GREATER KUALA LUMPUR

THE NATURAL OIL & GAS HUB IN ASIA

Part 2: O&G PRINCIPAL HUB IN GREATER KUALA LUMPUR, THE WAY TO GO AMIDST OIL PRICE SLUMP

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PART 2: GREATER KL – A NATURAL CHOICE FOR O&G COMPANIES TO ESTABLISH A REGIONAL HUB

In the first of our two part O&G series, InvestKL covered reasons on what makes Greater Kuala Lumpur (“GKL”) the ideal location for international oil and gas services companies (“O&G service companies”) to consider setting up their regional headquarters or engineering hub. Part 2 will dwell deeper on how O&G service companies could strategically position themselves in Greater KL.

The reasons have become more apparent for international O&G services companies to react as oil prices have been in the doldrums, trading within a familiar range with no signs of an upward trend anytime soon. Market players are beginning to question whether these current oil price ranges are a “New Norm”, while analysts and economists are also scrambling to figure out the trajectory of oil prices in the short to intermediate term with numerous forecasts floating around. Be it as it may, industry oil and gas players are unlikely to sit still and are aggressively re-strategizing with this new reality to alleviate cost pressures.

In the recent months, GKL has witnessed several big moves amongst international O&G services companies such as Saipem, PGS and the most recent, Subsea 7 which had relocated their regional headquarter from Singapore to GKL.

McDermott International has recently announced that it would close its Asia Pacific Regional Headquarter in Singapore after many years of presence and relocate it to GKL. This momentum is likely to pick up in the months to come for the rest of the international O&G players.

CASE STUDY

McDermott International announced at the end of the 3rd quarter 2015 their plans to relocate their regional headquarters from Singapore to Greater KL

Value proposition:

- Significant cost savings in doing business
- Availability of high skilled engineering talent
- Close proximity to its key customer (PETRONAS)

Source: http://www.upstreamonline.com

THE PRINCIPAL HUB INCENTIVE

Any consideration for International O&G services companies to move to GKL is made more attractive with the recently announced tax incentives by the Malaysian Government called the Principal Hub Incentive. This Principal Hub incentive is likely to attract O&G services companies who are looking to set up or relocate their existing Regional Headquarters/Engineering Hubs from high cost centres such as Singapore, Perth or Hong Kong to GKL to protect their profit margins during this challenging time.

Announced in April 2015, the Principal Hub Incentive has replaced all existing incentives such as Operational Headquarters ("OHQ"), International Procurement Centre ("IPC") and Regional Distribution Centre ("RDC").As this incentive gradually gains traction in Malaysia, it has certainly gained significant prominence in countries such as Switzerland, Netherlands and closer to home, Hong Kong and Singapore.

What is a Principal Hub?

It involves a locally incorporated company that takes advantage of GKL or any other place in Malaysia as a base to cater their regional and/or global business. The Principal Hub company encompasses all the key functions such as legal, management and operations including management of risk and decision making. While this incentive may have come at a time when Base Erosion Profit Shifting or BEPS by the Organisation for Economic Cooperation and Development ("OECD") is becoming a hot topic amongst large MNCs, the Malaysian authorities have already taken this into serious consideration in carving out the principal hub incentive to ensure all tax matters are properly adhered to. It is pertinent for any international O&G service companies that have intentions to set up their Principal Hub in GKL or Malaysia to have the necessary substance or qualifying services to be eligible for the incentive. Under the criteria of the Principal Hub Incentive, a company would have to carry out 3 qualifying services of which one of it must be derived from strategic services as follows:

Qualifying services

1 Strategic Services

- Regional P&L / business unit management, P&L management focuses on the growth of the company with direct influence on how company resources are allocated
- Strategic business planning and corporate development
- Corporate finance advisory
- Brand management
- Intellectual Property (IP) management
- Senior level talent acquisition and management

2 Business Services

- Bid and tender management
- Treasury and fund management
- Research, development and innovation
- Project management
- Sales and marketing
- Business development
- Technical support and consultancy
- Information management and processing
- Economic / investment research analysis
- Strategic sourcing, procurement and distribution
- Logistics services

3 Shared Services

- Corporate training and human resource management
- Finance and accounting
- General administration
- IT services

Figure 1: ***Qualifying services under the Principal Hub Incentive*** *Source: MIDA*

The corporate income tax rates for the principal hub incentive are broken into a 3-tiered system. The tax will be based on the level of business spend, value-added functions, risk transferred to the hub, number of high value jobs created and the countries it serves. The transfer pricing will have to commensurate with the substance in order to fully attain low tax rate and maximise the benefits, in line with spirit of BEPS. The table below shows the details of the tax incentives:

	Tier 3		Tier 2		Tier 1	
	5 years	+5 years	5 years	+5 years	5 years	+5 years
Corporate tax incentive (effective tax rate)	10%		5%		0%	
▸ High-value jobs by end of year 3 with minimum salary of RM5,000 per month ▸ At least 50% must be Malaysians by end of year 3 ▸ Including key positions with minimum salary of RM25,000 per month	15 3	20% increment	30 4	20% increment	50 5	20% increment
Qualifying services	At least 1 strategic service and 2 other services		At least 1 regional Profit & Loss (P&L) service and 2 other services		At least 1 regional Profit & Loss (P&L) service and 2 other services	
Annual business spending	RM3 million	30% increment	RM5 million	30% increment	RM10 million	30% increment
Serves and controls network companies* (minimum number of countries outside Malaysia)	3		4		5	
Trading of goods Annual sales (additional requirement for goods-based applicant company)	RM300 million					
Use of local ancillary services	Local banking and financial services and other ancillary services and facilities (e.g. trade and logistics services, legal and arbitration services, finance and treasury services)					
Applicant	Locally incorporated company with paid-up capital of more than RM2.5 million (can be 100% foreign-owned)					

***Figure 2:* 3-tiered corporate tax rate under the Principal Hub Incentive** *Source: MIDA*

International O&G service companies could certainly position themselves via the Principal Hub Incentive to serve the Asia Pacific/ASEAN region, centralising key functions such as regional management with decision making and profit and loss responsibility combined with business services functions namely engineering and design services, project management, business development, supply chain services, bid & tender management as well as shared service functions. Typically for such companies, revenues are derived via contracts from customers and the advantage of the principal hub structure is that it allows companies to recognise all types of income such as business income, service income, management income and others. However, O&G service companies would have to be mindful to comply with one of the conditions attached that is, 70% of the total income must be derived from abroad while the balance from the domestic market. The principal hub entity can sign contracts directly with its customers or recognise service or operating agreement with its related companies under its coverage. Service or operating agreements amongst O&G service companies are common mainly due to regulatory or tax reasons in the local jurisdiction of which the companies are operating. The next chart (page 5) shows a conceptual principal services hub structure of which O&G service companies could explore with a fabrication yard capability.

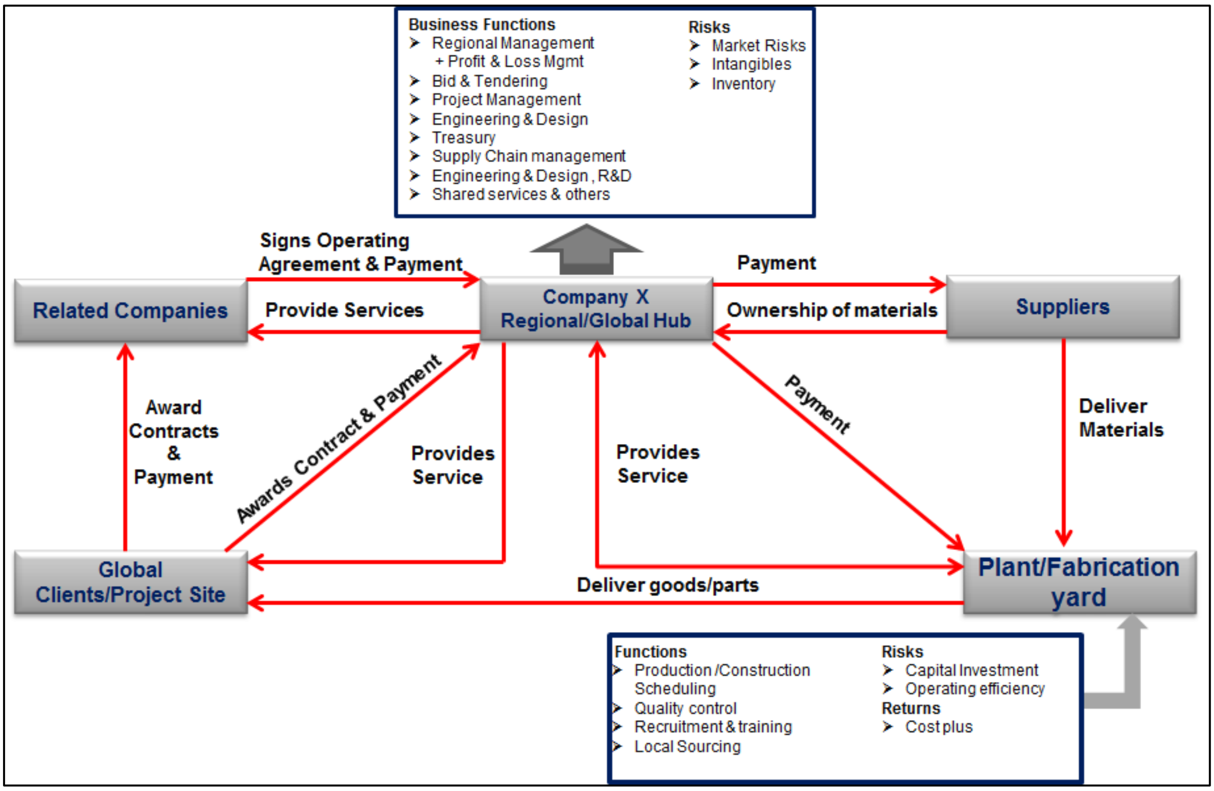

Figure 3: ***Conceptual Principal Services Hub Structure for O&G Service Companies***

The flexibility and the tax efficiency of the principal hub structure would certainly come in handy for the O&G service companies given the current slump in oil prices where companies are recalibrating their cost structure. Combined with GKL/Malaysia's value proposition such as cost competitiveness as well as World Energy Cities Partnership's ("WECP") recognition of GKL as a world energy city, O&G service companies will certainly be in a sweet spot to not only manage their costs but also enjoy a bigger return on investment in the event oil price skyrockets in the near future!

Strike it while the iron is hot!

O&G services companies should make GKL as their Principal hub given the matured O&G ecosystem in Malaysia.

KEY TAKEAWAYS

- Continued downward trend of world oil prices is causing major shock waves to the international O&G service companies' cost structure.
- GKL is an excellent choice for international O&G service companies during these challenging times given its cost competitiveness, excellent talent availability and a matured O&G ecosystem as compared to other high cost centres such as Perth and Singapore.
- The Principal hub incentive is an added sweetener for international O&G service companies.

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