

Analyzing petroleum royalty demand by the Kelantan state government against the federal government

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Abstract

Petroleum is one of the prime resources that simultaneously generates economic development as well as political division in both developed and developing countries. The fact that Malaysia is a resource-rich federation state with abundance of petroleum reserve has triggered conflicts between the federal and the state government, particularly between the parties that are of different political affiliation. In order to systematically analyze the premise, this research examines federalism politics in the context of Kelantan's petroleum royalty. To map this study, the concept of federalism is used as a tool of analysis to measure the quality of relationship between the federal and the state government following the dispute of petroleum distribution. The data were collected from primary as well as secondary sources before they were analyzed qualitatively. Primary data was collected through series of interview with authoritative figures, while secondary data was obtained from library sources. The findings show that the triggering factor of the conflict in the petroleum royalty claim by the Kelantan state government is the differences in ideology and political affiliation between both the federal and the state government. The asymmetrical degree of power between the federal and the state government which skewed to the former at the expense of the later are further exacerbated in the case of the different political party that respectively controlling both levels of government. This is an authentic display of the so-called quasi-federalism that affected the relations between the federal and the

state government under the federation system in Malaysia.

Keywords: *petroleum, royalty, federalism, Kelantan, federal*

Introduction

Oil and gas industry (petroleum), as a major economic activity, has long been a source of crisis and disputes amongst and within countries the world over. Obviously, being the highly sought after source of energy, it inevitably provides producing countries with lucrative source of national income. In as much as gold being the point of reference to measure the national wealth of ancient civilizations, petroleum has apparently overtaken the role and significance of gold in today's world, more so since almost the entire industrial economic infrastructures depend heavily on the former. True to form, countries with abundance of petroleum resources are generally considered as rich and wealthy by the standard of modern world's economic standing.

Whilst it is common to see petroleum turning to be one of the reasons for international conflicts, it is also commonplace to see petroleum precipitating intra-conflict within petroleum-producing nations themselves. Malaysia, Venezuela, Sudan, Iran and Iraq, to name a few, can serve as some of the instances to illustrate both types of conflicts. Obviously, petroleum has so considerable an impact to the world that renowned scholar like Mabro (1980) is convinced that petroleum trade is indeed the major cause for foreign interventions into the domestic affairs of countries endowed with substantial petroleum resources. Undoubtedly,

petroleum is the material factor that serves as an important indication to determine a country's economic well-being (Kenneth, 2010).

In order to allow a more detailed analysis and discussion, this study limits its scope to petroleum-related intra-conflict. Pursuant to that, within the context of politics of federalism, this study makes Malaysia as the case study. In particular, this study analyzes oil-related intra-conflicts between the federal and state governments of Malaysia. In doing so, it seeks to address mainly two questions: what are the impacts of such intra-conflict to Malaysia as an oil-producing country itself and how does such affect the relations between federal and state governments of Malaysia?

For more than three decades or so, the federal government i.e. Putrajaya is allegedly denying oil royalties for offshore petroleum found in the waters of one of its states i.e. Kelantan for which the latter has begun claiming for since 2009. However, both have since brought the case to the court of law i.e. Federal Court of Malaysia. It is pertinent to note that the preceding questions inevitably make up for the grounds for a number of important aspects that are also the main focus of this study's discussion.

Concept Of Federalism In The Context Of Kelantan's Oil Royalties

Upon independence in 1957, Malaysia has adopted the system of federalism. As far as this system is concerned, Malaysia has faced a multitude of challenges and internal disputes. Perhaps, one of the most notable conflicts is the federal-state relations, primarily one involving political interferences into the administrative and governance systems. In spite of the intricacy of such a system, up to a certain qualified extent, Malaysia has been able to keep its federal system intact until today. As a matter of fact, not only has the system been working to the best interests of Malaysia, it has as well contributed significantly to its political and economic prosperity. These, for one thing, can draw a significant relation to associated articles and provisions as provided for in the Federal Constitution of Malaysia which, among other things, empower the federal government to take necessary actions against threats it deems as capable of compromising the integrity of the federalism system.

As a federal country, Malaysia has three levels of governments namely, the federal, state and local governments. Each level has its own administrative jurisdictions and governing powers. The division of powers stands out to be most universal criterion for

all countries with federal system throughout the world (Strong 1966:13). Besides, it is also the major condition that allows for the formation of a federal system of a country to take place. For Strong (1996), an equitable, fair and acceptable division of power between the federal and state governments is an absolute prerequisite. The failure to do as such will only cause the federal system to fail, let alone to achieve and put to work what a properly functioning federal system is supposed to.

Literally, the root word of 'federal' comes from a Latin word of 'fides' which means a gathering or a bind (Leo Agustino 2011:195). In relation to that, Mohammad Agus (1999:66) states that the word 'federal' denotes 'agreement', 'treaty' or 'alliance'. Seen from the contextual research of federalism as a political system, it therefore can be understood as a voluntary agreement involving a group of sovereign states that have come to a consensual agreement to form a common bond and bind. Still, according to Elazar (1987), although the concept of federalism has been in use since 1945, its true and concise definition remains a debatable subject.

However, following the end of World War II, a scholar on the study of modern federalism has come up with a rather more comprehensive definition of federalism. In essence, federalism refers to a "method of dividing powers so that the general and regional government are each, within a sphere, co-ordinate and independent" (Wheare, 1967:10). Working on this definition, the concept of federalism observably stresses on the aspect of power division between the central and state government. Both are subsequently ought to be independent and at liberty to run own administration. In other words, for this concept to work, Wheare emphasizes on two key criteria: (a) well-defined division of powers between the federal and state governments and (b) freedom to run own administration based on the provisions stated in the constitution as well as common and mutual respect for the pre-determined power division.

In the context of power division in Malaysia, Part VII of the Federal Constitution states that, except for proceeds from land and forestry resources, the federal government has the right to all major natural resources of the country. Correspondingly, it also serves as a guarantee that the state governments' incomes derivable from state lands, mining sector and forestry will not be abridged (Ahmad Ibrahim 1999:439-479). Besides, the constitution also states the right of the state government to impose and collect import duty for its natural resources i.e. tin, iron and petroleum as provided for by Article 110

(3A) (Ahmad Ibrahim 1999:439) This provision benefits significantly states rich in natural resources like Perak, Terengganu, Kelantan, Sabah and Sarawak.

Subsequently, Petroleum Development Act 1974 gives the power and right for exploration and exploitation of petroleum whether onshore or offshore to "Petronas" - an incorporated national petroleum company. Through this act, among other things, states vest or assign their ownership in and the exclusive rights, powers, liberties and privileges in respect of the said petroleum, and to control the carrying on of downstream activities and development relating to petroleum and its products to Petronas (The Commissioner of Law Revision, Malaysia, Petronas Act 2006: 5). State governments, in consequence to that, are entitled to receive 5% of petroleum-based income (oil royalties) from Petronas, as provided for in Section 4 of the same act that specifically mentions "In return for the ownership and the rights, powers, liberties and privileges vested in it by virtue of this Act, the Corporation shall make to the Government of the Federation and the Government of any relevant State such cash payment as may be agreed between the parties concerned" (The Commissioner of Law Revision, Malaysia, 2006: 7).

Largely, the issue of oil royalties in Malaysia had only begun to make headlines nationwide when rival political parties won the state-level election and with that win, the right to form the state government. The cases of Terengganu in 1999 and Kelantan in 2004 can illustrate such an event. The cases of Sabah and Sarawak, on the other hand, were different as both were controlled by political parties who also happened to be part of the grand political coalition that formed the federal government. This put both to be under control of practically the same political parties. The cases of Terengganu and Kelantan, however, indicates that the federal government appeared to have denied due recognition of the right and sovereignty of the state government formed by rival political parties who had legally won the state-level election. In more ways than one, such can be seen as a deviation from the federalism concept. Besides, as Elazar (2008:2) puts it, the federalism is a system of multi-level government, mutually institutive, cooperative and respectful to and of each other's jurisdiction and scope of power. What had happened to Terengganu and Kelantan in 1999 and 2004 were evidently not what Elazar has in mind about what a federalism system is.

An Analysis Of The State Government Of Kelantan's Oil Royalty Claim

In order to begin the analysis, this study turns its focus to a number of important document, statements and events, as follow. Firstly, Petroleum Development Act 1974 (Act 144) signed by both Petronas and all state governments in Malaysia is "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 downstream activities and development relating to petroleum and its products (Laws of Malaysia, Act 144 2006:1). Secondly, Tun Abdul Razak's reply dated 15 November 1974 to a question posed by Lim Kit Siang who was the Member of Parliament for Petaling Timur at the material time affirmed that the federal government had agreed to make the payment of oil royalty to states involved. Tun Abdul Razak asserted that, "... *all states in Malaysia, except for Sabah and Selangor, had signed the agreement with Petronas as required by the Petroleum Development Act 1974. I was made to understand that the state government of Selangor had even in principal agreed to sign the agreement. According to this agreement, each of the signatory state will receive five percent from the value of oil discovered and acquired within and beyond the waters off the states, sold by Petronas or any other agencies or contractors.*" (Dewan Rakyat, 15 November 1974).

Thirdly, as per the agreement, the federal government is bound to pay 5% oil royalties to the state government of Kelantan, payable twice a year in March and September. This is based on the Petroleum Development Act 1974 (Act 144) (4) that states "*In return for the ownership and the rights, powers, liberties and privileges vested in it by virtue of this Act, the Corporation shall make to the Government of the Federation and the Government of any relevant State such cash payment as may be agreed between the parties concerned*" (Laws of Malaysia, Act 144: 2006:7). Fourthly, it remains a fact that the oil royalties on offshore and onshore oil discovered in Kelantan makes up part of the rights of the state for which Petronas is obliged to pay for i.e. 5%.

Having said that, it should be stressed that neither do the Petroleum Development Act 1974 (Act 144) together with 13 agreements with the states nor do the 13 grants of ownership transferred to Petronas restrict the limits of states' exclusive rights of onshore and offshore oil. In other words, all the preceding documents have not limited the range or distance of offshore oil discovered off the state's coast, from which the state government can claim its

oil royalty. Thus, this can only mean that as long as the oil is discovered within the waters off a state's coast, the state government is entitled to receive 5% royalties, notwithstanding the distance. Moreover, by virtue of an agreement that both Petronas and Kelantan had entered into on 9th May 1975, it was stated that in the consideration of Petronas agreeing to make cash payments to Kelantan (Kelantan Petroleum Agreement), the latter granted in perpetuity, conveyed to and vested in Petronas, the ownership in and the exclusive rights, powers, liberties and privileges of exploring, winning and obtaining petroleum whether lying on-shore or off-shore Kelantan (the Kelantan Grant) ([http://www.kehakiman.gov.my/judgment/file/01\(i\)-24-10-2012\(W\).pdf](http://www.kehakiman.gov.my/judgment/file/01(i)-24-10-2012(W).pdf)).

Fifthly, Kelantan is the exclusive owner of two oil wells located about 140 kilometers (km) from the coast of Kelantan named as Block PM301 and Block PM302 respectively. Both blocks were discovered and developed by a joint-venture company between CS Mutiara Petroleum Company Sdn. Bhd., Petronas Carigali Sdn. Bhd. and Shell Malaysia Exploration & Production in July 2001 (Utusan Online, 3 Jan 2004). The work carried out on both wells went on stages and the record shows that the zone of "Medan Bergading" of Block PM302 had produced about 250 million metric standard cubic per feet per day (MMcfd) of gas since 2015. In terms of oil royalties, it equals to about RM235, 991, 79.31. "Medan Kamelia" zone at Block PM301, on the other hand, had produced 110 million MMcfd daily since 2013. It comes to about RM103, 836,206.90 in terms of oil royalties (Husam 2013:71). Apart from that, it was estimated that, up until 2017, the entire zones had 8 trillion cubic feet of oil and gas deposits. There was even a possibility that there might be more.

Finally, Kelantan has also claimed ownership of a Block PM303 that lies on a disputed area of waters between Basin and Terengganu as indicated by the sea boundary map 1987 involving Medan Damar, Medan Bintang, Medan Lawit and Medan Jerneh. Except for Medan Damar that has yet to begin production, Medan Jerneh has commenced production in 1992, followed by Medan Bintang in 1994 and Medan Lawit in 1997. The values of combined productions of Medan Lawit and Medan Jerneh from 2000 up to Jun 2009 were RM 25.9 billion (Husam 2013:73). In addition to that, Kelantan has insisted that the payment of oil royalties from the federal government be made under the principle of "unitize" i.e. joint rights of exploration. Based on the said principle, the estimated total of accrued oil royalties were RM 8, 638, 980, 00, 00. These sums were based on the

estimated 12-years productions of the said wells i.e. 1997 until 2009.

An Analysis Of The Federal Government's Arguments Against Kelantan's Claim Of Oil Royalties

Firstly, the federal government asserted that Petroleum Mining Act 1966 (Act 83) grants it the rights to explore, prospect and mine petroleum as stated in Section 3 (1) that specifically establishes "*restriction on petroleum exploring, prospecting or conducting any operations for the purpose of mining natural resources from the sea bed or continental shelf except by virtue of an exploration license issued under the following sub-sections*" (The Commissioner of Law Revision, Malaysia, Petroleum Mining Act 2006: 6). Secondly, the federal government also affirmed that according to Continental Shelf Act 1966 (Act 83), Kelantan does not have the rights to claim the 5% oil royalties for offshore oil mined beyond Kelantan's territorial waters. In fact, the act allows the federal government to set the continental shelf limit and continental margin from which it can explore and exploit natural resources contained therein. As far as the right to continental shelf limit is concerned, Act 83 (3) mentions, "*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 be exercisable by the Federal Government*" (Laws of Malaysia Act 83, 2006: 6).

Thirdly, the federal government has also applied Emergency Ordinance Act 1969 (7) in order to solve conflicting interpretation of the Continental Shelf Act 1966 by limiting a state's continental shelf to 3 nautical miles (nm) (Laws of Malaysia 2006). Consequentially, territorial waters and the continental shelf beyond the 3 nm fall under the jurisdiction of the federal government. Fourthly, based on the provisions of the Territorial Sea Act 2012 (Act 750), the federal government has denied Kelantan's 5% oil royalties claim. Obviously, Act 750 - by virtue of the 3 nm rule - effectively grants the federal government with the rights over a state's continental shelf and territorial sea located 3 nm from the state's coastline.

Fifthly, the main purpose of agreements under Petroleum Development Act 1974 (Act 144) is for Malaysia and the states to grant exploration and mining rights to Petronas. Apparently, nowhere in the act does it specifically mention the word "royalties". However, it does contain the word "cash payments" to state governments. This payment is only issued upon any exploration and mining carried

out on-shore or off-shore, as stated in Kelantan Petroleum Agreement with Petronas dated 9th May 1975 whereby, "*Petronas shall make to the government cash payments in the form of a yearly sum amounting to the equivalent of 5 % of the value of the petroleum won and saved on-shore and off-shore Kelantan*".

Finally, areas with substantial oil and gas deposits off the coast of Kelantan include Block PM 301, PM 2, Malaysia - Thailand Joint Development Area (MTJDA) and Commercial Arrangement Area between Malaysia and Vietnam (PM3 CAA). As it is, Block PM 301 and PM 2 are located beyond 3 nm off Kelantan's coast. Both however are still within the national territorial waters of Malaysia. Yet, both MJDA and PM3 CAA are located in areas disputed by Thailand and Vietnam respectively. Due to the still unsolved dispute over the maritime borders between Malaysia and Thailand, the disputed area in question is jointly administered by both countries i.e. Malaysia-Thailand Joint Authority (MTJA). It is principally responsible to oversee activities carried out within the disputed area. Unless an amicable solution to the disputed maritime borders is realized, both have signed a Memorandum of Understanding that must be adhered to in order to regulate each conduct in the disputed area (Najib 2013:1).

Conclusions

The preceding discussion has extrapolated the ongoing conflict between the federal and state governments concerning oil royalties claim, particularly those of Kelantan. In this context, the payment of oil royalties by the federal government to state government can be taken as a proof of the proper implementation of the federal system. One needs to note that the state government has every right to plan and determine the way it spends or uses the oil royalties, to the way it sees as fit and proper

for the people, as provided for by the state's jurisdiction of power. Having this mind, the issue of oil royalties then can only be settled via political means i.e. a win-win relation between all stakeholders. Only if and when this materializes, this study argues, will all parties be able to reach the best decision that fulfills the best interests of all.

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