CHANGES IN THE FEDERAL-STATE OWNERSHIP AND EXPLOITATION OF PETROLEUM RESOURCES IN MALAYSIA

This article examines the rights of ownership of the Federation and the various States of Malaysia to the petroleum resources in on-shore land[1] and offshore land[2] at the time of the formation of the Malaysian Federation.[3] It also traces the gradual changes in the ownership of these resources in favour of the Federal Government, culminating in total or absolute Federal ownership in 1974 with the enactment of the *Petroleum Development Act,* 1974. These changes were brought about concurrently with improving exploration activities and the final change was effected soon after the announcement of the discovery of oil and gas in commercial quantities.[4]

The provisions of two major pieces of federal legislation relevant to the petroleum industry enacted in 1966, the *Petroleum Mining Act,* 1966 and *Continental Shelf Act,* 1966, will also be examined briefly. There will in addition be some discussion of the regulatory role of the States and the Federation in the petroleum industry prior to the enactment of the *Petroleum Development Act.* This will be contrasted with the new role of the Federal Government through its instrumentality, PETRONAS.[5]

A. Ownership of Petroleum Resources at the Formation of the Malaysian Federation

Petroleum resources are an interest in land[6] and in Malaysia

[1] 'On-shore land' includes the foreshores and the submarine areas beneath the territorial waters of the States. This definition is taken from the *Petroleum Mining Act,* 1966.

[2] 'Off-shore land' means the area of the continental shelf. This definition is taken from the *Petroleum Mining Act.*

[3] The Malaysian Federation was the result of the addition of three colonial states of British North Borneo, Sarawak and Singapore to the Federation of Malaya which became an independent nation in 1957. See N.E. Groves: 'The Constitution of Malaysia — the Malaysia Act' (1963) Mal. L.R., 245. In August 1965 Singapore left the Federation to become a separate independent republic within the Commonwealth.

[4] Clause 1 in 'Model Petroleum Agreement in respect of off-shore lands' included as Annex 1 to the *Petroleum Mining Rules* P.U. 155, 1965, includes a definition as follows:

> 'petroleum in commercial quantity' means the discovery of reserves of petroleum in such quantities which will permit their being economically developed, taking into consideration the locaton of the reserves, the depths and number of wells required to be drilled and the transport and terminal facilities needed to exploit the reserves which have been discovered.

[5] PETRONAS was established by authority of the *Petroleum Development Act,* 1974, in August, 1974. See V.K. Moorthy 'Malaysian National Oil Corporation — Is it a Government Instrumentality?' (1981) 30 *ICLQ* 638-659. In this Article the writer examines the question whether PETRONAS is a Government Instrumentality and arrives at the conclusion that it is.

[6] See definition of 'land' in s. 5 of National Land Code 1965.

'land' is within the jurisdiction of the various States[7] under the provision of the Federal Constitution.[8] The rights of ownership of the petroleum resources of a State is dependent on whether such resources are in a land area which is within the jurisdiction of the State.

Even prior to the drawing up of the 1958 Conventions on the Territorial Sea and the Continental Shelf[9] it was universally agreed that a coastal state[10] had the right to the exploration and exploitation of natural resources in the 'submerged lands' of the territorial waters and continental shelf. The International Court of Justice in the *North Sea Continental Shelf Cases* [11] expressed the opinion as follows:

> The rights of the coastal state in respect of the area of the Continental Shelf that constitutes a natural prolongation of its land territory into and under the sea exist *ipso facto* and *ab initio* by virtue of its sovereignty over the land and as an extension of its sovereign rights for the purpose of exploring the sea bed and exploiting its natural resources. In short, there is an inherent right. In order to exercise it, no special process has to be gone through, nor have any special legal acts to be performed

The seaward boundary of the States and the land area under the jurisdiction of the new Federation and the legislation which governed the exploration and exploitation of petroleum resources at the formation of Malaysia were as follows:

(i) *East Malaysian States*

The British Government had by the appropriate Orders-in-Council made in 1954 extended the boundaries of the colonies of North Borneo[12] and Sarawak seawards to include not only the territorial seas but also the submarine area of the continental self.[13]

[7] Under the various statutes dealing with land, land in a State is vested in the State Authority, the State Authority being the Ruler or Governor of the State concerned. See Tun Mohamed Suffian bin Hashim, *An Introduction to the Constitution of Malaysia* (2nd Ed. 1976 Kuala Lumpur) 166. Alienation of land to any person by the State Authority is subject to the reservation (statutory) of 'any metal or mineral... in or upon the land' including petroleum rights in favour of the State Authority: National Land Code 1965 s. 45(2)(d) and Mining Enactment (F.M.S. Chapter 147) s. 7; see also S.K. Das, *The Torrens System in Malaya* (1963 Singapore) 481.

[8] The vested rights of the States were given protection by the Federal Constitution which provides that the States have the competence to exercise legislative and executive powers in respect of land within their jurisdiction, including *inter alia,* the granting of 'permits and licences for prospecting mines, mining leases and certificates'. Ninth Schedule, List 11 2(c) of the Federal Constitution. *Cf. infra,* note 24.

[9] Copies of the texts of the Conventions are to be found in Lay, Churchill, Nordquist, eds., *New Directions in the Law of the Sea,* (1973, Oceania Publications).

[10] The term "coastal state" with regard to Malaysia for the exercise of the right of exploitation of petroleum in the "submerged lands" of the territorial waters and continental shelf, prior to the enactment of the Petroleum Development Act, 1974 was either the Federal Government or the various State Governments. This topic is discussed in this part of the paper.

[11] [1969] *I.C.J.* Reports 3, 22.

[12] This was the old name for the State of Sabah.

[13] The British Parliament did not make any similar Orders-in-Council to vest the jurisdiction in any sovereignty over the continental shelf in the States of West Malaysia.

As a consequence of these Orders, in 1956 North Borneo amended its *Land Ordinance*[14] to include provisions empowering the Government of the State to grant licences or leases for the extraction of 'all coal, minerals, precious stones and mineral oils' [found on onshore and offshore land]. In 1958 Sarawak enacted the first *Oil Mining Ordinance*[15] under which the State Government was empowered to issue licences for oil exploration in respect of any land. "Land" by definition includes 'the foreshores and submarine areas beneath Sarawak waters and also the area of the continental shelf.'[16]

(ii) *West Malaysian States*

The *Land Code*[17] defined 'State land' as follows:

> 'State land' means all land in any State including
>
> (i) the bed of any river, stream, lake, pond or water course, and
>
> (ii) the foreshore and bed of the sea within the territorial waters of the State.[18]

By customary international law there has been a general recognition among nations that the territorial limits of states, including colonial states, shall be three miles from the low water mark.[19] The rights to the ownership of petroleum resources in these areas of land were vested in the respective State Authorities. Unlike the East Malaysian States, these States had no legislation to regulate the exploration or exploitation of the petroleum resources.

(iii) *The Federation*

In accordance with customary international law the Federation had already become entitled to exercise jurisdiction and control over the submerged land of the continental shelf. It also acquired the right to exploit the natural resources including petroleum in those areas of the continental shelf adjoining the territorial waters of the West Malaysian States, at the time of its formation in 1957. The

[14] Chapter 68.

[15] Chapter 85.

[16] The information in this paragraph is based on the paper by Tan Sri Salleh bin Abas 'Mineral Resources and Present Legislation'. Proceedings of the Second Malaysian Law Conference 10th-12th July, 1973. Kuala Lumpur—50, 68. He also said that '... [I]t is under these two pieces of legislation that a number of licences and leases were issued in Sabah and Sarawak to several foreign oil companies for exploration and exploitation of oil on the continental shelf.

[17] Chapter 138. This Code came into force on 1st January 1928 and remained in force until its repeal by the new National Land Code, 1965, which repeated this definition of the limit of State land.

[18] S. 2 of the *Interpretation and General Clauses Ordinance* 1948, provides a definition of 'territorial waters' as follows: 'territorial waters' means in relation to any territory the inland waters of such territory and such part of the sea adjacent to the coast thereof as is deemed by international law to constitute the territorial waters of such territory.

[19] Federation of Malaya became a nation in 1957. In 1969 by *Emergency (Essential Powers) Ordinance* No. 7, 1969 Malaysia 'declared that the breadth of the territorial waters of Malaysia shall be twelve nautical miles...' (S. 3). This Ordinance also provided such extension will not be an extension of the limits of the territorial waters of the States. This point does not affect the theme of this paper, and so it is unnecessary to pay much attention to it.

status of the Federation was not altered upon the formation of the Federation of Malaysia in 1963.[20]

In 1966, the new Federation ratified the 1958 Convention of the Continental Shelf and enacted the *Continental Shelf Act,* 1966. This Act defines 'continental shelf as:

> "the seabed and subsoil of submarine areas adjacent to the coast of Malaysia but beyond the limits of the territorial waters of the States, the surface of which lies at a depth no greater than two hundred metres below the surface of the sea, or where the depth of the super-adjacent waters admits of the exploitation of the natural resources of the said areas at any greater depth.[21]

'Natural resources' are defined as:

(a) the mineral and other natural non-living resources of the seabed and subsoil; and

(b) living organisms belonging to sedentary species, that is to say, organisms which at the 'harvestable stage' either are immobile on or under the seabed or are unable to move except in constant physical contact with the seabed or the subsoil.

The Act contains a provision relevant to offshore petroleum operation (such as rigs and platforms) in s. 5(i)(b), which is as follows:

> Every installation or device and any waters within five hundred meters of an installation or device... shall be deemed to be situated in Malaysia, and for the purposes of jurisdiction shall be deemed to be situated in that part of Malaysia above high-water mark at ordinary spring tides which is nearest to that installation or device.. .

One of the aims of this Act is to formalise the right of the Federation to exploit the natural resources[22] in the seabed and subsoil of the continental shelf adjacent to the coast of the States of West Malaysia.

It should therefore be noted that at the formation of Malaysia the rights of the States of Malaysia to exercise jurisdiction and assert claims of rights of ownership to the petroleum resources in the seabed of the continental shelf were not uniform. The two East Malaysian States had, at the time of joining the Federation, such jurisdiction and rights over the 'submerged lands' in the territorial waters and the continental shelf, while the West Malaysian States had jurisdiction and rights over the submarine area of the territorial waters only. The Federation had such jurisdiction and rights over the remainder of the continental shelf of Malaysia.[23]

[20] See *infra,* note 23.

[21] This definition of the limits of the continental shelf is not at variance with the definition in Article 1 of the 1958 Convention on the Continental Shelf.

[22] Exploration for and exploitation of petroleum was dealt with by the Petroleum Mining Act, 1966. See post p. 190.

[23] Although the East Malaysian States had the proprietary rights in respect of the natural resources in the seabed of the continental shelf, the Federal Government was the unit in the federal structure that had responsibility for defence and external affairs of the whole of the national territory. Ninth Schedule — List 1. Federal List of the Federal Constitution provides that the Federation has responsibility for External Affairs (under Item I) and Defence of the Federation or any part thereof (under Item 2). See *infra,* note 37.

The search for oil in the continental shelf of Malaysia commenced in the mid-sixties. The immediate concern of the Federal Government was to provide the necessary legal framework for the exploration and eventual mining of petroleum in the continental shelf of West Malaysia. The result was the enactment of the *Petroleum Mining Act,* 1966. This Act was made applicable to the exploration for and exploitation of petroleum both onshore and offshore land of West Malaysia only because there was no legislation to regulate these activities in these areas.

Although under the Malaysian Constitution petroleum interest is the property of the respective States, the Constitution also provides that the Federal Government has the competence to legislate on the exploration and exploitation of these resources.[24] It was under this head of power that the Federal Parliament enacted the *Petroleum Mining Act.*

This legislation established the Petroleum Authority for the States of West Malaysia and the Federation[25] and provided for the grant of two kinds of titles: (i) an exploration licence for exploring and prospecting for petroleum, and (ii) a petroleum agreement for mining of petroleum.[26] It contained the general terms and conditions upon which these two kinds of titles were granted.[27]

The Petroleum Authority was empowered to consider, approve or reject applications for an exploration licence or a petroleum agreement in respect of any area of land.[28] The Petroleum Authority 'in respect of onshore land' was the Ruler or the Governor of the State concerned or the Yang di-Pertuan Agong[29] in respect of offshore land.[30] The Act also provided the following definition of 'petroleum':

> 'petroleum' includes any mineral oil or relative hydrocarbon and natural gas existing in its natural condition in strata but does not include coal or bituminous shales or other stratified deposits from which oil can be extracted by destructive distillation.[31]

B. Changes in the Ownership of Petroleum Resources in Favour of the Federation

By the late sixties the prospects of oil discovery became a real probability and the Federal Government was seriously considering the possibility of greater centralised Federal control over the petroleum industry. This was in order to implement a well co-ordinated national

[24] Ninth Schedule — List 1. Federal List Item 8(i) of the Federal Constitution provides that the Federation has powers, both legislative and executive, in respect of 'development of mineral resources; mines mining mineral and mineral ores; oils and oilfields; purchase, sale, import and export of minerals and mineral ores; petroleum products; and regulation of labour and safety of mines and oilfields.' See Tan Sri Salleh bin Abas *op. cit.,* 49-50.

[25] S.4(3).

[26] The *Petroleum Mining Act,* 1966 s. 4(1).

[27] S. 7, with respect to the terms of exploration licence and s. 8 with respect to the terms of petroleum agreement.

[28] S. 4(2).

[29] The Yang di-Pertuan Agong is the King of Malaysia.

[30] S.4(3).

[31] The definition of 'petroleum' in the *Petroleum Development Act,* 1974 is wider than this definition. This point will be discussed below. See *infra.* note 49.

energy policy with a view to accelerating the economic and industrial development of the nation.

The constitutional and legal hurdles were not easy to overcome, especially the vested and protected proprietary rights of the States of Sabah and Sarawak in the sea-bed of the continental shelf. The only real solution would have been negotiations and agreement between the Federal Government and the States concerned.

Before such negotiations could be undertaken the country was faced with a national crisis as a result of an outbreak of communal rioting and violence. On May 15th, 1969, a state of national emergency was declared. The Parliament next sat on February 20th, 1971. Between these two dates, the Yang di-Pertuan Agong was empowered by Article 150(2) of the Constitution to '... promulgate ordinances having the force of law if satisfied that immediate action is required'.[32] When the emergency was proclaimed, it was not possible to foretell when Parliament would next sit and resume the legislative functions in accordance with the Constitution. In the meanwhile action was called for in the petroleum sector; there was an urgency to establish some form of centralised control over the petroleum industry.[33]

On November 8th, 1969, the Yang di-Pertuan Agong, by exercise of powers conferred on him by Article 150(2) of the Constitution, promulgated the *Emergency (Essential Powers) Ordinance* 1969 (No. 10). This Ordinance amended the *Continental Shelf Act,*[34] and the *Petroleum Mining Act,*[35] so that these Acts applied not only in the States of Malaya [West Malaysia] but in East Malaysia as well.

It is noted that when the emergency ordinances cease to have effect under Article 150(7) of the Federal Constitution, the amendments made by the Ordinance 1969 (No. 10) will cease to have effect and the Acts will cease to apply to the East Malaysian States. The Acts will continue to apply in the West Malaysian States without the amendments introduced by the Ordinance.[36]

The *Continental Shelf Act* as amended was extended to apply to the East Malaysian States on 8th November, 1969. Section 3 of the Act contains the major amendment which had considerable impact on the petroleum industry by altering the rights of the East Malaysian States to the ownership of petroleum resources. Section 3 provides as follows:

[32] During a period of Emergency the States will not have benefit of the constitutional protection of their rights and the executive authority of the Federation (which includes the power to legislate) extends to any matter regardless of whether it is within the Federal List, State List or Concurrent List. See Tun Mohamed Suffian bin Hashim *op. cit.,* 226-240; S. Jayakumar, Emergency Powers in Malaysia in Tun Mohamed Suffian H.P. Lee and F.A. Trindade (ed.) *The Constitution of Malaysia* (1978 Oxford University Press, Kuala Lumpur). 332-349.

[33] For the economic and other policy reasons including the necessity to pool the negotiating skills or talents, see Jaginder Singh, The Legal Structure and Attendant Problems, of the National Petroleum Corporation of Malaysia (1976) Mal. L.R. 126-127.

[34] No. 57 of 1966 (revised as Act 83).

[35] No. 58 of 1966 (revised as Act 95).

[36] This statement was included in the Note to the *Petroleum Mining Act* 1966 (Revised —1972).

> All rights with respect to the exploration of the continental shelf and the exploitation of its natural resources are hereby vested in Malaysia and shall he exercisable by the Federal Government.

With the implementation of the above provision, the rights of *dominium* of the East Malaysian States in the continental shelf became vested in the Federation which already had the rights of *imperium.*[37] The transfer of the proprietary interest in natural resources in the continental shelf of East Malaysian States to the Federation resulted in uniformity of legal status of the continental shelf of the whole of Malaysia.

The *Continental Shelf Act* does not deal with the terms and conditions upon which petroleum should be explored for or extracted. Section 4(1) only provides that:

> No person shall explore, prospect or bore for or carry on any operations for the getting of petroleum in the seabed or subsoil of the continental shelf except under and in accordance with the Petroleum Mining Act, 1966.

The amendments effected by the Emergency (Essential Powers) Ordinance 1969 (No. 10), to the *Petroleum Mining Act,* deal with the changes in the petroleum sector consequent upon vesting of the proprietary interest in the natural resources, including petroleum in the continental shelf of the East Malaysian States, in the Federal Government. The Act as amended was extended to East Malaysia on 8th November, 1969.

The changes introduced by the Ordinance in relation to the petroleum sector of Sabah and Sarawak are incorporated in Section 13(2) of the *Petroleum Mining Act,* as follows:

(a) The Mining Ordinance of Sabah, the Oil Mining Ordinance of Sabah, the Oil Mining Ordinance of Sarawak and any other State law in force in Sabah or Sarawak relating to mining shall continue in force except in relation to the exploration, prospecting or mining for petroleum in offshore land and the provisions of the said Ordinances and any such law so far as they relate to the exploration, prospecting or mining for petroleum in offshore land shall be deemed to have been repealed.

(b) Any prospecting licence, mining licence or agreement issued or made under any written law in force in Sabah or Sarawak immediately before the 8th November, 1969, for the exploration, prospecting or mining for petroleum on offshore land shall continue to be in force subject to paragraphs (d) and (e).

(c) All rights accrued or due to and all liabilities and obligations imposed on or borne by the Governments of Sabah and Sarawak under or by virtue of any prospecting licence, mining

[37] The distinction made by Frankfurter J. in *United States* v. *California* 332 U.S. 19 (1947) 45. Justice Frankfurter in his dissenting opinion said that the majority failed to make the distinction recognised by Roman Law between *dominium,* which concerned property and ownership, and *imperium,* which related to political sovereignty. Frankfurter J. asserted that federal government's rights were in the nature of *imperium* while *dominium* was within the realm of the States. See *supra,* note 23.

lease or agreement referred to in paragraph (b) shall accrue and be due to and shall be imposed on and borne by the Federal Government.

(d) The provisions of the prospecting licence, mining lease or agreement referred to in paragraph (b) shall be construed subject to this Act.

(e) The Yang di-Pertuan Agong may at any time before the 31st December, 1972, by order make such further transitional or saving provision as he may consider necessary or expedient.

With these changes the East Malaysian States ceased to have any further interest or involvement in the exploitation of petroleum resources of the continental shelf. These changes did not curtail the rights of the Oil Companies acquired under the respective State legislation.[38]

The power of the Yang di-Pertuan Agong to promulgate Ordinances lapses as soon as Parliament first sits, after the Proclamation of an Emergency. The force and effect of the Ordinances promulgated by His Majesty can be ended:

— firstly, the Ordinance ceases to have effect after six months from the date of revocation of the Proclamation of Emergency by the Yang di-Pertuan Agong;[39]

— Secondly, by a resolution of both Houses of Parliament annulling the Proclamation of Emergency and the Ordinance. The Ordinance will cease to have effect six months from the date when such resolutions were passed;[40]

— thirdly, by a new Proclamation of Emergency.[41]

Since the Proclamation of Emergency of May 15th, 1969 was not expressly revoked nor had the Ordinance been annulled by resolutions passed by both Houses of Parliament under Article 150(3) of the Constitution, the *Emergency (Essential Powers) Ordinance,* 1969 (No. 10) still had the force of law. However, these changes in the ownership as brought about by the Ordinance were only an intermediate step. The desire of the Federal Government was to assert absolute control over the petroleum industry and remove it totally from the States' control.

C. VESTING OF PETROLEUM RESOURCES IN PETRONAS

The need for greater centralised control of the petroleum industry was augmented by important events which took place in the late sixties

[38] It is beyond the scope of this paper to investigate in any great depth the impact of these changes on the contractual rights and proprietary interest of the Oil Companies.

[39] Article 150(3) and (7) of the Federal Constitution.

[40] Article 150(3) and (7) of the Federal Constitution.

[41] In *Teh Cheng Poh alias Char Meh* v. *Public Prosecutor* [1979] 2 M.L.R. 623, 630 (P.C.) Lord Diplock observed:

> In their Lordships' view, a proclamation of a new Emergency declared to be threatening the security of the Federation as a whole must by necessary implication be intended to operate as a revocation of a previous proclamation if one is still in force.

and early seventies. In 1968, Indonesia, a close neighbour of Malaysia and one of the major producers of oil in the world, adopted the system of Production Sharing Contracts[42] with Oil Companies under which not only the overall financial benefits but also the social and economic benefits that would accrue to the host country were far better than those under the system embodied in the *Petroleum Mining Act.* In addition, the Organisation of Petroleum Exporting Countries (O.P.E.C.) was taking measures for step by step Government participation. For example Kuwait took action whereby the share of Government participation was unilaterally raised to 60% with retrospective effect from January, 1974. These modifications naturally resulted in a considerable improvement in that Government's fiscal take.[43] It was against this background that the next change in the ownership to petroleum resources was effected. This dramatic change which jolted the petroleum industry was caused by the Petroleum Development Act, 1974.[44] It affected the vested interests of not only the States but also the Oil Companies which had acquired proprietary interest in petroleum resources under the terms of exploration licences and petroleum agreements. It resulted in the vesting of the entire petroleum resources of the country in a Federal Government instrumentality—PETRONAS.

The preamble of this Act states the principal legal subjects and legal action as follows:

> An Act to provide for exploration and exploitation of petroleum whether onshore or offshore by a Corporation in which will be vested the entire ownership in and the exclusive rights, powers, liberties and privileges, in respect of the said petroleum and to control the carrying on of downsteam activities and development relating to petroleum and its products.

In introducing the Petroleum Development Bill, for the second reading in Parliament, the opening remarks of the Minister of Primary Industries were:

> The purpose of this Bill is to provide a legislative framework for the exploration and exploitation of petroleum by a Corporation — in which will be vested the entire ownership in petroleum whether lying onshore or offshore of Malaysia.

[42] The essential principles of the Production Sharing Contract system will be discussed in the latter part of this paper. See *infra,* note 73.

[43] This fact was noted in the speech by the Honourable Minister of Primary Industries to introduce the Petroleum Development Bill for the Second reading in Parliament in July 1974. This Speech will hereinafter be referred to as 'the Minister's Speech'. *Cf.* David N. Smith and Louis T. Wells Jr. *Negotiating Third World Mineral Agreements* (1975 Ballinger Publishing Company), 131: 'In late 1971, OPEC established guidelines suggesting that its member countries receive an initial 25 percent participation in the equity of local petroleum operating companies and that this participation increase by stages to an eventual 51 percent control'; Mana Saeed Al-Otaiba, *OPEC and the Petroleum Industry,* (1975 Groom Helm London) Chapter 18, Preliminary Steps towards Participation 161-166 *passim.* 'Most governments demand participation not only for the purpose of increasing their oil revenues but because of their belief that participation will provide them with the opportunity to increase their sovereignty over the sources of their wealth, in addition to taking an active part in the administration of their oil affairs'. 161.

[44] This Act was rushed through Parliament and brought into force on 1st October, 1974.

The Minister described the Bill as 'certainly a historic piece of legislation ever to come before this House.' In discussing the policy aspects, he said:

> The strategy is to increase the value of our Oil industry and our effort would be based on an integrated approach so that all aspects of the Oil industry would be developed complementarity with each other.

1. *Incorporation of PETRONAS*

The instrumentality through which this co-ordinated national oil policy was to be implemented was PETRONAS. The *Petroleum Development Act,* authorised the incorporation of PETRONAS 'under the *Companies Act,* 1965 or under the law relating to incorporation of companies.'[45] Upon the incorporation, 'the ownership in … petroleum whether onshore or offshore of Malaysia'[46] was to be vested in this Corporation. Such vesting took effect 'on the execution of an instrument in the form contained in the schedule to this Act'.[47] The vesting 'shall be irrevocable and shall ensure for the benefit of the Corporation and its successor.'[48] The vesting instrument would be executed by the Federal Government and the various State Governments.

2. *Vesting of Petroleum Resources in PETRONAS*

The definition of 'petroleum' in this Act is wider than the definition in the *Petroleum Mining Act.* In section 10 of this Act, it is defined as:

> any mineral oil or relative hydrocarbon and natural gas existing in its natural condition and casinghead petroleum spirit including bituminous shales and other stratified deposits from which oil can be extracted.[49]

The reason for such a wider definition was that the petroleum rights were to be assigned to PETRONAS whereas under the earlier enactment the definition of 'petroleum' was confined to the limited interest that the Petroleum Authority could grant to Oil Companies under the exploration licence or the petroleum agreement.

The petroleum resources that the Act purported to vest in PETRONAS can be classified into the following three categories:

(a) Petroleum interest of the Federation;

(b) Petroleum interest of Oil Companies;

(c) Petroleum interest of the States.

[45] S. 2(1). In another Article entitled 'Corporate Status, Objects and Powers of the Malaysian National Oil Corporation to be published in the forthcoming issue of *Lawasia,* Sydney, the writer discusses the relationship between the *Petroleum Development Act,* 1974 and the *Companies Act,* 1965, as both these Acts are constituent Acts of PETRONAS. The writer establishes that although PETRONAS is incorporated under the *Companies Act,* it is a public statutory corporation established by a special Act, and its objects and powers are determined by this special Act and not by the *Companies Act.*

[46] S.2(1).

[47] S.2(2).

[48] S.2(3).

[49] *Cf.* The definition of 'petroleum' in the *Petroleum Mining Act,* discussed above. See *supra* note 45.

The constitutional and statutory provisions that govern the assignments to and the vesting in PETRONAS of the three categories of petroleum resources will now be examined.

(a) *Petroleum Interest of the Federation*

(i) Petroleum interest in which the Federation had a present vested interest were in the offshore area of Malaysia, excluding those offshore areas where the Oil Companies had already acquired a proprietary interest under the exploration licence or petroleum agreement.

(ii) Petroleum interest in the onshore land, *i.e.* in the area of the Federal territory.[50]

The Federation can assign and vest the petroleum resources found in land over which it had sovereignty and jurisdiction to PETRONAS and Parliament can validly legislate for this purpose under Article 69(1) of the Federal Constitution which provides that:

The Federation has power to acquire hold and dispose of property of any kind and to make contracts.

The execution of the instrument by the Federal Government to effect the assignment of the petroleum resources to PETRONAS was therefore a valid disposition under this Article.

(b) *Petroleum Interest of Oil Companies*

The proprietary interest acquired by the Oil Companies through the exploration licence and petroleum agreement under the various East Malaysian state legislation and the *Petroleum Mining Act,* in offshore land, were compulsorily acquired by the Federal Government and assigned to and vested in PETRONAS.

The amended Section 9 of the *Petroleum Development Act,* makes transitional provisions for the payment of compensation to Oil Companies upon the determination of the exploration licences and petroleum agreements.

Section 9(1) provides that:

Any exploration licences issued and any petroleum agreements entered into pursuant to the Petroleum Mining Act 1966 and licences, leases and agreements issued or made or any mining leases issued under any written law in force relating to prospecting exploration or mining for petroleum shall continue to be in force for a period of six months from the date of the coming into force of this Act or for such extended period as the Prime Minister may allow.

Section 9(2) then provides that:

Where the six months' period has elapsed and no extension thereto under sub-section (1) is allowed, the licences, leases or agreements

[50] The Federal territory was established in 1973 pursuant to s. 5 of the *Constitution (Amendment) (No. 2) Act,* 1973. This Act gave Kuala Lumpur the status of Federal Capital and the Federal Government acquired the proprietary interest in and control of all land within the Federal Territory.

mentioned in that sub-section shall determine or cease to have effect and there shall be paid to the person whose rights under the licence, lease or agreement have been so determined, *adequate compensation which may be in the form of a single sum or in the form of periodical payments of money or in such other form as may be determined by the Federal Government or under any arrangement agreed upon between such person and other person designated by the Federal Government.* (Italics added)

Section 9(2) was included in the *Petroleum Development Act,* at about the same time as the execution of the Production Sharing Contracts[51] with the Oil Companies in late 1976. This sub-section should have been included in the original Act because without it, Section 9(1) would be *ultra vires* Article 13[52] of the Federal Constitution.

This Article provides for the payment of compensation whenever the Federal Government deprives any person of his property. It states that:

(1) No person shall be deprived of property save in accordance with law, and

(2) No law shall provide for the compulsory acquisition or use of property without adequate compensation.

The inherent right of a State to compulsorily acquire private property is based on the principle of *eminent domain.*[53] In *Chiranjit Lal* v. *Union of India*[54] Mukherjia J. clarified the concept of *eminent domain* as follows:

> It is a right inherent in every sovereign to take and appropriate private property belonging to individual citizens for public use. This right which is described as *eminent domain* in American Law, is like the power of taxation, an offspring of political necessity, and it is supposed to be based upon an implied reservation by Government that private property acquired by its citizens under its protection may be taken or its use controlled for public benefit irrespective of the wishes of the owner.[55]

Section 9(2) of the *Petroleum Development Act,* recognises the interests under the exploration licence and the petroleum agreement as property rights for the purpose of Article 13 of the Constitution.[56] It is therefore unnecessary to embark on a detailed investigation as

[51] See below under the heading "Role of the Government under terms of the Petroleum Development Act" for a discussion of the terms of these Contracts.
[52] This Article is very similar to the corresponding Article (prior to its amendment in 1955) in the Indian Constitution.
[53] Durga Das Basu, *Commentary on the Constitution of India,* (5th Ed. 1965 Sarkar & Sons (Private) Ltd.) Vol. 2 Calcutta, 207.
[54] (1951) S.C. 41.
[55] *Ibid.* 54.
[56] In numerous cases before the courts in India, one of the important items of property given recognition and deemed to be included in the corresponding Article in the Indian Constitution is: 'any proprietary interest even though temporary or precarious such as that of a mortgagee or lessee'. Durga Das Basu, *Commentary on the Constitution of India, op. cit.,* 729. In *Shantabai* v. *State of Bombay* 1958 S.C. 532, 533, 536, Bose J. made it clear that a purely contractual right was not property within the meaning of the relevant Article unless it included a proprietary interest, *e.g.* where a licence is coupled with a grant.

to whether these interests are rights in *rem*.[57] By the time the *Petroleum Development Act,* became law the Oil Companies had invested considerable sums of money in exploration work. By late 1973 it was made public that there were reserves of oil and gas in the Malaysian continental shelf that could be produced in commercial quantity. Section 9(2) of the *Petroleum Development Act,* provides that adequate compensation to the Oil Companies should take one of the following forms:

(i) a single payment of money; or

(ii) periodical payments of money; or

(iii) such other form as may be determined by the Federal Government; or

(iv) any arrangement agreed upon between the Oil Companies concerned and the 'other person designated by the Federal Government'.

The form of the payment of adequate compensation under item (iv) is not explicit. However various pronouncements by the Government and certain events that have taken place lead to the conclusion that the term 'any arrangement' includes the entering into the Production Sharing Contract with PETRONAS which is the 'other person' contemplated by that expression in the Section.[58] In view of the substantial investment already committed by the Oil Companies and the bright prospects of returns on the projects which could far exceed any monetary compensation under items (i) and (ii) above, these Companies opted for the form of compensation included in item (iv) above. This involved very serious negotiations of the terms of the new arrangement between PETRONAS and the Companies.

Negotiations with Oil Companies were undertaken by Federal Government even before the enactment of the Act and the formation of PETRONAS. As the Minister of Primary Industries stated:

> To facilitate the implementation of Production Sharing, my Ministry took the initiative last year [1973] when circumstances became ripe, in terms of the global oil industry, to enter into a series of negotiations with the Oil Companies to seek their agreement to convert into Production Sharing, contracts to be implemented when the law establishing a National Oil Corporation and providing for the conversion to Production Sharing[59] is passed by this House. Letters of intent to that effect were therefore signed with six of the Oil Companies while the rest agreed to do so in principle, without yet signing such letters. One Oil Company has even agreed to backdate its Production Sharing Conversion to 16th October, 1973.

It must be noted that not all Oil Companies were prepared to accept the new role and give up their vested interests without a hard bargain.

[57] Such as an irrevocable licence confering proprietary interest or leasehold interest or *profit a prendre* or some other interest of a property nature.

[58] An investigation as to whether PETRONAS has the necessary power to enter into these contracts is beyond the scope of this Article.

[59] The *Petroleum Development Act,* 1974 does not contain any provision for 'the conversion to production sharing' system.

All acquired or vested proprietary interests of the Oil Companies were determined within six months after the Act came into force.[60] This was because no extension was granted by the Prime Minister under section 9(1) of the Act. From April 1st, 1975, to the date of execution of the Production Sharing Contracts in late 1976, it was a 'battle of nerves' between PETRONAS (or the Federal Government) and the Oil Companies. The Oil Companies are reputed to have a high level of negotiating skills coupled with the strength derived from the fact that their bases are in powerful industrial nations. However on this occasion the negotiating strength was with the Malaysian Authorities owing to a number of fortuitous circumstances. These were:

(a) it had already been established that there was petroleum in commercial quantity in the area of the continental shelf;

(b) Oil Companies had more to gain under any reasonable arrangements to continue with the operations rather than take the compensation;

(c) Though a small, developing country Malaysia felt itself able to emulate the stance of the other third world petroleum producing countries in the O.P.E.C. and assert her national authority in petroleum matters;

(d) The international market for petroleum was an excellent sellers' market.[61]

(c) *Petroleum Interest of the States*

The constitutional basis on which PETRONAS took over State-owned petroleum resources is Article 83(I)[62] of the Federal Constitution. This Article empowers the Federal Government to acquire petroleum interests which are the property of the State Authority.

The Lord President of the Federal Court, Malaysia has observed that 'in practice, the Federal Government does not invoke this Article unless negotiations between the Federal Ministry or Department requiring the land and the State Government concerned have been unsuccessful.'[63] There is a lack of public information on whether

[60] Since the Act came into force on October 1, 1974, the six months period came to an end of March 31, 1975.

[61] Malaysia also did not need the oil revenue immediately as her revenue from exports of other commodities such as rubber, tin and palm oil was high and her foreign exchange position was in good shape.

[62] Article 83(1) of the Constitution provides:

> If the Federal Government is satisfied that land in a State, not being alienated land, is needed for Federal purposes, that Government may, after consultation with the State Government, require the State Government, and it shall then be the duty of that Government, to cause to be made to the Federation, or to such public authority as the Federal Government may direct, such grant of the land as the Federal Government may direct: Provided that the Federal Government shall not require the grant of any land reserved for a State purpose unless it is satisfied that it is in the national interest so to do.

Although the Article provides for the acquisition of land it is inherent in this Article that acquisiton could be of a lesser interest in land, *i.e.* petroleum interest, as will be shown below when considering Article 83(2) of the Constitution.

[63] Tun Mohamed Suffian bin Hashim *op. cit.*

there were negotiations between the Federal Government and State Governments and whether or not they resulted in acceptable agreements.

If there were a freely negotiated agreement between the Federal Government and the various State Governments, there would be no necessity for the Federal Parliament to legislate on the subject of assignment of the petroleum resources located within the State jurisdiction to PETRONAS. The assignment could have been accomplished by agreement between the Federal Government or PETRONAS (as an agent of the Federal Government) and the State Governments.

Not all the States readily executed the instrument assigning the petroleum interest to PETRONAS. In fact the oil producing State of Sabah executed the instrument only sometime in June 1976, several months after the enactment of the *Petroleum Development Act.*

Under the terms of Article 83, the Federal Government, if it is satisfied that land in a State is needed for Federal purposes, may require the State Government to cause to be made to the Federation or to such public authority as the Federal Government may direct, such grant of land. The Federal Government is empowered to require the State Government to grant to the Federal Government (or to a public authority) any land reserved for a State purpose if the Federal Government is satisfied that 'it is in the national interest to do so.'[64] All such grants of land by the State Government to the Federal Government (or to a public authority) must be in perpetuity and 'without restrictions as to the use' of such land.[65]

Article 83(2) of the Constitution, clearly empowers the Federal Government to acquire only the petroleum interest in land. The full text of this Article is as follows:

> 2. Where in accordance with Clause (1) the Federal Government requires the State Government to cause to be made a grant of land in perpetuity, the grant shall be made without restrictions as to the use of the land but shall be subject to the payment annually of an appropriate quit rent and the Federation shall pay to the State a premium equal to the market value for the grant; and where the Federal Government so requires, the State Government to cause to be granted *any other interest in land,* the Federation shall pay to the State the just annual rent therefore and such premium if any is required by the State Government, as may be just. (italics added)

The payment of annual rental and the premium by the Federation is reflected in the *Petroleum Development Act.* Section 4 of that Act provides that in return for the vesting of the ownership of petroleum resources, PETRONAS 'shall make to... the Government of any relevant State such cash payment as may be agreed between the parties concerned.'[66] Although the State Governments have no right to question or dispute the acquisition of land or interest in land by the Federal Government, they have the right to object to or dispute the quantum of rent or premium payable by the Federal Government in respect of the land or interest in land sought to be acquired by the Federal Government. In case of such dispute or disagreement, either the Federal Government or the State Government has the right to submit

[64] Federal Constitution of Malaysia, Article 83(1).
[65] Federal Constitution of Malaysia, Article 83(2).
[66] S. 4, *Petroleum Development Act.*

the dispute for adjudication to the Lands Tribunal.[67] It has previously been noted that the proprietary interests in petroleum resources of Sabah and Sarawak were transferred to the Federal Government by the Emergency (Essential Powers) Ordinance No. 10 of 1969. There is a lack of information to whether the payment by the Federal Government or PETRONAS to these East Malaysian States includes a payment for these proprietary interests as well.

D. CHANGES IN THE ROLE OF STATES IN THE PETROLEUM INDUSTRY

There was a drastic change in the role of the States in the petroleum industry before and after the enactment of the *Petroleum Development Act.*

1. *Role of the States prior to the Enactment of the Petroleum Development Act.*

Prior to the Petroleum Development Act the States and the Federation granted the proprietary interest in the petroleum resources over which they had control and jurisdiction to the Oil Companies under various forms of title. These were the exploration licences and production agreements under the *Petroleum Mining Act,* and the licences and mining leases under various East Malaysian legislation. Under these various forms of title, the Oil Company was granted the exclusive rights to search for and develop any petroleum within the agreement area, as well as the right to dispose of any petroleum produced from that area, without any Government interference. The ownership of oil and gas passed to the Oil Companies at the wellhead.[68] This type of system was popularly referred to as the 'concession system'. It was based on the payment of royalty and taxes by the Oil Companies in return for the right to explore and mine petroleum.

Under this system the Oil Companies made the following payments to the Government:

— fixed yearly payment (surface rental) at the end of 5 years.

— a royalty of 8-11.5% of the value of crude oil won and saved, on casinghead petroleum spirit recovered and on natural gas sold.

— Tax under the terms and conditions of the Petroleum (Income Tax) Act, 1967 at the rate of 55%. For the latter purpose, royalty was expensed when the oil was for export but credited when it was locally consumed.

— Posted price[69] was used for the calculation of taxable income

[67] The Lands Tribunal is composed of
(a) a chairman who shall be a judge or qualified to be a judge;
(b) a member appointed by the Federal Government;
(c) a member appointed by the State Government.
The party dissatisfied with the award of the Tribunal may appeal to the Federal Court on any question of Law. See s. 87 of the Federal Constitution.

[68] The Minister's Speech.

[69] In R.D. Langenkamp, *Handbook of Oil Industry Terms and Phrases,* (1974 The Petroleum Publishing Company Tulsa, Oklahoma), the terms "posted price" is defined as follows:
The price an oil purchaser will pay for crude oil of a certain API gravity and from a particular field or area. Once literally posted in the field, the announced price is now published in area newspapers. With government

instead of market price.[70]

The main weakness of this system, as seen by the Third World oil producing countries, lay in the use of 'posted prices' for the calculation of royalty and tax payments to the host country. The integrated multinational Oil Companies were in a strong position to exert effective control over the pricing of either crude or finished products of petroleum, and the exercise of this power over pricing made it impossible for host countries to increase their revenue.[71] The other weakness of the system lay in the minimum control the host country Government was able to exert over the management of the exploration and mining operation of the Oil Companies. These companies had a broad latitude of freedom and discretions in such management.

2. *Role of the Government under Terms of the Petroleum Development Act.*

The entire legal framework for the petroleum production was completely altered by the *Petroleum Development Act.*

Firstly, with the assignment of the entire petroleum resources to PETRONAS, the Federal Government achieved its ultimate goal of removing the petroleum industry from the control of the States.

Secondly, PETRONAS was vested with the exclusive rights to explore for and exploit petroleum deposits in the country. The only unit of Government that has any involvement in the petroleum industry after the enactment of the *Petroleum Development Act,* is the Federal Government through PETRONAS.

The role of PETRONAS is not one of a regulatory nature but of direct participation in the exploration and extraction of petroleum. By this means, the Federal Government has taken absolute charge of the petroleum exploration and exploitation operations which were previously under the control of the Oil Companies. The Minister for Primary Industries has made it clear that Government expects that 'the Government Oil Company shall have and be responsible for the management of petroleum operation and the Oil Company for its execution as contractor.'[72] The Government has also spelt out the terms upon which PETRONAS shall engage the Oil Companies for

control affecting almost all aspects of the industry, prices of oil and gas are not permitted to be set by the industry's supply and demand requirements as they once were.

[70] The Minister's Speech.

[71] *Cf.* Mana Saeed Al-Otaiba, *OPEC and the Petroleum Industry, op. cit.* Chapter 10, 107. Stabilising Oil Prices: '…the direct cause underlying the creation of O.P.E.C. was a common desire among the producing countries to put an end to price reductions.. .' and '. .. the adoption of ways and means of stabilising prices in international oil markets to prevent harmful or unnecessary fluctuations in crude oil prices'.

[72] The Minister's Speech. There is no express provision in the Act that empowers PETRONAS to engage the Companies to assist in the exercise of its statutory powers of oil exploration and exploitation. The position of such contracts of PETRONAS, a public authority executing statutory powers, is examined by the writer in another Article entitled 'Contractual Liability of PETRONAS' to be published soon.

the exploration and mining operations. The vital terms that will be incorporated in the contract are as follows:

— The oil contractor shall furnish all the necessary risk capital including technical assistance in the exploration of oil or gas. Cost recovery will only be allowed if oil or gas is discovered, and even then it shall be limited to a maximum of 40% of the production per annum.

— The remaining production, after deduction of the percentage for cost recovery, shall be split in the ratio of 65:35 with the bigger share going to the Government or its Oil Company. This ratio is subject to negotiation between the Government and the Oil Company and Government may very well have a larger take.

— The ownership of all project related equipment bought by the Contractor shall pass to the Government or its Oil Company upon entry into the country, the cost to be recovered from the 40% cost deduction from oil produced.[73]

E. CONCLUSION

The discovery of petroleum was a sudden and new experience to Malaysia, happening within a few years of its attainment of the status of an independent nation. It may not have been within the contemplation of the framers of the Constitution that Malaysia was endowed with such a valuable natural resource. Hence they did not make any specific or clear provision in the Constitution that would have made the task of the Federation in establishing effective control far easier.

The aim of the Federation was to maximise the return on this resource by efficient exploitation through the medium of a central authority. As pointed out earlier on. legal developments went hand in hand with developments in the exploration and production activities. In fact, it would have been quite possible for Malaysia to have adopted and used the Production Sharing Contract system by States without having to alter the ownership rights as it did. However, there would still be a need for a central co-ordinating body to implement the national policy on petroleum so as to avoid or prevent variance of terms used by the States in regard to exploration or production activities undertaken by the Oil Companies.

From the point of view of the Oil Companies, the change was welcome although they were dissatisfied in giving up their vested proprietary interests. These companies envisage greater efficiency and effectiveness in the course of their business transactions if they deal with a central authority rather than with a State Government. The principal reason for this is that in Malaysia, the Federation has far greater legislative and executive powers than the component States. The Oil Companies would therefore be able to have quicker resolution

73 The Minister's speech. In broad terms these principles have been adhered to in the Production Sharing Contracts signed with the Oil Companies but in detail there have been some variations: the Oil Company will be entitled to recover its cost up to a maximum of 20 per cent of the gross production of oil in kind; and the remaining crude production will be split in the ratio of 70:30, the larger share taken by PETRONAS.

of any of their problems if they dealt with the Federal Government through PETRONAS.

The continued presence of the Oil Companies however hides the vast legal changes that were brought about by the *Petroleum Development Act.* The major results that flowed either directly or indirectly from the implementation of the *Petroleum Development Act,* may be summarised as follows:

(1) Malaysia established the National Oil Corporation known as PETRONAS.

(2) The Federation vested its right of ownership to petroleum resources under its control and jurisdiction in PETRONAS.

(3) It compulsorily acquired the rights to the ownership of petroleum resources of the various States and caused such rights to be vested in PETRONAS.

(4) All proprietary interests acquired by the Oil Companies under the production agreements or exploration licences and other forms of title were compulsorily acquired by the Federal Government and vested in PETRONAS.

(5) The Federation and the States ceased to have the usual regulatory role in the petroleum industry. The *Petroleum Mining Act,* became a dead letter.

(6) The Federation, through PETRONAS, entered the commercial arena of petroleum exploration, production and marketing and plans shortly to manufacture and distribute petroleum and petro-chemical products.

(7) All proprietary concepts, such as leasehold interests, licences and *profit a prendre* are no longer applicable to the Malaysian petroleum industry because the entire petroleum resources of the country are vested in PETRONAS which is given the exclusive right to explore and exploit these resources. The 'farmout'[74] concept is therefore irrelevant or inapplicable to the Malaysian petroleum industry.

(8) The Federal Government approved the use of Oil Companies as contractors to assist PETRONAS in the exploration and exploitation of petroleum and adopted the Indonesian Production Sharing Contract system. The Oil Companies have accepted this arrangement in lieu of monetary compensation.

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[74] The 'farmout' concept is defined as an assignment of all or part of an interest in and or part of a mining concession with a reservation to the assignor of an interest in the concession or in its production or the value thereof.' See H.P. Williams, 'Matters to be taken into consideration in the negotiation of Farmouts and Operating Agreements' in *Australian Mining and Petroleum Law Journal* (1978) Vol. 1 No. 2, 509.

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