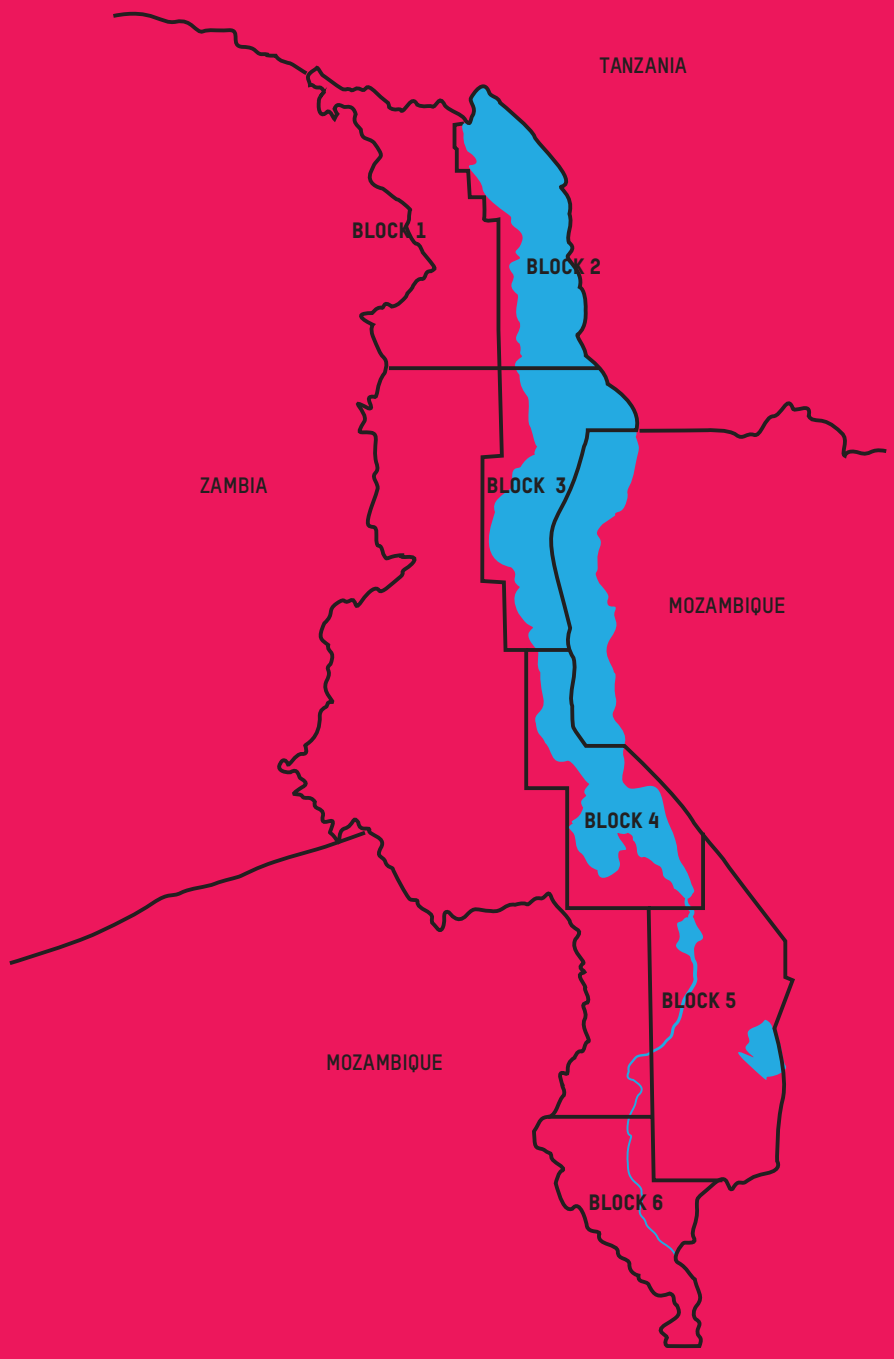
MALAWI'S TROUBLED OIL SECTOR: LICENSES, CONTRACTS AND THEIR IMPLICATIONS

January 2017



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ABOUT THE RESEARCHERS AND AUTHORS OF THE REPORT

Resources for Development Consulting is a policy research firm that seeks to assist citizens in resource-rich developing countries to secure a fair share of extractive sector wealth by analysing contracts and broader fiscal regimes, and conducting integrated economic analyses in order to assess plausible government revenues.

Don Hubert is President of Resources for Development Consulting. Dr Hubert is based in Canada, having just completed a three-year posting in Mozambique where he worked on the extractive sector for the United Nations, bilateral donors and non-governmental organizations. His work focuses using contract analysis and project economic modelling to strengthen extractive sector governance. He has conducted economic analyses of extractive sector projects in Belize, Chad, Kenya, Mozambique, Tanzania, Uganda and Zimbabwe. He has been a Canadian diplomat and a University Professor, and holds a PhD from the University of Cambridge, UK.

Gordon Kirkwood has been Senior Associate with RES4DEV Consulting since 2014. Dr. Kirkwood worked in the oil and gas industry for BP for 30 years as a Petroleum Engineer, Economist and Business Advisor in countries including: UK, Egypt, Venezuela and the United Arab Emirates. Dr. Kirkwood is a Chartered Engineer (Petroleum), a European Engineer and Fellow of the Institute of Materials, Minerals and Mining. He has provided technical support for Resources for Development Consulting projects in Belize, Cambodia, Kenya, Malawi, Mozambique and Tanzania.

Rachel Etter-Phoya has been working in the extractives industries, with a focus on Malawi for the past five years. She currently serves as a CIM integrated expert with Citizens for Justice in Lilongwe, Malawi, and sits on the Malawi Extractives Industries Transparency Initiative Multi-Stakeholder Group. She has been engaged on a number of other extractives related projects including with Southern Africa Resource Watch and Imani Development and runs Malawi's only website dedicated to the extractive industries.

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Report was designed and printed by Imperial Marketing: imperialmarketing07@gmail.com

Kayelekera is Malawi's only large-scale mining operation. Photo: Paladin Website

1. INTRODUCTION

For more than a decade, Malawi has looked to the extractive sector as a potential engine of the economy and a major additional source of government revenue. Expectations have not been met.

The country has only one large-scale mining operation and due to depressed uranium prices the mine is now on care and maintenance. Even during its years of operation, however, the mine contributed little to the Treasury. This was due in part to the normal cycle of revenue generation where investment costs are recovered in the early years. But part of the problem was the tax breaks offered to Paladin in the contract for the Kayelekera uranium mine.

There are other mining prospects that could make a significant contribution to the economy and government revenues, including Globe Metals & Mining's Kanyika niobium project and Mkango Resource's Songwe Hill rare earth deposit. A recent Oxfam report provides useful insights into the potential revenue generation from mining in general and Songwe Hill in particular.[1]

Solid minerals are not the only option. Southern and eastern Africa has become hot spots for oil and gas exploration. Significant finds in surrounding countries including Tanzania and Mozambique as well as Kenya and Uganda have heightened interest in exploration in Malawi. No oil has yet been found in the country. In fact, serious exploration has not even begun. But there is a chance that commercial quantities of oil may be found in the coming years.

This report analyses the embryonic petroleum sector in Malawi. It examines the designation of six petroleum exploration areas known as "Blocks," it analyses the initial allocation of exploration licenses and the signing of oil contracts for Blocks 4, 5 and 6. At its core, it is a story of secret oil contracts signed in the days before the election in 2014 where those representing the citizens of Malawi made the mistakes of Kayelekera once again.

Countries cannot control their natural resource endowment or the value those resources will have on international markets. What they do control, are the terms under which they allow international companies to explore and exploit. These terms are contained in project-specific contracts that can remain in force for many decades. Good contracts establish clear rights and responsibilities for both the company and the government and ensure an equitable division of the profits. And good contracts do not exist in isolation. Rather, they rest on a foundation of strategic policy and sound law.

In seeking to develop an oil sector, Malawi failed to act on the clear lessons of Kayelekera. Officials sought to fast-track exploration activities, ignoring the need to put in place a clear national policy and to revise the badly out-dated Petroleum (Exploration and Production) Act of 1983. Between 2011 and 2013, companies were granted exploration licenses for the six blocks where geology suggests that oil *might* be found. Officials also chose to adopt a specific tax regime for the oil sector known as a "production sharing system" and prepared a model "production sharing agreement." Although the model agreement was not yet complete, contract negotiations began for three of the six blocks. To the surprise of government officials involved, secret negotiations resulted in the signing of three production sharing agreements (PSAs) eight days before the elections in May of 2014.

The allocation of oil exploration licenses, and the signing of production sharing agreements have been controversial from the outset. In the weeks before the agreements were signed, the Solicitor General recommended that the government should not proceed. Once the contracts were signed, the Attorney General undertook a review to determine whether the contracts were signed in violation of Malawian laws and regulations.

For the Attorney General, the problem with Malawi's oil contracts was that they should have been signed only after the exploration phase was completed.[2] He was also concerned that the behind-the-scenes ownership violated the petroleum regulations.[3] Unfortunately, the problems with the evolution of the oil

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sector in Malawi run far deeper. The government promoted oil exploration in the absence of a clear policy framework; adopted a production sharing system without a clear legal framework; fast-tracked the finalization of the contract negotiations in secret; and agreed to generous and in some cases incoherent tax terms.

The analysis that follows explains the relationship between oil licenses and oil contracts, explains how production sharing agreements work and analyses the specific tax terms that have been agreed in the signed PSAs. It is based on a careful review of the Model Production Sharing Agreement of 12 March 2014 and the PSAs for Blocks 4 and 5 signed on 12 May 2014. Other key sources of information include Pacific Oil's application for a petroleum license for Block 6 (1 June 2013), Pacific's proposed Production Sharing Agreement submitted to the government in first months of 2014, internal memorandum prepared by the Ministry of Mining, and the initial legal opinion on the oil contracts prepared by the Attorney General in 2015.[4]
As this report is being finalized, the saga continues to unfold. As will become clear in the pages that follow, the contracts signed in May of 2014 have serious shortcomings. Recognizing these problems, the government has begun to renegotiate the fiscal (tax) terms. It appears that an Addendum will be added to the existing contracts increasing the government's share of potential benefits from as-yet undiscovered oil. It is likely that there will be increases to the royalty rate and the government's equity share, as well as the provisions that determine the allocation of production that lies at the heart of production sharing agreements. Little can be said with confidence, however, as once again the negotiations are taking place in secret.

Citizens and civil society organizations continue to demand for transparency in the extractive industry sector. Photo: Citizen for Justice

2. CONTRACT DISCLOSURE

Information on petroleum licensing and contracts in Malawi has been closely guarded. Even within Government circles, there are indications that access to basic license documents has been highly restricted. The situation with production sharing agreements has been even worse. Government officials responsible for preparing the model production sharing agreement and initiating negotiations with companies were unaware of the finalization of negotiations and the signing of the contracts immediately prior to the election in 2014.[5]

While in many jurisdictions mining and petroleum contracts have been confidential documents, there is a strong shift towards full public disclosure.[6] Examples of countries in sub-Saharan Africa that have disclosed extractive sector contracts include Burkina Faso, Democratic Republic of Congo, Liberia, Mali, Mauritania, Mozambique, Republic of Congo and Sierra Leone.[7] The EITI added contract disclosure to their list of recommended practices in 2013.[8] International organizations such as the International Monetary Fund (IMF) encourage contract transparency while the World Bank's International Finance Corporation (IFC) now makes contract disclosure a condition of their support.[9]

It is widely accepted that confidentiality increases the risks of both corruption and revenue leakage. Even where all contract provisions are appropriate, confidentiality breeds suspicion

of wrongdoing.

An often-unacknowledged benefit of contract disclosure is accessibility by government officials. As is clearly the case in Malawi, restricting access to signed contracts means that they are often unavailable even to government officials who require knowledge of contract provisions in order to carry out their duties.

The benefits of contract disclosure are obvious. The risks of doing so have been systematically overstated. Commercial sensitivity is often cited as a barrier to public disclosure, but it has not been an issue in dozens of countries that have published contracts.[10] In fact, companies often disclose contracts to their investors yet seek to deny similar access to citizens.
Malawi has recently made important progress in contract disclosure in the mining sector. Civil society organizations have been calling for full disclosure of Malawi's extractive sector contracts since the Mining Development Agreement with Paladin was signed in 2007.[11] Malawi's EITI multi-stakeholder group – made up of representatives from government, civil society and the private sector – committed to contract transparency in 2015.[12] The EITI process has finally delivered results, with Paladin and Nyala contracts being made publicly available on ResourseContracts.org – a global repository of extractive sector contracts.[13]

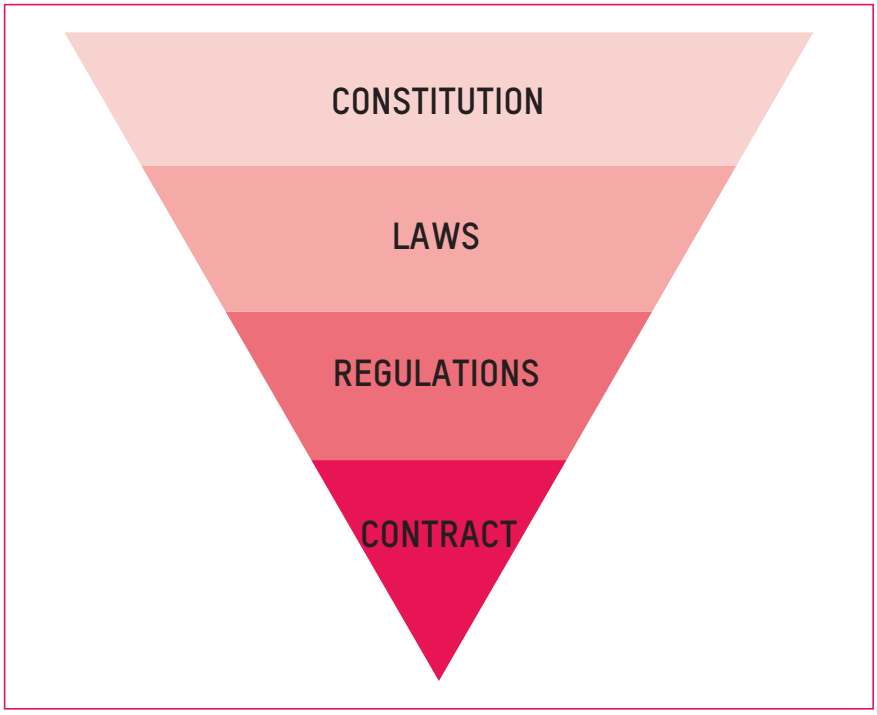
There is no legal barrier to the disclosure of the Malawi Production Sharing Agreements. In fact, the opposite is true: both the government and the company obligated to making the signed agreements public. The contracts for both Blocks 4 and 5 include a clause that states: "The Ministry and the Contractor *shall make public* this Agreement and any amendments or written interpretations of this Agreement".[14]

3. OIL CONTRACTS

Oil contracts establish the terms under which private companies explore for oil. There are, of course, other ways in which a country can develop an oil industry. The largest oil companies in the world are not private; they are the national oil companies (NOCs) of Saudi Arabia, Russia and Iran. These are the exception however. Most countries lack the technical expertise to develop a domestic oil sector. Equally importantly, few countries want to risk their own financial resources in the high-risk venture of exploring for oil. The solution is to encourage private companies to explore and develop oil resources based on terms set out in a contract.

There are common interests between the private company and the government – both hope that exploration results in the discovery of large, commercially viable oil fields. However, the two parties to the contract also have conflicting objectives – both want a substantial share of the profits. The challenge for the government then is to offer contract terms that both maximize government revenue but also attract private companies to take the exploration risk. Tough terms might look good on paper, but they are of no value if credible companies are not willing to sign up. At the same time, highly generous terms are likely to attract companies, but can leave the government with only a small portion of the proceeds. The challenge in designing fiscal regimes, and in negotiating contracts, is to get the balance right.

Figure 1: Sources of Fiscal Terms



THE HIERARCHY OF LAWS AND CONTRACTS

Oil contracts cannot be understood in isolation.[15] They are only one component of the broader framework that determines the government's share of potential oil revenue (Figure 1). In some countries, the Constitution provides the foundation on which the rest of the framework is based. In Malawi, however, the Constitution contains no reference to the ownership of sub-surface rights. The foundational law for the petroleum sector therefore is the

Most countries lack the technical expertise to develop a domestic oil sector. Equally importantly, few countries want to risk their own financial resources in the high-risk venture of exploring for oil.

out-dated Petroleum (Exploration and Production) Act (1983) which vests ownership of petroleum resources in the "Life President on behalf of the people of Malawi."[16]

THE PETROLEUM ACT IS SUPPORTED BY A SERIES OF REGULATIONS INCLUDING LICENE

applications, the constitution of blocks, general provisions, fees and charges, reports and accounts, and the registration and transfer of licenses.[17]

Most of the specific detail on company rights and responsibilities, and the financial terms that govern company operations, are contained in a contract. The "contract," sometimes known as the "host country agreement," is the foundational document that establishes the rights and responsibilities of the government and the company (often referred to as the contractor). In Malawi, these contracts are called Production Sharing Agreements (PSAs).

Contracts relate to a specific geographic area, variously called "blocks," "concessions" or "areas." New regulations in 2009 established the boundaries of 6 separate blocks in the regions where geology suggests that there might be a chance of finding oil[18] (See Figure 2). Three of the six blocks (2, 3 and 4) include Lake Malawi and overlap with one of Malawi's two World Heritage Sites, Lake Malawi National Park. The boundaries of Blocks 2 and 3 are also linked to the

Figure 2: Map of Malawi's Blocks

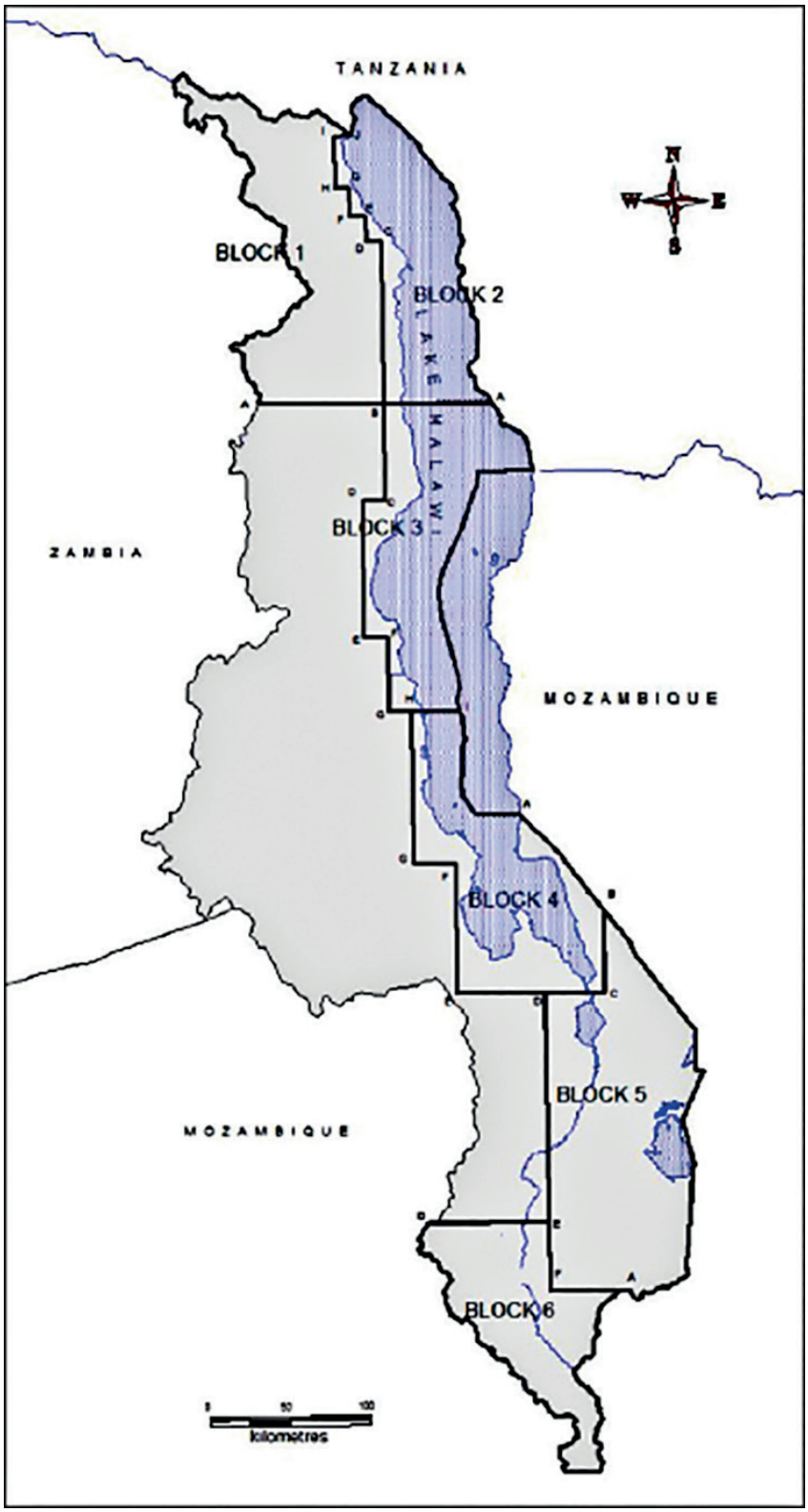
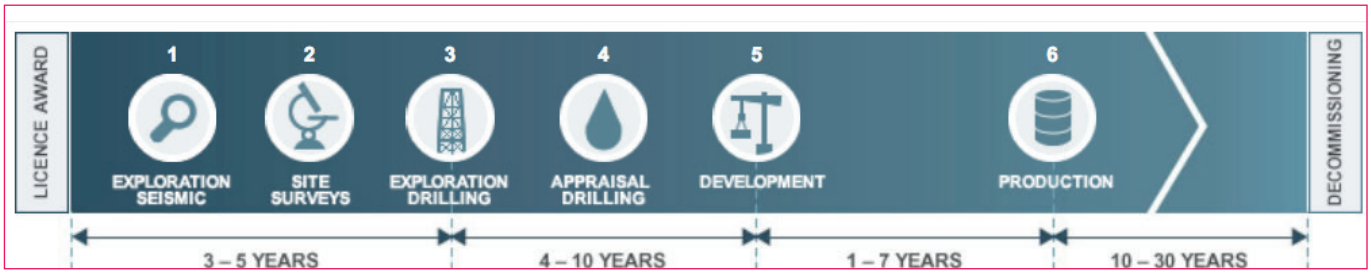


Figure 3: Project Life-Cycle Covered by Oil Contracts



on-going boundary dispute with Tanzania with Malawi claiming all of northern part of the Lake and Tanzania claiming the north-eastern half.[19]

In contrast to the mining sector where contracts are commonly signed after the discovery of minerals, in the petroleum sector it is normal for contracts to cover all of the phases of a petroleum project: exploration, development, production and decommissioning. As can be seen in Figure 3[20], the timeframe covered by an oil contract can easily exceed 40 years. The time scales involved should generate greater prudence on the part of those negotiating agreements as the impact could be felt for generations.

CONTRACTS AND LICENSES

The interplay between contracts and licenses varies from country to country. In countries with a strong mining tradition, prospecting or exploration licenses may be granted at the outset. But these normally only confer the right to begin exploration and are linked to an oil contract that covers the full lifecycle. In Namibia, for example, a one-page Petroleum Exploration License grants the right to begin exploration activities. Before the license is issued, however, a detailed Petroleum Agreement is agreed that establishes rights and responsibilities from exploration through decommissioning. If exploration were successful, a short "Petroleum Development Licence" would be issued based on an approved development plan.

Given that oil contracts establish contractual terms that can last for many decades, it is essential to establish a clear legal framework before contracts are negotiated and licenses granted. In Kenya and Mozambique, for example, licensing rounds have been delayed in order to revise out-dated Petroleum legislation.[21]

Malawi, unfortunately, did not follow this standard practice. Oil companies had undertaken some initial reconnaissance in the 1980s. Reports suggest that Malawi began actively seeking to attract oil exploration companies to continue that work in the mid-2000s. There are indications that the option of developing a national policy and updating the Petroleum Act was considered and

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There are indications that the option of developing a national policy and updating the Petroleum Act was considered and rejected in favour of capitalizing on early investor interest by Capital Hill. Photo: Malawi Government

rejected in favour of capitalizing on early investor interest.[22]
The result is that important inconsistencies are embedded in the licenses and contracts already agreed.
In particular, there has been much confusion about the sequencing between the issuing of licenses and the negotiation and signing of oil contracts. In contrast to most other jurisdictions, the Prospecting Licenses issued by Malawi are mini-contracts, setting out terms that apply through the exploration phase.
The licences indicate that oil production cannot begin until the company has signed a Production Sharing Agreement, implying that the agreement is to be signed following the discovery of oil. This interpretation is inconsistent, however, with normal industry practice where production sharing agreements normally cover both the exploration and production phases. This is also the case with Malawi's Production Sharing Agreements that explicitly cover the entire life-cycle of the project from exploration, through development, production and finally decommissioning.

4. PETROLEUM LICENSES AND PRODUCTION SHARING AGREEMENTS

Malawi has been courting potential oil exploration companies since at least 2006. The Petroleum Regulations were amended in 2009, including the designation of the six Blocks mentioned above and revisions to the licence application regulations, in order to facilitate the issuance of licenses. A standard Prospecting Licence was also prepared as the basis for negotiations with companies.

International best practice suggests that petroleum rights should be allocated through a transparent process, ideally based on competitive bids.[23] However, in countries with no history of oil discoveries, it is common for rights to be allocated through company applications. Unfortunately, well-established oil companies are often not interested in high-risk exploration and applicants are smaller companies, sometimes with relatively little capacity or expertise.

Malawi's Petroleum Regulations allow the Minister to grant exploration licenses following the submission of applications by companies. There is little clarity, however, on the process through which applications are solicited or assessed. It appears that the licensing process began with advertisement in local and international papers. An inter-Ministerial Mineral Rights Committee reviewed the applications and prepared recommendations that were then forwarded to the Minister and ultimately approved by the Head of State.[24]

Six Prospecting Licences were signed between September 2011 and July 2013. In three cases, Blocks 4, 5 and 6, Prospecting Licences have been accompanied by Production Sharing Agreements. The dates and signatories are set out in Table 1.

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Table 1: Existing Licenses and Production Sharing Agreements

	Company	Prospecting Licence	PSAs
Block 1	SacOil Holdings Limited (South Africa)	12 December 2012	
Block 2	Surestream Petroleum Limited (United Kingdom)	22 September 2011	
Block 3	Surestream Petroleum Limited (United Kingdom)	22 September 2011	
Block 4	RAK Gas MB45 Limited (Cayman Islands)	5 July 2013	12 May 2014
Block 5	RAK Gas MB45 Limited (Cayman Islands)	5 July 2013	12 May 2014
Block 6	Pacific Oil Limited (British Virgin Islands)	24 July 2013	12 May 2014

Table 2: Overview of Fiscal Systems

AREA	ROYALTY/TAX	PRODUCTION SHARING	SERVICE
Africa	Nigeria (Shelf), Chad, Congo, Ghana, Madagascar, Morocco, Namibia, Niger, Senegal, Somalia, Sierra Leon, South Africa, Tunisia (Old)	Nigeria (Deepwater), Algeria, Angola, Benin, Cameroon, Congo, Cote D'Ivoire, Egypt, EG, Ethiopia, Gabon, Gambia, Kenya, Liberia, Libya, Madagascar, Mozambique, Sudan, Tanzania (new), Uganda, Zambia	Nigeria JVC
Europe	Italy, France, Ireland, Netherlands, Norway, Poland, Portugal, Romania, Spain, Denmark	Poland, Turkey, Malta, Albania	
Asia	Australia, Brunel, South Korea, Nepal, New Zealand, Thailand, Timor	Bangladesh, Cambodia, China, Georgia, India, Indonesia, Laos, Malaysia, Mongolia, Pakistan, Vietnam	Phillipines
FSU	Russia	Azerbaijan, Georgia, Kazakhstan, Russia, Turkmenistan, Uzbekistan	
Latin America	Argentina, Bolivia, Brazil, Columbia, Paraguay, Trinidad	Belize, Cuba, Guatemala, Nicaragua, Panama, Trinidad (old), Venezuela	Chile, Ecuador, Panama, Peru, Honduras, Mexico
Middle East	Abu Dhabi, Dubai, Turkey	Bahrain, Iraq, Jordan, Libya, Oman, Qatar, Syria, Yemen	Iran, Kuwait, Saud Arabia
N.America	USA, Canada		

5. PRODUCTION SHARING SYSTEMS

Traditional analyses of petroleum fiscal regimes draw a sharp distinction between three different types: royalty and tax, production sharing and service agreements.[25] Table 2 below shows the regional distribution of these three main systems.[26] The specific model chosen, however, is less important than is often thought. Governments can ensure that they secure a fair share of the overall revenues whichever model is chosen. It is the specific terms within the system, rather than the system itself, which determine whether the government has negotiated a good deal.[27] Over time the sharp distinctions between these models have blurred and so-called hybrid models (adding royalties and income tax to a production-sharing system) are now common

Malawi's Petroleum Act does not provide specific details on the fiscal system to be adopted in the petroleum sector. The Financial section (Part IV) indicates only that a royalty is to be paid on petroleum recovered. It appears,

Over time the sharp distinctions between these models have blurred and so-called hybrid models (adding royalties and income tax to a production-sharing system) are now common

however, that sometime in 2009, officials decided that Malawi should adopt a production sharing system for its oil sector.[28] The production sharing system was developed by Indonesia in the 1960s and has since been widely adopted, particularly in the developing world. In this system, ownership of the petroleum remains with the state, while the contractor funds exploration and development activities and is reimbursed through a share of the petroleum produced.

THE MODEL PRODUCTION SHARING AGREEMENT

Adopting a new fiscal system would normally be done through the development of a national petroleum policy and a revision to the relevant legislation and regulations. Officials chose, however, to short-circuit this process in order to capitalize on investor interest at a time when government attention (and donor interest) was focused on establishing policy and legislation for the mining sector.[29]

The solution devised by officials was to compensate for an inadequate legal foundation by drafting a "model' production sharing agreement.[30] Petroleum agreements are long complicated documents – often 60 pages or more. Negotiations with companies do not start with a blank page. Rather, they begin with a model contract that contains specific provisions open for negotiation.

The drafting of Malawi's model PSA began in early 2010.[31] At first, this involved borrowing clauses from other model contracts available in the region. Technical support was provided by a number of international players starting with the Commonwealth Secretariat and later including the International Monetary Fund (IMF), the African Legal Support Fund, the University of Dundee, and the International Senior Lawyers Project.

Intense consultations and revisions took place during late 2013 and early 2014, and by March of that year, officials estimated that the model contract was 80% complete.[32] However, significant work remained, including careful analysis of the tax rates that would generate the appropriate balance between attracting inwards investment and securing a fair share of the profits.

CONTRACT NEGOTIATIONS

Exploration licenses for Blocks 4 and 5 were held by RAK Gas MB45 Limited, a Cayman Island subsidiary of the state oil company for Ras Al Khaima Emirate in the United Arab Emirates. Pacific Oil Limited, an oil exploration company registered in the British Virgin Islands, held the exploration license for Block 6.

Although the drafting model PSA was not yet complete, the government began PSA negotiations for the three Blocks. The negotiations appear for the three Blocks too place in the same time period and it may be that they were conducted jointly.[33]

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While the relationship between RAK Gas and Pacific remains unclear, the CEO of RAK Gas is also listed as the CEO of Pacific. The signed Pacific PSA is not yet available and has therefore not been included in this analysis. There are indications, however, that it is identical to the two RAK Gas PSAs.[34]

Little information is available on the negotiations. Some insights, however, can be gleaned from Pacific's License Application and from their draft Production Sharing Agreement. In their license application of 1 June 2013, Pacific proposes fiscal (tax) terms that seem reasonably favourable to the government (a 5% royalty, a 30% corporate income tax, a 70% cost recovery limit and a 10% carried state equity) while placing unusual emphasis on early benefits to Malawians including the right of a "local party" to acquire a 10% participating interest and Corporate Social Responsibility payments (USD 120,000 per year).

The fiscal terms in the proposed Production Sharing Agreement are much less favourable to the government. The royalty is removed entirely (Article 13.4) while corporate income tax is to be paid by the government from its share of production.[35] The provisions on state equity and "local" party participation remain the same. The amount to be allocated to Corporate Social Responsibility remains the same (USD 120,000) but greater specificity is provided on the likely beneficiaries including "schools and health centres, contributing towards Presidential National Initiatives for social development, Safe Motherhood Project, Mudzi Transformational Trust."[36]

THE SIGNED PSAS – 12 MAY 2014

Government officials were under intense pressure to complete the drafting of the Model PSA during a flurry of meetings in February and March of 2014. A full draft was published on 12 March 2014, though officials believed that this was only 80% complete and little work had yet be done to calibrate the fiscal (tax) terms.

Negotiations with RAK Gas (Block 4 and 5) and Pacific Oil (Block 6) were happening in parallel. Although the rationale remains unclear, pressure was building to finalize the PSAs. The Solicitor General's office recommended against signing the PSAs in advice provided in March of 2014. Government officials involved in the negotiations also resisted claiming that more time was needed. At the time, it appeared that caution had prevailed and that the negotiations had been postponed.

Months later, however, it became clear that the negotiations had been completed, and that PSA contracts for Blocks 4 and 5 with RAK Gas and Block 6 with Pacific had been signed by the then Minister and the Principal Secretary both responsible for mining, just eight days before the elections in May of 2014.

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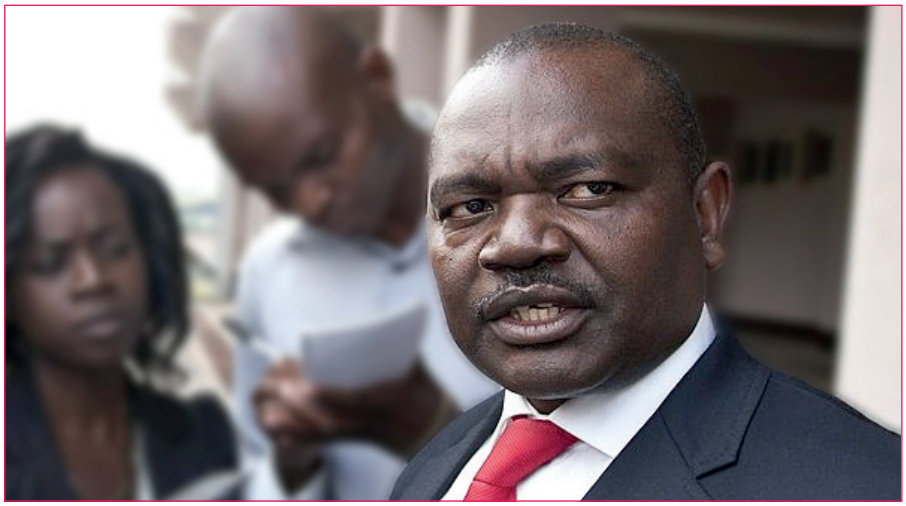
6. THE ATTORNEY GENERAL'S REVIEW

From the outset, the signing of the Production Sharing Agreements was controversial. In the midst of the negotiations in March of 2014, the Solicitor General's office specifically recommended against signing Production Sharing Agreements.[37]

On 18 December 2014, the Ministry of Natural Resources, Energy and Mining gave notice to all companies involved in oil and gas exploration in Malawi to cease all operations pending a review to ensure that Licenses or Agreements were signed "in accordance with the laws of the country."[38]

On 22 December 2014, at a meeting held at the Ministry of Foreign Affairs, the Attorney General was instructed to provide legal advice on six specific issues:

(a) Whether the Exploration Licenses were properly and lawfully issued;
(b) Whether it is possible to revoke the Exploration Licenses
(c) Whether Hamra Oil Limited lawfully acquired the equity stake in the Surestream prospect;
(d) Whether it was proper to issue the licenses to related parties;
(e) Whether the Production Sharing Agreements were properly entered into;
(f) Whether Government could possibly renegotiate the Production Sharing Agreements.



Malawi's Attorney General, Kalekeni Kaphale. Photo: Nation Publications Limited

The Attorney General issued his opinion on these matters on 8 January 2015.[39] The opinion focused on the following key issues.

First, according to Regulation 2(2) of the Petroleum (Application) Regulations of 2009 states that no more than two exploration licenses can be granted to an applicant. The Attorney General's opinion, however, indicated that underlying ownership of the relevant companies might violate the regulations. Specifically, he notes that:

- Blocks 2 and 3 came to be controlled by Hamra Oil Limited when they acquired a controlling interest in Surestream.
- Hamra Oil Limited is controlled by the same entity as RAK Gas (Blocks 4 and 5): the Ras Al Khaima Emirate.[40]
- Pacific Oil could be related to RAK Gas as Kamal Ataya (CEO of RAK Gas) also signed license and contract documents for Pacific Oil and for Hamra.

There were indications, therefore, that five of the six Blocks had been allocated to related companies in violation of the Regulations. The Attorney General indicated that, as it was not within the Minister's powers to confer more than 2 licenses to related parties, that either the licenses could be revoked or, alternatively, that the companies be allowed to choose only 2 Blocks and acquire an amended license.

Second, the Attorney General commented on the validity of the Production Sharing Agreements. He noted that if the initial Licenses were invalid due to the underlying ownership, the associated PSAs would be invalid as well. He also indicated that the Production Sharing Agreements were improperly issued as according to Clause 8 of the Licenses, PSAs were to be negotiated only *after* the discovery of petroleum.

The Attorney General's opinion concluded on the need to undertake additional research in order to "show the interconnectedness of Hamra, RAK Gas and Pacific Oil."[41] There are indications that following additional research, the AG issued a second opinion formally recommending the cancelation of the licenses (and therefore also the PSAs) for Blocks 4 and 5.[42]

On 11 February 2014, soon after the Second Alternative Mining Indaba, Minister of Foreign Affairs George Chaponda told the press in Lilongwe that the President had lifted ban on oil exploration on Lake Malawi.[43] It seems that this announcement was premature, as according to correspondence from RAK Gas, on 23 February 2015, the Secretary for Natural Resources, Energy and Mining wrote to RAK Gas inviting them to "show cause" for why the RAK Gas Licenses should not be revoked.[44]

In correspondence, RAK Gas contested the opinion of the Attorney General. First, they claim that the prohibition in the regulations only limits a company to *applying* for more than two licenses in a single application and says nothing about subsequent changes in ownership. Second, they claim that Hamra and RAK Gas are not legally affiliated because one is owned by an individual while the other is owned by a government.[45] It appears that these points were reiterated at a meeting between the Principal Secretary and RAK Gas on 13 May 2016.

On 16 October 2016, it was reported that the Attorney General revised his position based on additional information provided and that the companies were notified that they could proceed with exploration activities.[46]

7. SOURCES OF POTENTIAL GOVERNMENT REVENUE

Production sharing agreements are complicated contracts that cover dozens of discrete issues. Foremost among these are the fiscal (tax) terms that will determine the share of divisible (after cost) revenue that will go to the government and to the company. In the Malawi fiscal system, there are four main sources of government revenue.

1. Royalty
2. Profit Oil
3. State Participation
4. Corporate Income Tax

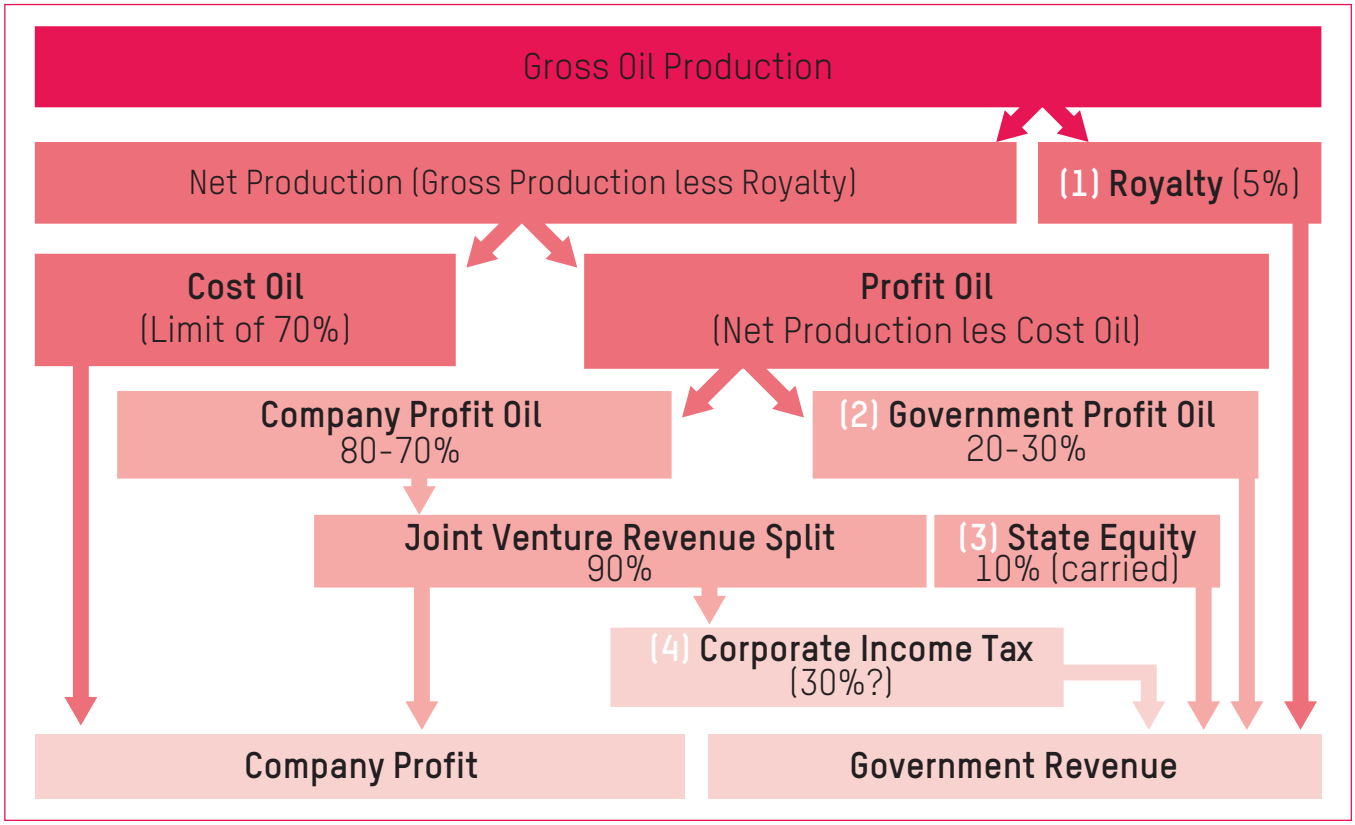
It is important to recognize that fiscal terms must be understood as a package. Generous terms in one area can be offset by more stringent terms in another area. And the package of terms only really becomes meaningful when applied to a project (real or hypothetical) with project production and cost estimates tested against varying oil prices.47 The sequence for allocating *potential* revenue between the Malawian government and RAK Gas is set out in Figure 4.

(1) ROYALTY

For most fiscal regimes, the payment of a royalty is the first step in the calculation of government revenue. As a result, is often known as a payment "off the top." Royalties are a payment to government calculated as a percentage of the value of production and are paid in full from the start of production.

Royalty payments have traditionally been viewed as compensation to the government

Figure 4: Allocation of Revenue – Block 4 & 5 PSAs



for the depletion of a non-renewable resource. But royalties are now more commonly viewed as a way to guarantee government revenue in the early years of production before profit-based taxes come on stream. There has been a general move away from high royalty rates (e.g. +10%), as they are not sensitive to the profitability of the project and can be a significant disincentive, particularly for marginal fields.

There are indications that Malawi had considered imposing a relatively high royalty rate. The provisional royalty rate in the Model PSA of March 2014 was 12.5% with a reduction to 10% for deep water finds.[48] Similarly, early applications for Prospecting Licences indicated a willingness to agree to a 12% royalty, though with a reduction in the early years.[49] However, later License applications refer to a 5% royalty. The PSAs for Blocks 4 and 5 signed on 12 May 2015 contain a royalty of 5% (Article 30.1).

(2) PRODUCTION SHARING

The second source of government revenue in the Malawi fiscal system is a share of the oil produced. There are two steps in the allocation of oil produced: the recovery of costs by the contractor and the division of the remaining oil between the contractor and the government.

Cost Oil: Production sharing systems allow the contractor to recover its costs through an allocation of an initial amount of production termed "cost oil." Recovered costs include the exploration for oil, the development of the facilities to produce oil, and the operation of those facilities. In the first years of production, accumulated exploration and development costs normally exceed the value of total production.

Many production sharing systems place a limit on the proportion of overall production that can be devoted to cost oil. This is done in order to ensure that at least some "profit oil" is available to be split between the company and the government at early stages in the project when total investor costs exceed total project revenues. The model PSA and the signed PSAs have a cost recovery limit of 70%. Under these terms, at least 30% of production will always be shared between the company and the government.

It is important to note that the cost recovery limit has an impact only on the timing of reimbursements to the company. Where limits are imposed, costs are carried forward and claimed in subsequent years. A second technique, limits on the depreciation of capital assets, is sometimes used to slow the pace of cost recovery. The model contract and the signed PSAs impose a fairly normal limit on capital depreciation of 20% per year.

Profit Oil: Once costs have been recovered, the remaining oil production, known as "profit oil", is split between the company and the government. The division is normally based on some kind of sliding scale. Traditionally, the percentage of profit oil flowing to the government increased with the volume of production (normally measured in thousands of barrels of oil per day or bopd). However, this approach is no longer recommended, as there is no necessary relationship between production volumes and profitability. It is now more common for profit oil to be split based on the ratio of cumulative project expenses to cumulative project revenue: a ratio known as an "r-factor."

Consistent with international best practice, the Model PSA of 12 March 2014 proposes the use of an r-factor to allocate profit oil with the allocation ranging from 30% for the government in the early stages rising to as much as 70% if the project was highly profitable.

The profit oil provisions in the PSAs for Blocks 4 and 5 signed on 12 May 2014 are more generous to the company and are highly unusual in combining both production volume and an r-factor in determining the split of profit oil. According to the contract, profit oil will be split based on volume until the top threshold is exceeded, at which point the profit oil split will be based on the r-factor. This could lead to the strange situation where a large oil field producing 149,000 bopd would yield a 30% share to the government for its entire life, but if production increased in the early years to 151,000 bopd, the government share would drop

down to 20% until the r-factor increased. To provide a sense of scale, oil discoveries in Uganda and Kenya are both expected to generate production volumes in excess of 150,000 barrels per day.

Volume Based Profit Oil Split
1-150,000 Barrels of Oil Per Day

BOPD	Govt Share
0-12,500	20%
12,500-25,000	22.5%
25,000-50,000	25%
50,000-100,000	27.5%
100,000-150,000	30%

R-factor Based Profit Oil Split
+150,000 Barrels of Oil Per Day

R-Factor	Govt Share
0-1	20%
1-2	22.4%
2-3	24.8%
3-4	27.2%
4+	29.6%

In addition to the unusual mix of volume and r-factor in the production split, it is also important to note that the profit oil split in the signed PSAs is much more favourable to the company than the notional figures in the model PSA, with the government share ranging from a low of 20% to a high of only 30%.

(3) STATE EQUITY

Many countries with production sharing systems provide an option for the host government to participate in the project as a joint owner. The size of the equity stake held by governments, or by national oil companies, ranges widely but for emerging producers tends to be between 5% and 20%.

The rationale for state participation is not necessarily economic. There are no economic benefits provided by state participation that cannot be achieved through an appropriate mix of conventional taxes. And in some cases, state equity has not proven to be an effective way for governments to secure revenue.

Other reasons why governments might seek an equity stake include: the development of a skilled workforce, the possibility of linking to downstream enterprises (i.e. refineries) and the commercial knowledge that could be gained from being on the "inside" of the project. As the experience of state participation in oil projects in sub-Saharan Africa is mixed, it is likely that national pride may also play an important role.

As an equity partner, the government would participate on essentially the same terms as other commercial partners. Yet there is one important difference. Governments normally delay taking up their stake until exploration efforts succeed, or even until production has begun. This is referred to as a "carried interest." The different forms of state participation are set out in Table 3. A carried interest represents a significant financial burden on the company.

Table 3: Different Forms of State Equity

	Full Equity	Partial Carry	Full Carry
Exploration	State pays full share of cost as incurred	Company pays all costs (state sometimes pays back)	Company pays all costs
Development		State pays full share	Company pays all costs (state sometimes pays back production)
Production		State pays full share	State pays full share
Countries	Norway, Venezuela	Mozambique, PNG	Algeria, Angola, Egypt

State equity has been a prominent feature in Malawi for both the mining and petroleum sector. Significant fiscal concessions were offered to Paladin in exchange for a 15% stake in the Kayelekera mine. The Model PSA and the signed PSAs for Blocks 4 and 5 both provide for a 10% equity stake with a "full carry" meaning that the government would pay no costs until the start of production. Negotiating a full carry is highly unusual for countries that have no history of oil discovery or production.

Provision has also been made for an expanded stake to be held either by the government or by a "local party." The Model PSA of 12 March 2014 includes provisions allowing the government to secure an additional 20% stake in the project by paying fair market value and assigning those rights to "Malawian companies, individuals, a state-owned entity or trust" (Article 35.5). Provisions in the PSAs for Blocks 4 and 5 signed on 12 May 2014 are even more unusual, providing for a 10% stake to be transferred to a "local party" at a price to be agreed between the contractor and government (Article 31). The transfer must take place, however, within two years of the signing date of the PSA.

(4) CORPORATE INCOME TAX

It is increasingly common for countries employing a production sharing system to also impose a corporate income tax. In fact, in production sharing schemes where the government's share of profit oil is small, like Malawi, corporate income tax can easily be the main source of government revenue.[50]

Both the model PSA and the signed PSAs are clear that the company will be liable for corporate income tax. According to Malawian tax law, this would mean a 30% tax rate for nationally registered companies and a 35% tax rate for foreign companies.

However, the signed PSAs contain a very unusual clause that will result in a reduction from the standard 30% rate. Specifically, Article 30.10 states that the government agrees to negotiate in good faith a reduction to the rate of corporate income tax at the contractor's request made at any time at least two years following the signing of the contract. Unfortunately, the pattern of offering project-specific tax holidays, as was done with the Paladin Kayelekera contract, was repeated.

Income tax is assessed on "net" or taxable income, calculated as gross income less eligible expenses. Most expenses are claimed in the year in which they were incurred. Capital expenditures however are "depreciated" over time. There does not appear to be any petroleum specific depreciation schedule and it is assumed that the normal rates set out in the Taxation Act would apply. The model PSA also seeks to put in place restrictions on the proportion of debt (3:1) on which interest payments would be tax

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deductible. This is an important provision as companies often shift profits by claim excessive debt financing costs. This important clause, however, does not exist in the signed PSAs.

STABILIZATION

Production sharing agreements put in place terms that could govern a project for many decades. Companies seek to ensure that the core economic terms under which they make their investment decisions are retained throughout the life of the contract through what are known as "stabilization" clauses.[51]

International best practice suggests removing, or at least significantly limiting, stabilization provisions. Too often in the past, stabilization has provided one-way benefits. Companies have secured guarantees that their economic position will not be undermined while at the same time ensuring that they can benefit from any future changes. It is now widely recognized that stabilization provisions create profound difficulties in tax administration with different project operating under fundamentally different tax regimes. Best practice therefore suggests that if stabilization is offered at all it is for specific tax rates, and often in return for an increase in royalty or income tax rates.

In keeping with best practice, the model PSA provides for stabilization for a limited period (7 years) and for only specific fiscal provisions.[52] In contrast, in the signed PSAs "the Government guarantees to the contractor, *for the duration of this Agreement,* that it will maintain the stability of the fiscal and economics conditions of this Agreement." (Article 49.3) And Article 49.5 explicitly provides for one-way benefits by allowing the company to take advantage of any beneficial future change in legislation.

In keeping with best practice, the model PSA provides for stabilization for a limited period (7 years) and for only specific fiscal provisions. In contrast, in the signed PSAs "the Government guarantees to the contractor, for the duration of this Agreement, that it will maintain the stability of the fiscal and economics conditions of this Agreement."

8. CONCLUSIONS

According to international best practice, tax terms for extractive sector projects should be established in law and not subjected to project project-by-project negotiations. The reasons for this are clear: secret negotiations often result in bad agreements.

Malawi has suffered the consequences of project-specific negotiations with the Paladin contract for Kayelekera. For the mining sector, the lesson seems to have been learned. With extensive international support, Malawi has put in place a sector policy and has developed a new Mining Bill and revised the tax terms that will apply to mining projects. It appears that future projects will be governed by these terms.

Yet even while Malawi was implementing the principles of international best practice in the mining sector it was ignoring them in the oil sector. Exploration licenses were granted without a national policy framework. A production sharing system was adopted without revising the badly out-dated Petroleum Act. A model contract was prepared in order to minimize the provisions open for negotiation, yet many of those agreed clauses were subsequently changed.

The results are not surprising. There are serious inconsistencies between the old Petroleum Act, the exploration licenses and the three signed Production Sharing Agreements. In some cases, the tax terms are simply incoherent, as with the allocation of profit oil based on both the volume of production and an r-factor. In other cases, they are overly generous to the company, as with the commitment to reduce the corporate income tax rate and the stabilization provisions. Unfortunately the Attorney General's review did not consider the content of the contracts, only the potential links among Block owners and the signing of the PSAs before the discovery of petroleum.

The fiscal regime seems to be highly influenced by Malawi's approach to the mining sector. The percentages are identical for royalties, corporate income tax and state equity. The main difference in the fiscal regime is the addition of a modest share of profit oil (20-30%). There is nothing wrong with making use of the same fiscal instruments. International analyses suggest, however, that the share of after cost revenue going to the government should be significantly higher in the oil sector (65-85%) than in the mining sector (40-60%).[53]

Furthermore, strong biases from the mining sector have also been carried into the oil sector. Securing state equity has been a priority in Malawi's extractive sector. In the Kayelekera negotiations, the government reduced the rate of corporate income tax and gave away the resource rent tax in favour of a 10% stake in the project. In the signed PSAs, all government cost are borne by the company until production begins. This is an unusual provision for a country with no history of oil discovery or production, and it would have come at the expense of economic benefits elsewhere in the fiscal regime.

Finding the right balance of fiscal instruments is not easy. It appears that considerable work was devoted to the model PSA, including advice from various international experts. There is no indication, however, that the package of fiscal instruments was tested against hypothetical projects in order to determine the appropriate balance between attracting investment and securing government revenue. More detailed analysis would be necessary to draw clear conclusions on how the terms in the signed PSAs compare with those offered by peer countries.

There are indications that the government has decided to renegotiate the fiscal terms of the Rak GAS PSAs. An addendum is likely to be added to the PSAs increasing the royalty rate and the government's equity share, and resolving some of the uncertainties in the allocation of profit oil.

It remains to be seen whether

the results of this renegotiation will represent a good deal for the citizens of Malawi. There are reasons to be concerned. In contrast to the mining sector, there has been little capacity building within government on the petroleum sector generally or petroleum fiscal systems specifically.

Analysing the economics of extractive sector projects and their implications for government revenue is a task that need not be left to governments.[54] Oxfam Malawi, the Natural Resources Justice Network, and the Publish What You Pay Coalition have recently published a detailed analysis of mining economics including a case study of Mkango's Songwe Hill deposit.[55] Similar analysis is badly needed for those within government who are responsible for management of the petroleum sector and for those outside government who seek to ensure that Malawian's receive a fair share of the country's natural resource wealth.

RECOMMENDATIONS FOR THE GOVERNMENT OF MALAWI

1. Disclose the Production Sharing Agreement signed with RAK Gas (Blocks 4 and 5) and with Pacific Oil (Block 6).
2. Disclose the Addendum, once signed, that includes revisions to the fiscal terms for the RAK Gas PSAs along with a justification for the changes. Clarify whether a similar Addendum exists for the Pacific PSA.
3. Investigate whether there was any sort of corruption or money exchanging hands in the allocation of petroleum licenses or production sharing agreements.
4. Report on all payments made by companies holding petroleum Licences or Production Sharing Agreements, including CSR, to any organization.
5. Report on beneficial owners (the natural persons who directly or indirectly ultimately owns or controls the corporate entity) of mining and petroleum rights in Malawi as will be required by the EITI.
6. Establish a solid foundation for the potential development of the petroleum sector by developing a National Policy and revising the Petroleum (Exploration and Production) Act.
7. Finalize the Model Production Sharing Agreement including testing proposed fiscal terms tested against plausible oil projects for Malawi in order to ensure the appropriate balance between attracting inward investment and securing potential government revenue.

RECOMMENDATIONS FOR CIVIL SOCIETY

1. Prepare a comprehensive economic analysis of potential oil projects, as has been done for the mining sector, in order to inform Free, Prior and Informed Consent (FPIC) and raise awareness on how the government would generate revenue based on the Production Sharing Agreements.

RECOMMENDATIONS FOR THE DONORS

1. Provide support for the Government of Malawi to establish a solid legal and policy foundation for Malawi's petroleum sector as has been done for the mining sector.

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ABOUT RESOURCES FOR DEVELOPMENT CONSULTING

Resources for Development Consulting is a policy research firm that seeks to assist citizens in resource-rich developing countries to secure a fair share of extractive sector wealth by analysing contracts and broader fiscal regimes, and conducting integrated economic analyses in order to assess plausible government revenues.

Don Hubert is President of Resources for Development Consulting. Dr Hubert is based in

Canada, having just completed a three-year posting in Mozambique where he worked on the extractive sector for the United Nations, bilateral donors and non-governmental organizations. His work focuses using contract analysis and project economic modelling to strengthen extractive sector governance. He has conducted economic analyses of extractive sector projects in Belize, Chad, Kenya, Mozambique, Tanzania, Uganda and Zimbabwe. He has been a Canadian diplomat and a University Professor, and holds a PhD from the University of Cambridge, UK.

Gordon Kirkwood has been Senior Associate with RES4DEV Consulting since 2014. Dr. Kirkwood worked in the oil and gas industry for BP for 30 years as a Petroleum Engineer, Economist and Business Advisor in countries including: UK, Egypt, Venezuela and the United Arab Emirates. Dr. Kirkwood is a Chartered Engineer (Petroleum), a European Engineer and Fellow of the Institute of Materials, Minerals and Mining. He has provided technical support for Resources for Development Consulting projects in Belize, Cambodia, Kenya, Malawi, Mozambique and Tanzania.

Rachel Etter-Phoya has been working in the extractives industries, with a focus on Malawi for the past five years. She currently serves as a CIM integrated expert with Citizens for Justice in Lilongwe, Malawi, and sits on the Malawi Extractives Industries Transparency Initiative Multi-Stakeholder Group. She has been engaged on a number of other extractives related projects including with Southern Africa Resource Watch and Imani Development and runs Malawi's only website dedicated to the extractive industries.

NOTES

(Endnotes)

1 See, Future Mining Revenues for Malawi: A Case Study of Mkango's Songwe Hill Project, Oxfam Malawi, 2016.

2 See reference to the Solicitor General's advice to only sign PSAs when oil and gas is discovered in Golden Matonga, "AG faults oil, gas search deals", *The Nation*, 2 April 2015.

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5 Based on interviews with several government officials involved in the preliminary negotiations.

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14 Article 16.10. Emphasis added.

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16 Chapter 61:02, Article 2(1).

17 Relevant regulations include: Petroleum (Applications) Regulations; Petroleum (Constitution of Blocks) Regulations; Petroleum (General Provisions) Regulations; Petroleum (Prescribed Fees and Annual Charges) Regulations; Petroleum (Records, Reports and Accounts) Regulations; Petroleum (Registration and Transfer of Licences) Regulations.

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23 See Silvana Tordo, "Petroleum exploration and production rights: allocation strategies and design issues," World Bank, 2010

24 EITI Scoping Study, p. 26.

25 See Fiscal Systems for Hydrocarbons, 2006.

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27 Different systems do expose the company and Government differently to the upsides and downsides of a project in terms of timing, capital cost, production rate and reserves.

28 See Memorandum titled "Model PSA Process" from David Kienzler, Special Assistant, Ministry of Mining to Leonard Kalindekafe, Principal Secretary, Ministry of Mining, 24 March 2014.

29 For more information, see documentation on the $25 million World Bank Mining Governance and Growth Support Project (2011 to 2018).

30 The PS writes in his response to the Solicitor General of 25 March 2014 that "the Ministry is still looking for financial and technical

resources to formulate a petroleum policy and review our petroleum law" and indicates that the alternative chosen was to "come up with A VERY COMPREHENSIVE PSA." (emphasis in the original).

31 See Memorandum titled "Model PSA Process" from David Kienzler, Special Assistant, Ministry of Mining to Leonard Kalindekafe, Principal Secretary, Ministry of Mining, 24 March 2014.

32 Based on interviews with several government officials involved in the preliminary negotiations.

33 See Letter from International Senior Lawyers Project to Leonard Kalindekafe offering support for negotiations with RAK Gas and Pacific, 4 October 2013.

34 Based on interviews with several government officials involved in the preliminary negotiations.

35 While it might seem strange for the contractor not to actually pay its share of corporate income tax, the provision is not uncommon and exists in order to allow international companies to secure a tax credit in their home jurisdictions. In a production sharing system, the profit oil share paid to the Government is not understood as a "tax" from the perspective of other countries and is therefore not eligible for a tax credit. In order to provide the company with an acceptable tax receipt, the Government "pays" corporate income tax on behalf of the company out of its share of profit oil. The result is known as a "deemed" tax that has no impact on company cash flow and generates no additional government revenue.

36 Article 18.6. The full text reads: "During the period of this Agreement the Contractor will contribute, on a Yearly basis, USD one hundred and twenty thousand (120,000) to help Malawi with its social development programmes. This will be the Contractor's Corporate Social Responsibility allocation, and the use of such contribution shall be subject to such monitoring and controls as are deemed appropriate by the Contractor, in its sole discretion, to ensure compliance with Anti-Bribery Laws applicable to the Contractor or its relevant employees. Examples of the kind of schemes to be embraced include, but are not restricted to: Building of schools and health centres, contributing towards Presidential National Initiatives for social development, Safe Motherhood Project, Mudzi Transformational Trust."

37 Attorney General's Opinion Regarding The Award By The Malawi Government Of Oil Exploration Licenses To And Entry Into Production Sharing Agreements With Hamra Oil Limited, RAK Gas MB45 Limited And Pacific Oil Limited, 8 January 2015, p. 3.

38 See Press Release Ref No. C/48/1/1A 18 November 2014.

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40 See Deed of Guarantee between Surestream, Hamra and RAK Gas, December 2013.

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42 See, Oil Deal Headache, The Nation, 15 November 2015.

43 See, Mutharika Lifts Ban on Oil Exploration, The Nation, 11 February 2015.

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49 Application for Petroleum License 3, Surestream Petroleum, 2010, p 27.

50 Examples would include Belize, Cambodia and Mozambique.

51 Oil Contracts: How to Read and Understand Them, Open Oil, p. 187-191.

52 See Model PSA, March 2014, Appendix D.

53 See Philip Daniel, Generating Extractive Industry Revenues, IMF, 2013, p. 7.

54 For examples of project economic analysis, including the assessment of fiscal terms for resource projects, see: Future Mining Revenues for Malawi: A Case Study of Mkango's Songwe Hill Project, Oxfam Malawi, 2016; Oil Revenue Prospects for Cambodia, Resources for Development, 2015; Potential Government Revenues from Turkana Oil, Cordaid, 2016; Mapping Risks to Future Government Petroleum Revenues, Oxfam Kenya, 2016; Samuel Bekoe, David Mihalyi, An Analysis of Ghana's 2015 Oil Revenue Performance: Testing the Model, NRGI, 2015; and Lenneke Kono-Tange and Johnny West , Towards transparency in Extractives in Chad – applying oil project modeling, 2015, PWYP, 2015.

55 See, Future Mining Revenues for Malawi: A Case Study of Mkango's Songwe Hill Project, Oxfam Malawi, 2016.

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Oxfam in Malawi
Green Heritage Building
City Centre Area 13
Private Bag B331, Lilongwe
Tel: 00265 1770 489/525/563
Email: infomalawi@oxfam.org.uk
Oxfam in Malawi
Oxfam in Malawi