

OWNERSHIP OF EXTRACTIVE RESOURCES IN PNG

Position Paper – February 2012

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EXECUTIVE SUMMARY

The resource industry in Papua New Guinea is experiencing an unprecedented period of growth with exploration and development activity in both sectors at an all-time high. The industry is the backbone of the PNG economy and currently contributes over one third of government tax revenue with payments of more than K2 billion a year. PNG could develop several new mines and additional gas projects over the next five years if it maintains a conducive investment environment.

Mineral and petroleum resources in PNG are owned by the State, allowing for equitable national distribution of the resulting benefits. The Chamber is a strong supporter of State ownership of resources, which is the norm worldwide except for part of the US and a small part of Canada. The Chamber views the promotion of landholder ownership (ōprivate ownershipö) as a populist policy presented as a panacea to address the problems facing the grassroots communities without any consideration of the impacts the changes will bring.

Complex regimes of landownership already pose significant challenges for resource development in PNG and a change in resource ownership would magnify these social problems many fold. Because there is no system of land title for customary land, an explorer would be left with the task of dealing with a resource owned by a community that is always open to challenge from within and without, and where agreements may always be in a state of flux. The end result would be a complete loss of security of tenure, making it all but impossible for the resource industry to operate.

State ownership of minerals is vital to the development of PNG, and allows resources to be developed for the benefit of all citizens as required by the Constitution. The State issues production licences over these resources, and they are managed in an effective and orderly manner that is recognised internationally and accepted by the investor. A change in resource ownership would result in a breakdown of this system; the risk profile would be unacceptable to potential developers.

The provincial and local-level governments would be big losers in a system underwritten by private ownership of minerals. Resource extraction would become a private business activity for individuals and groups. Landowners would want everything, including royalty and State equity, and would only share these with provincial and local-level governments if they felt inclined.

The benefits provided by the resources projects are diverse and substantial and include: taxes (company tax, royalty, dividend withholding tax, salary and wages tax, duties, production levy), dividends (equity), tax credit scheme projects, special support grants and development levies, employment, education and training, public health programs, business and agricultural development, and community infrastructure.

Papua New Guinea has one of the most equitable benefit sharing systems in the world for mining and petroleum developments. The country has developed a formula for benefit sharing which is unique on a worldwide basis. It includes the National Government, affected provincial and local-level governments, and the impacted communities.



The key resources issue in PNG today is the challenge facing landowners and government at all levels in converting the benefits generated by the mining and petroleum industry into real and tangible improvements in the lives of everyday citizens.

This fundamental issue can only be addressed through good governance, accountability and revenue transparency. It will not be solved by converting the resources sectors to private ownership. The Chamber believes such a move would create chaos in the resources industry and disrupt the national economy.

CHAMBER'S POSITION ON RESOURCE OWNERSHIP

The Chamber strongly supports the current situation whereby the State owns the mineral and petroleum resources, and is opposed to the concept of landholder ownership of resources (öprivate ownershipö).

The Chamber welcomes Prime Minister O'Neill's assurance that his Government will not consider changes to the present position on ownership of resources or equity holdings and his strong commitment to a stable and welcoming investment climate and inclusive and consultative government.

PERFORMANCE OF THE PNG MINING AND PETROLEUM INDUSTRY UNDER THE CURRENT SYSTEM OF STATE OWNERSHIP OF RESOURCES

The resource industry in PNG is experiencing an unprecedented period of activity and growth and this has shielded PNG from the effects of the Global Financial Crisis that has impacted many other countries. Activity has now reached a level where PNG is the envy of many other mineral-producing nations, and the country has gained the confidence and respect of the international markets. Given that the level of exploration fell sharply following the Asian financial crisis in 1997, this is a great tribute to the efforts of industry and government in promoting and nurturing the sector over the past 10 years.

Exploration is at all time high, resulting in widespread benefits as exploration funds are spent in the provincial centres and towns and on grassroots employment across the nation. The informal mining sector is thought to have grown to 60,000-80,000 part-time and full-time artisanal miners across the country, producing gold with a value estimated at K550 million to K600 million a year.

Since the current surge began in 2003, PNG has successfully added two major mining projects to the country's portfolio and will soon become the newest member of the exclusive club of LNG-producing nations. It will also shortly become the world's first deep-sea mining nation. Formal employment in the mining and petroleum sectors has grown to over 30,000.

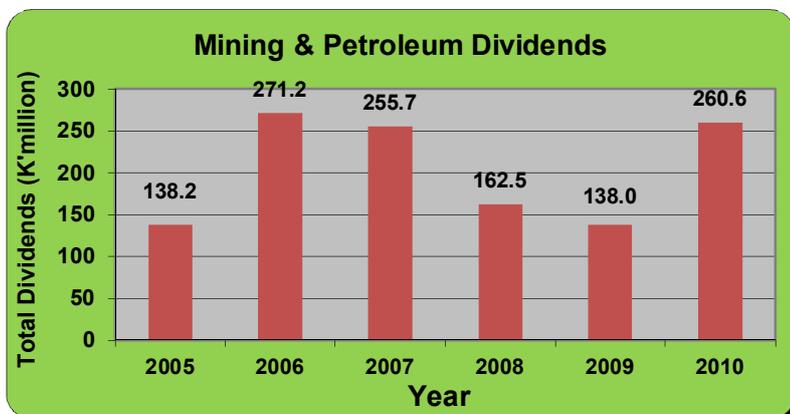
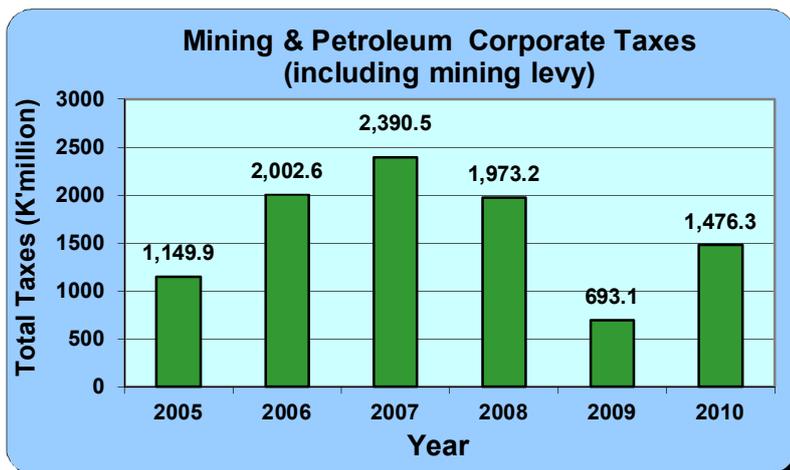
If the welcoming environment for investors is maintained, there is every chance PNG will see the development of several additional mining projects in the next five years, as well as several gas

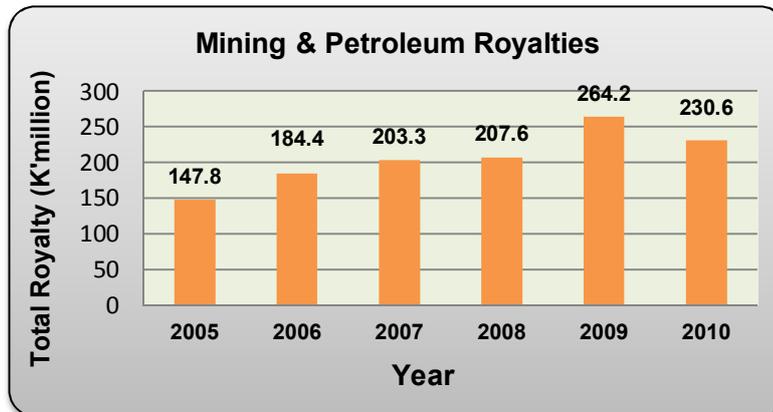


projects, including at least one more LNG development. This is a wonderful success story that few nations of similar size have achieved.

The benefits provided by the resources projects are diverse and substantial and include: taxes (company tax, royalty, dividend withholding tax, salary and wages tax, duties, production levy), dividends (equity), tax credit scheme projects, special support grants and development levies, employment, education and training, public health programs, business and agricultural development, and community infrastructure.

PNG's mining and petroleum industry is the backbone of the economy and contributes over one third of government tax revenue. The industry paid K9,686 million in corporate tax, K1,226 million in dividends, K1,238 million in royalties and K538 million in dividend withholding taxes to the National Government from 2005 - 2010. This totals K12,688 million, an average of more than K2,100 million a year. In addition, the industry contributes significant amounts in salary and wages tax, duties and levies, and the tax credit scheme, as well as dividends to some host provincial governments and landowners.





Royalties received by the National Government are paid to the host provincial and local-level governments and project landholders in accordance with the respective project agreements. Landowners and the four provincial governments hosting the larger mature projects (OkTedi, Porgera, Lihir and the oil fields) are the main beneficiaries. Over the past six years, the Fly River Provincial Government has received K233 million in royalties and the Ok Tedi mine area landowners K225 million.

The largest proportion of the technical manpower being trained in PNG is generated from the mining and petroleum industry. The industry is a very significant player in the training of apprentices and the up-skilling of graduates in the country.

PROMOTION OF LANDHOLDER OWNERSHIP OF RESOURCES

It is the Chamber's view that the concept of landholder ownership of resources is a populist policy promoted without any consideration of the impacts or implications of the proposal. In some cases, it can be interpreted as a form of cargo-cult politics promising a get rich quick outcome (‘everyone will be rich; everyone will have money in their pockets’).

If resource development was to take place under a regime of landholder ownership, it would enrich a few small groups of privileged landowners at the expense of everyone else. These elitist groups receiving the lion's share of the resource benefits would not be interested in the welfare of the rest of the country. This regime would promote selfish and separatist attitudes which are inherently at odds with the aim of nation-building.

Under the present system where impacted communities are given considerable benefits, there are widespread examples of misuse of these benefits and numerous ongoing disputes caused by jealousy and greed. A change in ownership will greatly magnify these issues and lead to chaos.

When large cash payments are made to landowners there is a prevalence to spend for today and forget about tomorrow. In some cases, large chunks of the money are swallowed up in repaying



outstanding loans and debts for extravagant expenses and luxuries, usually at exorbitant interest rates

The landholder ownership of resources philosophy is being promoted as the panacea to address the fundamental problems facing the grassroots communities, namely the urgent need for basic facilities and services. It is a diversionary tactic that fails to address the core primary challenge facing the nation, the issue of ever growing corruption and mismanagement of government funds.

Politicians and aspiring politicians pushing the landholder ownership of resources have alarmed many industry players and the overseas markets and put in jeopardy PNG's hard-won reputation for welcoming investment.

Leaders often do not seem to realise (or are unconcerned) that strong statements made for what they believe are local consumption or local politics go all around the world in minutes. When it comes to an international industry and international markets, any statement made by a person in authority, no matter how casual or offhand, is taken at face value and may cause major repercussions.

CHANGING THE OWNERSHIP OF RESOURCES AND SECURITY OF TENURE IN PNG

Security of tenure in the resource industry relates to the principle that the investor needs to be assured, prior to committing resources to exploration, of the ability and the right to profitably develop any successful discovery. Fundamental to this, is the right to proceed from the exploration to the development stage ("the right to mine") and to develop and operate a project with acceptable risk parameters and uncertainties.

Any economic activity exposed to high levels of risk and uncertainty requires stable and predictable rules to enable the investor to ensure an adequate and timely return on investment. This is even more apparent in the cyclical and complex world of resource exploration and development, where front-end investments often require many billions of dollars, and the risks involved are not only high but also unique.

Exploration involves expenditure of large sums of money upfront with a low probability of success in finding a commercial discovery leading to a return on investment. Lead times between initial discovery of a deposit and commercial development in the mineral sector take at least 15 years in PNG (Lihir), and have been as long as 40-50 years (Ramu, Kainantu, Frieda). Lead times for stranded gas are similar. Sometimes, mineral discoveries and stranded oil and gas fields only become commercial over time because of developments in processing technologies (Ramu) or improvements in infrastructure or economics (PNG LNG). The investor's only guarantee is the security of tenure inherent in this lengthy process underwritten by the sanctity of the exploration title and the ability to convert this into a production tenement.

Even when a commercial discovery is made, there are still many other risks throughout the life cycle of a resource project, including the technological, environmental, infrastructure and social challenges inherent in project development and operation, as well as the challenges of raising the finance and political risk insurance, the volatility of commodity prices, materials substitution and shifting trends in commodity markets, and political and policy shifts by government.



Given good geological prospects and an internationally competitive taxation regime, a jurisdiction that offers a legislative regime that guarantees security of tenure throughout all the phases of exploration and development and reduces transaction costs will gain a competitive advantage over others that leave more room to uncertainty. In any survey of resource companies which ranks investment decision criteria, security of tenure is invariably rated as the most important parameter.

Complex regimes of landownership, different types and levels of usufructuary rights, shifting patterns of occupancy and migration, past warfare and conquest, and historical land disputes make land and community issues a significant challenge for project development in PNG. This is accentuated in the resource sectors where the scale of the potential benefits markedly increases the level of land disputes and spurious and vexatious land claims, as well as the number of self-appointed spokesman, consultants and aspiring middlemen.

This scenario combined with landholder ownership of resources would be unmanageable on anyone's scale. Regardless of the cultural and traditional mores and beliefs, the simple fact is that a change in resource ownership would magnify the social problems already being experienced many fold. Because there is no system of land title for customary land, the solidity and permanence of any agreement would be totally at the whim of the community or dominant individuals within the community, who could use their position at any time to blackmail the investor. It would result in a plethora of agents, consultants, charlatans and even warlords aspiring to represent landowners in access negotiations for exploration, as well as for development.

The end result would be a complete loss of security of tenure, making it impossible for the resource industry to operate, and, in turn, crippling the PNG economy.

Landholder ownership of resources has superficial and emotional appeal to those fortunate enough to be currently benefitting from a resource project, or expecting to be benefitting from a future project, but all this will be at the cost of the vast majority.

RESOURCE OWNERSHIP IN OTHER COUNTRIES

Mineral resources in all countries around the world, except for a majority part (63%) of the United States and a small part of Canada (less than 10%), belong to the State. This includes all valuable rocks, minerals, oil or gas found on or within the earth. Organisations or individuals in these countries cannot legally extract and sell any mineral commodity without first obtaining authorisation from the government.

In the US, ownership of mineral resources was originally granted to the individuals or organisations that owned the surface. These property owners had both "surface rights" and "mineral rights".

Around 37% of land in the US is owned by government, so for this area the mineral rights are owned by the public. For example, Nevada, which produces most of the gold in the US, is more than 84% government-owned. The minerals and petroleum under the remaining 63% of land is privately owned (mineral rights). Mineral rights are distinct from "surface rights" or the right to the use of the surface of the land, and may be sold, transferred, or leased in a similar manner as other



property rights. Mineral rights may be severed whereby they are sold or retained separately from the surface rights. A person may own all the mineral rights for a parcel or any fraction of the rights, or own rights to only one kind of mineral, such as oil and gas, or to only one formation or depth interval.

The Chamber believes that the US system for managing mineral and petroleum resources on private land is not one PNG could, or should, aspire to. It is a system that is unique, extremely complex and employs armies of lawyers, land men, brokers and administrators. Regulatory systems applicable to development of resources on private or public land vary significantly from State to State, further adding to the complexity.

From the PNG perspective, the most important issue is that while the system of private ownership of mineral rights in the US is very complex, there is still a system of titles that establishes ownership for all private land. This is not the case in PNG, leaving the explorer with the enormous challenge of dealing with a resource owned by a community that is always open to challenge from within and without, and where agreements may always be in a state of flux. This scenario is unworkable for the resources industry.

THE IMPACT ON LEGISLATION OF CHANGING THE OWNERSHIP OF RESOURCES

State ownership of minerals is vital to the development of PNG, enabling resources to be developed for the benefit of all citizens as required by the Constitution. While landowner support and agreement is integral to all resource projects, the State issues production licences over these resources, and they are managed in an effective and orderly manner that is recognised internationally and accepted by the investor. PNG's success in resource development speaks for itself

Overall, if the State were not the owner of all extractive resources and the Mining and Oil and Gas Acts were amended by removing the requirements for compliance with Section 53 of the Constitution, as proposed in the private Member's Mining (Amendment) Bill 2009, there would be very little of the current operative parts of the Acts that would remain constitutionally valid. The State could not directly regulate the exploration and production of minerals. This would be up to individual landowners. The State could not issue licences and leases, unless at the request and with the authority of the correct landowners. It is questionable whether the State could or would agree to do so, and any such licence would not have any real utility because it would always be subject to the fluidity of customary landowner arrangements.

A change to the ownership of resources would result in enormous legislative, financial, social and political impacts, and would turn the existing regulatory system on its head. An entirely new policy would need to be devised, and the existing legislation replaced with something quite different. There would be a complete breakdown in the well-established, internationally recognised system that underpins resource development in PNG. Without confidence in the existence of a legal right to obtain a development licence, expenditure on exploration would be irrational and would cease. There would be no new resource developments. Security of title would be non-existent, and the risk profile would be unacceptable to any potential developer.



THE IMPACT ON PROVINCIAL AND LOCAL-LEVEL GOVERNMENTS OF CHANGING OWNERSHIP OF RESOURCES

The provincial and local-level governments would be big losers in a system underwritten by private ownership of minerals. Resource extraction would become a private business activity for individuals and groups, similar to developing a coffee plantation. It would no longer be a matter for Public Purpose or National Interest. Landowners would want the lion's share of everything; they would be entitled to the royalty and would only share it with provincial and local-level governments if they felt inclined. They would demand the 30% or 22.5% equity option (or more) now available to the State for mineral and petroleum developments respectively.

As the State would become merely a collector of taxes, it would be unlikely to feel bound to provide any special benefits to the private owners, such as a tax credit scheme, special support grants, equity funding, etc. The local-level and provincial governments would similarly miss out on these benefits.

THE KEY RESOURCES ISSUE IN PNG TODAY - TRANSPARENCY AND GOOD GOVERNANCE

Papua New Guinea has one of the most equitable benefit sharing systems in the world for mining and petroleum developments. The country has developed a formula for benefit sharing which is unique on a worldwide basis. It includes the National Government, affected provincial and local-level governments, and the impacted communities.

The key resources issue in PNG today is the challenge facing landowners and government at all levels in converting the benefits generated by the mining and petroleum industry into real and tangible improvements in the lives of everyday citizens. This is related to the growing corruption and mismanagement issue which can only be addressed through increased governance and transparency.

There are many other factors influencing delivery of government services, including accountability and performance in the public service, destruction or decommissioning of infrastructure through tribal warfare, land claims, law and order issues, clan jealousies, and a lack of community spirit. However, ultimately, many of the root causes underlying these issues can be traced back to some form of corruption.

Changing mineral ownership will not address these problems. It requires a fundamental shift in the way that governments and landowner leaders manage, utilise and distribute resource benefits, and the way they report on this to their respective constituents. It requires a major shift towards transparency, integrity and openness.

The National Government, provincial governments, and leaders of landowner companies and organisations need to regularly and comprehensively explain to their constituents the value of the benefits they receive and how they have been used. Provincial governments that have received hundreds of millions of kina rarely explain to the people the existence of these funds, let alone what has been achieved with them, or what are the plans for future expenditure and investment. Nor are



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audited reports readily available for the public to view. Yet these provinces are continually asking for more. Similarly, many landowner companies have not produced annual reports, held regular meetings or conducted election of office bearers.

The Chamber believes that real improvements in social services will only come about when there is a commitment right across the whole spectrum of government, industry and community to address this issue. In particular, there needs to be commitment from the very highest levels of government.

We do not see how this fundamental issue will be addressed by converting the resources sectors to private ownership. Such a move would avoid the real issue while creating chaos in the resources industry and the national economy.