty, Timor-Leste receives 90% of the upstream revenues from development within the JPDA, and Australia receives 10% (Timor Sea Treaty, Article 4).

3. The Greater Sunrise Field and the Unitization Agreement

The Sunrise Field is an area containing particularly large petroleum deposits that straddles the eastern boundary of the JPDA, falling partly within the JPDA and partly within the seabed area over which Australia considers itself to hold uncontested seabed rights based on its 1972 agreements with Indonesia. (See Inset.) The location of the Sunrise Field both within and outside of the JPDA presented a problem. The possible application of two legal regimes to the same oil field created uncertainty for investors seeking to develop it. Since petroleum is contained in reserves in liquid or gaseous form, the units may flow freely (or be forced to flow) beneath the surface from one area of a large reserve to another area of the same reserve.

In practice, this means that if two different operators each drilled a well above the reserve many miles apart, they would be competing for the same petroleum. The “race to extract” the most petroleum first (a phenomenon that can often arise under “rule of capture” legal regimes, discussed above) can have adverse consequences on the economic productivity of a field. It can lead to an inefficient use of capital and a rush to sell the product as quickly as possible, even if the market prices would otherwise favor waiting. The possibility of a competitive race with investors on either side of a demarcation line initially dissuaded them from developing the Greater Sunrise oilfields. In order to overcome this largely legal obstacle, in 2003 Timor-Leste and Australia signed the **Sunrise International Unitization Agreement (6 March 2003)**. The agreement consolidated the geographic area of the Sunrise oil field under one legal regime—the JPDA.

However, future production from the Greater Sunrise would be apportioned by an agreed percentage *first*. The percentages agreed to were 21.1% to Timor-Leste, and 78.9% to Australia. These percentages were based on the geographical area of the field that fell into the JPDA and the Australian-claimed zones, respectively. In essence, under the Sunrise International Unitization Agreement, *all* petroleum produced in the Sunrise would be first by geographic

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percentage, with an apportionment of 78.9% going to Australia. The remaining 21.1% would be apportioned under the shares established by the JPDA, with 90% of it directed to Timor-Leste and 10% of it to Australia. These percentages were perceived as unfair by many Timorese, with Timor-Leste receiving only 18.99% (that is, 90% of 21.1%) of the total share of petroleum from the Greater Sunrise. Accordingly, the subsequent CMATS Treaty (see below) altered the apportionment of shares between the two countries.

4. The CMATS Treaty—“The Greater Sunrise Agreement”

The Treaty Between the Government of Australia and the Government of the Democratic Republic of Timor-Leste on Certain Maritime Arrangements in the Timor Sea (12 Jan. 2006) (“CMATS”) was ratified by the parliament, and entered into force, in 2007. It makes several significant changes to (but does not replace or usurp) the Timor Sea Treaty, and further refines the countries’ approach to distributing the revenue from the Greater Sunrise Oil Field.

CMATS and the Maritime Boundary

The Timor Sea Treaty originally contained a provision causing the treaty to lapse automatically in the case that a marine boundary is finally established. *See* Timor Sea Treaty, Article 22. However, this provision was later superseded by Article 3 of the CMATS:

CMATS

Article 3: Duration of the Timor Sea Treaty

The text of Article 22 of the Timor Sea Treaty relating to the duration of that Treaty is replaced by the following:

“This Treaty shall be in force until there is a permanent seabed delimitation between Australia and East Timor-Leste or for thirty years from the date of its entry into force, whichever is sooner. This Treaty may be renewed by agreement between Australia and East Timor-Leste. Petroleum activities of limited liability corporations or other limited liability entities entered into under the terms of the Treaty shall continue even if the Treaty is no longer in force under conditions equivalent to those in place under the Treaty.”

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This provision is complemented by language in the following Article that also addresses the issue of the maritime boundary:

CMATS

Article 4: Moratorium

- (1) Neither Australia nor Timor-Leste shall assert, pursue or further by any means in relation to the other Party its claims to sovereign rights and jurisdiction and maritime boundaries for the period of this Treaty.

This binding moratorium on the assertion of claims relating to the maritime boundary for the life of the CMATS treaty means, effectively, that Timor-Leste has given up its right to assert its claims relating to the boundary dispute for decades. Unlike legislation, which issues from a single deliberative body, treaties are established through a process of bi- or multi-lateral negotiation. The moratorium on resolving or adjudicating maritime boundaries appears to be a concession that Timor-Leste exchanged in return for an increased share of revenues from the Greater Sunrise oil field.

Apportionment of revenue from the Greater Sunrise

In exchange for relinquishing the right to assert a maritime boundary during the life of the treaty, Timor-Leste negotiated an increased portion of the product from the Greater Sunrise. CMATS retains the unitization of the Greater Sunrise field, but apportions Timor-Leste a 50% share in petroleum revenues from development in that field—compared to the 18.1% share it was afforded under the Timor Sea Treaty and International Unitization Agreement. Realization of any revenues from the Greater Sunrise Field is contingent on commercial development of the field.

CMATS

Article 5: Division of Revenues from the Unit Area

- (1) The Parties shall share equally revenue derived directly from the production of that petroleum lying within the Unit Area in so far as the revenue relates to the upstream exploitation of that petroleum.

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The following table provides a side-by-side comparison of the domestic and international legal regimes discussed above.

TABLE 1: Comparison Chart of Domestic and International Legal Regimes

	Domestic Regime	International Regime
Geographical Area	Timor-Leste Territory, Territorial Waters, Undisputed EEZ	Joint Petroleum Development Area
Ownership Rights	Timor-Leste Constitution: State of RDTL owns 100%	Treaty Agreements: State of RDTL owns 90% in JPDA and 50% in Greater Sunrise
Regulatory Authority	National Petroleum Authority	Joint Commission (oversight) Designated Authority: National Petroleum Authority of Timor-Leste
Regulatory Regime	2005 Law on Petroleum Activities	Petroleum Mining Code
State/Investor Relationship	Production Sharing Contracts	Production Sharing Contracts

5. Summary

All of Timor-Leste's petroleum currently comes from fields in the Timor Sea, in a geographical location that is subject to sovereignty claims by both Timor-Leste and Australia. To resolve the dispute without disrupting production from this area, the two nations have foregone delimiting a maritime boundary. Instead, Timor-Leste has entered into treaty agreements that establish a regime of shared authority over petroleum activities within the region. The JPDA, as it is known, is overseen by the Joint Commission, comprised of representatives of both countries. The day-to-day management of activities in the JPDA, including the awarding of new contracts for exploration and development, is conducted by the Timorese National Petroleum Authority. Timor-Leste receives a 90% share of the petroleum revenues generated in the JPDA, and a 50% share of revenues that may be generated in the Greater Sunrise area.

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GLOSSARY

Downstream Petroleum Extraction: The processing (refining), transporting, and distributing of oil and gas resources.

Exclusive Economic Zone (EEZ): Under international law, an area up to 200 nautical miles from the shoreline that a nation can claim the right to all resources in and under the sea.

The Greater Sunrise Field: An area between Timor-Leste and Australia containing large petroleum deposits, jointly managed by the two countries.

International Treaty: A legally binding agreement between two or more nations.

License or Concession: A standardized exclusive right to extract oil or gas, sold or auctioned off by the government.

National Petroleum Authority (NPA): The Timor-Leste government agency responsible for managing and regulating petroleum activities.

Production Sharing Agreement (PSA): A contract between an extraction business and the government, obligating the company to extract the oil in return for a share of the revenues.

Upstream Petroleum Extraction: The exploration and production of oil and gas resources.