

## Factors of Oil Royalty Revenue Claim During the Administration Era of Musa Aman

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### Abstract

The issue of oil royalty in the state of Sabah has been raised by the opposition parties during the administration of Musa Aman, particularly demanding a minimum of 20 percent oil royalty return to the state. It is also linked to the development of Sabah, which is linked to its status as one of the poorest states in Malaysia. While Sabah possesses numerous land products, such as oil and natural gas, it fails to give a return to the development and welfare of the population. This article discusses the factors contributing to the demand for oil royalty revenue in the state of Sabah during the administration of Musa Aman. It employed the primary method by interviewing three politicians. Secondary sources were also used as additional input and support to this article. These were obtained through local newspaper, such as Daily Express as well as several online newspaper portals including Borneo Today, TheBorneoPost and mstar online. The results demonstrated three main factors that contribute to the demand for oil royalty revenue in the state of Sabah, namely the Federal Agreement of Malaysia 1963, Petroleum Development Act 1974, and the issue of poverty. The findings also suggested the need to examine the agreement between the Sabah state government and Petronas.

**Keywords:** Claims, Royalties, Oil, Sabah

### Introduction

Since its establishment on 17 August 1974, Petronas has been responsible for the petroleum management of Malaysia and supported by policies such as the Petroleum

Development Act 1974, National Petroleum Policy, National Energy Policy, and National Disposal Policy (Balakrishnan 2002: 60). According to Balakrishnan (2002: 61), Petronas was established with the goal of implementing industrialization as done by commercial or profit-oriented companies to ensure that the country can benefit from the petroleum profits. In line with this purpose, the federal government enacted the Petroleum Development Act 1974 which provides Petronas exclusive rights and control over the nation's petroleum (Balakrishnan 2002: 69).

The federal government's supervision of petroleum was further strengthened by the implementation of the Petroleum Development Act 1974, which aims for the exploration and exploitation of petroleum either onshore or offshore by a Corporation that will be vested with all ownership and exclusive rights, powers, freedoms, and privileges over the said petroleum, and to control the usage and development activities related to petroleum and its output to make provisions regarding the establishment of a Corporation under the Companies Act 1965 [Act 125] or under laws relating to the incorporation of companies and regarding the powers of the Corporation and for making provisions on matters related or incidental to it.

On 14 June 1976, Sabah, which was then led by Harris Salleh (Daily Express, 7 June 2014), became the last oil-producing state to sign an agreement with the federal government (Gale, 1981). The agreement gave exclusive ownership and management authority of Sabah's petroleum to the federal government. Datu Mustapha Datu Harun, who was the state leader at that time, refused to cooperate with the federal government in order to protect the complete independence of Sabah from being controlled by the federal government (Gale, 1981). Undoubtedly, complete authority and management power by the federal government facilitates the implementation of policies and the acquisition of oil revenues; however, it promotes the issue of inequality in the provision of oil revenues to the state government (Brosio, 2003).

The agreement between Sabah and the federal government also had an impact over the oil production jurisdiction under Petronas and the payment of five percent oil royalties to the state of Sabah (Faisal, 2018). The latter issue has received strong opposition from a number of political parties in Sabah that propounded their demand for a higher amount of oil revenue. This tension is particularly pertinent during General Election (GE), such as in the 1990 general election when Joseph Pairin Kitingan demanded a higher oil royalty of 50 percent (Jomo K. S. and Wee Chong Hui 2002). The oil royalty issue continues even throughout Barisan Nasional's (BN) leadership of the state government. For instance, the elite members of BN in Sabah demanded 20 percent of oil profits in 2014 (Faisal, 2018). Furthermore, the issue of five percent oil royalty was also mentioned by Tun Stephens Donald who claimed that the Malaysia Agreement 1963 (MA63) had allocated 20 percent of the total oil royalty to the state of Sabah (Daily Express, 7 June 2014). Nevertheless, the implementation of five percent oil royalty continued during the leadership era of Musa Aman since the signing of agreement between the federal and state governments in 1976.

The oil royalty issue is also linked to the development of Sabah due to its status as one of the poorest states in Malaysia (Borneo Today, 19 September 2018). Sabah has an abundance of land products such as oil and natural gas, yet it fails to provide returns to the development and welfare of the local population (Borneo Today, 19 September 2018). However, such statement was dissed by Musa Aman who claimed that the five percent oil royalty should not be used as a measure of Sabah's development. This is because Sabah has received larger allocations in various Federal government development programs including the Ninth Malaysia Plan and Sabah Development Corridor (mstar, 24 November 2008).

Therefore, this article aims to explore the factors of oil royalty revenue claims during the administration of Musa Aman. The study is motivated by two main reasons. Firstly, it aims to investigate the fundamental background and reasons for the development of oil royalty claims higher than the set amount of five percent. Secondly, it explores any agreements signed by the Sabah state government that have an impact on its oil royalty revenue. This article contributes to a comparison on the causes of oil royalty revenue claims in the state of Sabah with other states that are also facing the same issues, such as Sarawak, Terengganu, and Kelantan. Furthermore, this study examines the results of primary data explaining the MA63 agreement and the Petroleum Development Act 1974, which are deemed to be affiliated to the factors triggering the demand for royalties higher than five percent by the state of Sabah. This article used structured interviews involving three politicians. Secondary sources were also used as additional input obtained through local newspaper including the Daily Express as well as several online independent newspaper portals such as Borneo Today, TheBorneoPost and mstar online. The results of this study revealed three main factors causing oil royalty claims in the state of Sabah, namely the Malaysian Federal Agreement 1963, the Petroleum Development Act 1974, and the issue of poverty.

### **Fiscal Federalism, Royalty, and Its Implementation in Malaysia**

The fiscal system for oil resources is implemented when the central government, state government, and investors share a common objective of maximizing the investment value in petroleum resources (Tordo et al., 2000:10). The implementation of fiscal system differs across nations, which includes the payment of taxation structures such as royalties. Additionally, its division depends on the factors found in the management system of exploration and development (Mazeel, 2014:6). The main element that needs attention is that fiscal federalism works to close the profit gap between the central government and the state government (Bird, 1999). Since the occurrence of nationalism on petroleum resources that began in the 1960s, oil-producing countries obtained 60% to 90% of oil profits through taxes and royalties while the remaining profits were given to oil-producing companies (Dawe, 2008; Meurs, 1981; Johnston, 2003). Furthermore, fiscal federalism system implements a sharing system for oil profits, offering the advantage of transferring fiscal resources to state governments that have oil resources as the main source of income. The federal government also distributes the oil profits equally not only to oil-producing states but also to those with no oil resources (Ahmad & Mottu, 2002).

Fiscal federalism is often associated with royalty, which is one of the branches of tax instrument known for its easy implementation on administrative management and in determining the amount of production (Ahmad 2006: 437). The amount of royalty payment usually varies across states with a certain amount of profit is shared with the federal government (Otto, 2001). Royalty payment stands as a return payment to the landowners for providing oil-producing companies with access and rights to develop oil resources for their benefit (Cawood, 2004). It is also regarded as a type of tax provided by law that is given to the landowner where the oil resource exists where the tax charged resulted from the oil production and this tax is allocated specifically in the mining sector (Otto et al., 2006:50).

Previously, the Concession System was employed as the fiscal system for petroleum products implemented by the Malaysian government. According to Mehden and Troner (2007), the Concession System was signed between Shell and the Malaysian government in the 1960s following the increase in gas and oil production from the offshore and coastal areas of Sarawak and Sabah. This situation caused more foreign oil companies, such as Elf,

Aquitaine, Oceanic, and Telseki, to agree in adopting such system for the exploration and production process in this country. The main components of this system were taxes and royalties imposed on oil companies as well as the revenues collected by the state government (Lee, 2013; Razalli, 2005). This system is also regulated under state enactment where its operation was conducted through a lease of exclusive rights by the landowner to the oil-producing companies (Lee, 2013).

Following the implementation of the Petroleum Development Act 1974, the Concession System was changed to the Production Sharing System, which transferred the state government's control and ownership of oil and gas resources to Petronas (Razalli, 2005). This Act also prompted the implementation of the Production Sharing System and abolished the Concession System (Lee, 2013). As a result, both the federal government and foreign oil-producing companies are entitled for 10 percent of the royalties while the state government only receives five percent of the royalties (Lee, 2013). The provision of such Act also gives the federal government an advantage to control and obtain higher oil revenue in comparison to the Concession System that gave full authority to oil-producing companies (Mehden & Troner, 2007). However, changes in the fiscal system for petroleum resources in Malaysia, namely the implementation of the Production Sharing System since 1976, have resulted in state governments losing the power, control, and ownership of oil and gas to Petronas (Lee, 2013; Razalli, 2005).

### **Malaysian Federation Formation Agreement 1963**

The demand for higher oil royalty is believed to be part of the essence of the Malaysian Federation Formation Agreement 1963 (Rahman & Pandikar Amin, 2018). This is in line with the understanding and research done by political leaders in Sabah who link the oil royalty issue with the Malaysian Agreement 1963 (MA63). Many politicians from the opposition parties during the administration of Musa Aman are of the view that the establishment of Petronas should align with the agreed matters contained in MA63. This is because the agreement reflects both equality and justice between the state government of Sabah, state government of Sarawak, and Peninsular Malaysia (Interviewee No. 1: 2022). This statement is supported by Wee Chong Hui (1995: 24) who stated that the development of royalty payments to the state government of Sabah is set under the Petroleum Development Act 1974 and Petronas has the authority to conduct petroleum-related activities in the respective state, simultaneously reducing the state government's power over royalty payments. Several criticisms are also directed towards the establishment of Petronas, which should protect the rights as agreed in MA63. Therefore, distribution to 13 states in Malaysia should not happen.

The establishment of the Federation of Malaysia also took into account the voices of the people of Sabah (North Borneo) and Sarawak. The agreement from the people of Sabah and Sarawak involved Singapore and Peninsular Malaysia, which was then known as Malaya, and the discussion of the formation of the Federation of Malaysia did not take into account the total population of the people of Sabah and Sarawak. As the four countries that agreed to establish the Federation of Malaysia, there should be a negotiation between Sabah, Sarawak, Singapore, and Peninsular Malaysia regarding the administration of hydrocarbons found in Sabah and the amount of royalty that the state government should receive (Interviewee No. 1: 2022). Nevertheless, the fact that there were matters related to oil in MA63 was denied through the establishment of the Federation of Malaysia, in which the British proposed to Tunku Abdul Rahman and Lee Kuan Yew for Sabah and Sarawak to be invited into Malaysia (Interviewee No. 2: 2023). Therefore, there was no discussion related to

oil in MA63 across any process of liberating Malaysia in 1963. All discussions of the agreement between Sabah and the British were not accountable to the Federal Government of Malaysia. Additionally, discussions related to oil rates in the formation of the Federation of Malaysia only occurred with Brunei; however, the oil negotiation was rejected by Brunei due to the proposed granting of oil ownership to Malaysia (Interviewee No. 2: 2023).

A number of disputes also existed involving the division of powers as stipulated in MA63. It also involved the administrative rights of approximately 200 nautical miles of Sabah coast areas between the federal and state governments. This is because the basis of land ownership is under the jurisdiction of the Sabah state government. However, due to the implementation of the Emergency Ordinance 1969, the coastal areas of Sabah are under the responsibility of the central government, which is specifically administered by the National Security Council (MKN) (Interviewee No. 1: 2022). Land management responsibilities within the jurisdiction of the state of Sabah are enshrined in the list of state jurisdictions as stated in the Ninth Schedule of List II, Federal Constitution.

The development of the issue of oil royalty claims linked to MA63 was the main topic of discussion during the establishment of the MA63 committee under the Pakatan Harapan (PH) administration in 2018. The committee was seen as a positive development because it focused on petroleum rights efforts for the state of Sabah. A total of 21 issues were discussed during the establishment of this committee, with 17 issues had been agreed upon. Meanwhile, the remaining 4 issues are still at the discussion stage, which are related to cash payments, royalties, administrative control of oil and gas platforms, and the Territorial Sea Act. If these 21 proposed issues become law, then Sabah's rights in the Territorial Seas Act will be returned to the state government (Interviewee No. 1: 2022). The committee was also established as a negotiation on the issue of oil royalty revenue in Sabah. However, the provision of 20 percent oil royalty revenue to the state of Sabah is deemed too high, particularly as oil profits are also distributed to poor states in Malaysia (Interviewee No. 3:2023).

#### **Petroleum Development Act 1974**

The establishment of Petronas has a strong historical connection with the drafting of the Petroleum Development Act 1974. It began during the reign of former Prime Minister, Razak Hussein, who had a negotiation meeting with Tengku Razaleigh in search of political funds for UMNO. Tengku Razaleigh proposed the idea of utilizing oil profits from oil areas that were abandoned by Shell. However, the proposal was rejected by Razak Hussein who instead suggested for the oil areas to be cultivated so that the proceeds could benefit the country (Interviewee No. 2: 2023).

Conversely, the Petroleum Development Act 1974 was signed between the Sabah state government with the federal government on 14 June 1976 (Daily Express, 7 June 2014). It is believed that such agreement was prompted by the government's aim of updating, standardizing the administration, and managing hydrocarbons throughout the Federation of Malaysia (Interviewee No. 1: 2022). Furthermore, the agreements signed by the Sabah and Sarawak state governments were different from those signed by Terengganu and Kelantan. The agreement was seen as a mistake made by Sabah as it released the state government's petroleum rights to Petronas through the word "vested" as stated in the agreement. In fact, there were doubts as to whether this agreement was approved by the Sabah Legislative Assembly. Similar doubts were also raised on the legal capacity of the word "vested" (Interviewee No. 1: 2022). This is because it creates a connotation of giving Petronas the rights

(or vested) - i.e., a promise - that the company will pay a profit of five percent if oil is found and produced in any area near the respective states (Interviewee No. 2: 2023). The agreement signed on this Act also witnessed a difference in the total percentage of profits given to the Sabah state government before the formation of the federal government of Malaysia. According to Muhammad Anuar (1978:370), the Prospect License Agreement for the state of Sabah has allocated 12 1/2 percent of the total oil royalty payment for oil production on the land surface and in the waters of Sabah. Nonetheless, there was a change in the amount of oil royalty payments after the formation of the Malaysian Federation. A committee was established to review the amount of tax payments for oil exploration and exploitation activities in Malaysia and they recommended the implementation of an equitable sharing model to calculate profits from oil production in this country.

The Petroleum Development Act 1974 was first proposed by Dr. Ismail bin Abdul Rahman who was the Deputy Prime Minister then. The main purpose of enacting this Act was to regulate oil production in this country. This effort has been widely implemented by the Arab countries as a strategy for determining the oil selling price. The enactment of such law was also proposed by Tengku Razaleigh who stated that this Act shall unite areas in Malaysia that can potentially produce oil under the administration of the federal government. The Act can therefore prevent the interference of foreign giant oil companies. As such, the provision of this Act gives regulatory authority under the Prime Minister's jurisdiction through a corporation, namely Petronas (Interviewee No. 2: 2023). The Prime Minister's position as the chairman of Petronas is deemed to have a conflict of interest with his role as the chairman of MKN. This situation was exemplary during the Emergency Ordinance between 1969 to 2011 that witnessed the administration of Sabah waters by MKN. The administration and production of oil in the waters of Sabah by Petronas was linked to the ordinance passed by the Prime Minister to conduct petroleum activities in the waters of Sabah (Interviewee No. 1: 2022). Nevertheless, it should be understood that the Prime Minister's role is enshrined under the Petroleum Development Act 1974. This is because the Prime Minister not only carries the duties as an advisor but also has the authority over oil products subject to the allocation of power under the Petroleum Development Act 1974 (Interviewee No. 2: 2023).

The agreement signed by oil-producing states to receive five percent was a formula proposed to Rahman Yaakub who was the former Chief Minister of Sarawak. This five percent formula was accepted by the Sarawak state government and further proposed to other oil-producing states in Malaysia. It is worth highlighting that the five percent granted to the oil-producing states is not a royalty; it is a cash payment made by Petronas based on the net oil profits. The granting of oil royalties was only used in state enactments and it was not implemented because the country's oil had already been given by the British government to Shell (Interviewee No. 2: 2023). The Oxford English dictionary defines oil royalty as a royal privilege and payment made by oil producers to site owners (Ross, 2012:95). The agreement between state governments and Petronas also has an impact on the difference between royalties and cash payments that are often used to explain the meaning of oil profit payment in this country. Oil production in Malaysia has undergone two main phases. The first phase demonstrates the federal government's lack of involvement in local oil production. However, since the 1960s, oil companies began to increase their exploration activities in Malaysian waters, impacting the changes in federal government policy. This situation led to a transition to the second phase when the federal government established Petronas in 1974 to regulate the oil industry in order to obtain greater profits (Gale, 1981).

However, this study takes into consideration views from several researchers who explain about the definition of royalty. According to Cawood (2004), the payment of royalties is an instrument used as a return payment to the landowner for providing access to the oil-producing company and also giving the right to the oil company to develop oil resources that benefit the producing company. In contrast, Otto et al. (2006:5) stated that royalty is a type of tax provided by law that allows the tax to be referred to as royalty. This tax is also given to the owner of the land with oil resources that resulted from the production obtained and this tax is allocated specifically in the mining sector.

The provision of five percent oil profits to the Sabah state government as stipulated in this Act has been used since the beginning of the agreement signing and implemented by other oil-producing states namely Sarawak and Terengganu (Interviewee No. 3: 2023). Opposition by Sabah leaders, such as Datu Mustapha Datu Harun, is not due to the Petroleum Development Act 1974; however, a conflict exists between the state government under the leadership of Datu Mustapha Datu Harun and the federal government due to other matters. This caused the Sabah state government under the leadership of Datu Mustapha Datu Harun to refuse from negotiating with Petronas on matters related to oil in Sabah. However, when Datu Mustapha Datu Harun lost his power as the leader of Sabah, the state government was led by Parti Berjaya. Leaders from Parti Berjaya later agreed to the proposal and negotiation given by Rahman Yaakub regarding the percentage of oil profit in the state of Sabah (Interviewee No. 2: 2023).

### **Poverty Issue**

According to the World Bank, Sabah is one of the poorest states in Malaysia particularly during the administration of Musa Aman, subsequently demonstrating the inefficiency of BN (Borneo Today, 31 July 2017). The allegation against the poverty rate that is linked to the progress of Sabah was also propounded by the leader of the Star party ahead of the 14th GE held in 2018. According to Jeffrey, the achievements and progress achieved by the state of Sabah were merely rhetoric to attract the people's votes ahead of GE 14 (Borneo Today, 19 April 2018). The poverty issue is also linked to oil and gas resources that contribute to the income of the Sabah state government. However, Rahman Dahlan denotes that oil profits are not the main source of income for the state. This is because the agricultural sector is the highest contributor with 27 percent compared to the 8.3 percent contribution by the mining sector, including oil resources (The Borneo Post, 11 October 2017). Hence, the link between Sabah being the poorest state and its status as an oil-producing state is deemed inaccurate. This is because the issue of poverty occurs when the state government fails to focus on the state's development. For instance, Arab countries that are the main global producers of oil, such as Saudi Arabia and Kuwait, but do not focus on development. The governance of oil resources and wealth from these resources in Arab countries is seen to fail if the government does not have a plan and the people do not benefit from the wealth of those resources (Interviewee No. 2: 2023).

Coinciding with the issue of poverty, Brophy and Wandera (2019) stated that good management of oil products can contribute to the development of a country and eradicate poverty. On the other hand, many oil-producing countries fail to manage oil revenues well, causing such wealth to only benefit the elite and further strengthen the existing corruption in the administrative system. A number of oil-producing countries have faced the issue of poverty despite having abundant oil resources, such as Nigeria (Oyeranmi, 2020) and Venezuela (Jones, 2019). Moreover, the issue of Sabah being the poorest state should not be

raised because there are still many poor states in this country. For example, while Kelantan had its independence earlier than Sabah, it is still in its backward state. The issue of poverty also occurs in other states, such as Kedah and Terengganu (Interviewee No. 2: 2023).

Therefore, the issue of being the poorest state in Malaysia does not apply to Sabah; the fact remains that Sabah is not the poorest state in the country, unlike Kelantan, Terengganu, Perlis, and Kedah. Sabah has numerous sources of income, such as timber production, that remains the state government's right and gives great returns to Sabah. Nevertheless, the main issue for Sabah is that it has a large territory and requires more infrastructure. Therefore, a high cost is required from the federal government, such as the cost for road construction in the state (Interviewee No. 3: 2023).

## **Conclusion**

This article explores the factors of oil royalty claims during the administration era of Musa Aman. The five percent of oil royalty resulted from the agreement between the Sabah state government and Petronas. There are three factors causing the demand for oil royalties in Sabah during the administration of Musa Aman, namely the Malaysian Federal Agreement 1963, Petroleum Development Act 1974, and the issue of poverty. It should be noted that there is no solid statement in MA63 advocating oil royalty of more than five percent as claimed by politicians. From the discussion above, it could be seen that there was no discussion related to oil in MA63 across any process of liberating Malaysia in 1963. All discussions of the agreement between Sabah and the British were not accountable to the Federal Government of Malaysia.

We also highlighted the effects of the signed under agreement of the Petroleum Development Act 1974 between the Sabah state government and Petronas which shows that there is a difference in the total percentage of profits given to the Sabah state government before the formation of the federal government of Malaysia. It is also important to know that the five percent granted to the oil-producing states is not a royalty; it is a cash payment made by Petronas based on the net oil profits. The granting of oil royalties was only used in state enactments and it was not implemented because the country's oil had already been given by the British government to Shell. Nevertheless, the setting up on the establishment of the MA63 committee under the Pakatan Harapan (PH) administration in 2018 was seen as a positive development because it focused on petroleum rights efforts for the state of Sabah.

The interviewee has raised the issues about the administrative rights of approximately 200 nautical miles of Sabah coast areas between the federal and state governments. It also raised the jurisdiction issue of the Sabah state government in controlling and managing oil production along its waters. Furthermore, the conflict of interest regarding the Prime Minister holding two duties at a time is considered irrelevant because it can cause injustice as a decision-maker related to oil exploration and production in the state of Sabah. Concerns were also expressed regarding the issue of the word "vested" and to what extent it affects the state government's jurisdiction in controlling and managing oil resources in Sabah. With regard to the issue of poverty, the poorest state in Malaysia does not apply to Sabah; the fact remains that Sabah is not the poorest state in the country, unlike Kelantan, Terengganu, Perlis, and Kedah. The issue of poverty occurs when the state government fails to focus on the state's development. Hence, the link between Sabah being the poorest state and its status as an oil-producing state is deemed inaccurate.

Therefore, this study suggests the need for a detailed investigation regarding the agreement signed under the Petroleum Development Act 1974 between the Sabah state



government and Petronas. This can further explain the source of power for the word “vested”. Additionally, Sabah should never be deemed as the poorest state in Malaysia as the state’s source of income is not entirely dependent on oil and gas, but also includes forest revenue, water tax revenue, and land revenue.

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### **Interviews**

- Interviewee No. 1 (2022) Former Member of House of Representative, 20 September, Kuala Lumpur.
- Interviewee No. 2 (2023) Former Minister of Finance of Malaysia, 9 February, Kuala Lumpur.
- Interviewee No. 3 (2023) Former Prime Minister of Malaysia, 17 January, Kuala Lumpur.