WHITEPAPER:

PRODUCTION SHARING CONTRACTS

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PRODUCTION SHARING CONTRACTS

Production Sharing Contracts or Agreements (PSC hereafter) are ubiquitous in much of Asia, Africa and the Middle East, with only a handful of countries in these regions adopting a Royalty/Tax or concession (RT) regime or some hybrid. The fundamental distinction between PSC and RT regimes lies in the ownership of the resource, a point frequently missed by companies who are used to operating under RT regimes. The resource is owned by the State and profit is shared with the investor after reimbursement of costs, usually in the form of crude. The investor, therefore, functions as a Contractor. PSCs also tend to be more regulated by the State, often with a National Oil Company (NOC) playing a central role be it in regulatory approvals or preferential participant. There is a prevalence of NOCs in countries operating under a PSC regime.

There is a balance of risk between the private investor and the State with the foundation being for the State to take as much as possible of the economic rent, while still maintaining attractiveness for investors. Such a balance is very delicate and some countries have performed this more successfully than others. However, success is often related to prospectivity. An investor will be more willing to tolerate harsh terms if the returns are perceived to be worth the effort. This point is covered in an analysis of Southeast Asian Fiscal regimes available from Palantir Solutions.
COMMON FEATURES

The first key feature in a PSC is cost recovery, where project costs are reimbursed from crude sales revenues. The second key feature is profit share, which is the sharing of remaining revenues between the State and the Contractor. Commonly, the Contractor can be a group of different companies with varying shares of the Contractor’s profit.

Other features commonly incorporated are stated below in a non-exhaustive list:

- **Royalty**
- State Taxes
- Domestic Market Obligation
- Value Added Tax
- First Tranche Petroleum

- **Bonuses Fees**
- Area Rentals
- **State participation**
- Export Duty
- Local Taxes
- Special Tax
- Withholding Tax
- **Corporate Tax**

*The features most frequently incorporated are shown in bold.*

A royalty is a percentage of the sales revenue taken off the top of gross production. Corporate tax functions by calculating a taxable income by considering profits and deductions. State participation usually occurs at the development or production phase of the PSC, once the contractor has borne all exploration risk and costs and prior to production start. The State backs in to the PSC with a specified equity and starts functioning like a normal partner, although not always liable to pay their share of all costs.

PSCs often stipulate minimum work programmes; for example, the contractor is obligated to perform a specified amount of seismic studies and drill a number of exploration wells, often within a specific timeframe laid down in the contract. The PSC usually has a limited duration, which is generally in the range of 20 to 40 years, with possible extensions of 5 to 10 years thereafter. Any physical assets constructed for the production of the resource has its ownership transferred to the State. Fields already in production may be handed to the State.
COST RECOVERY

The reimbursement of costs from sales revenue is known as cost recovery. The Contractor is allowed to recover current and sunk (past) costs, commonly including capital and operating expenditure, general and administrative costs and interest. A dedicated portion of gross revenue is usually allocated, meaning that the revenue (after royalty, if any) is capped at a specific percentage. Operating costs normally take precedence in the recovery order and can sometimes be uncapped. If there is not enough available revenue in the current year to recover the costs, the balance is carried forward into future years (or periods). The following figure illustrates this principle. Sometimes, an uplift of carried forward costs is applied for additional recovery.

Figure 1 - Cost Recovery with balance carried forward into future years

PROFIT SHARE

The revenue remaining after cost recovery and royalty is termed profit oil (or gas) and is split between the Contractor and the State. The percentage split applied is determined via many diverse mechanisms.
A production-linked mechanism can have the percentage split varying according to production rate. It makes sense for the State to want a higher share of the Profit at higher productivity. Taking this concept further is the use of rate of return, whereby the rate of return of the PSC (based on net cash flow) determines the split. Again, a higher rate of return would raise the percentage split for the State. Another popular variation is the R-factor, whereby a factor is calculated from cumulative revenue divided by cumulative costs and this ratio determines the split. A higher factor would have a split more favourable to the State.

The profit splits therefore tend to come in different tiers applying different splits. An example for R-factor is shown below.

<table>
<thead>
<tr>
<th>R-Factor</th>
<th>State</th>
<th>Contractor</th>
</tr>
</thead>
<tbody>
<tr>
<td>&lt;1.0</td>
<td>40%</td>
<td>60%</td>
</tr>
<tr>
<td>&lt;1.5</td>
<td>50%</td>
<td>50%</td>
</tr>
<tr>
<td>&lt;2.0</td>
<td>60%</td>
<td>40%</td>
</tr>
<tr>
<td>≥2.0</td>
<td>70%</td>
<td>30%</td>
</tr>
</tbody>
</table>

**CALCULATIONS**

The following figure gives a breakdown of the calculations involved in evaluating a PSC to arrive at net revenue. The example is based on these assumptions:

1. Gross (sales) revenue of $100
2. 10% royalty rate
3. 60% limit (cap) on cost recovery
4. Costs exceed the cost recovery limit and are carried forward into the next period
5. Profit split of 40% to Contractor
From the net revenue we can calculate Government Take, which can be viewed as the net benefit obtained by the Government. It is defined as

\[
\text{Government Take} = \frac{\text{Government Receipts}}{\text{Gross Revenue} - \text{Project Costs}}
\]

In most countries, a corporate tax is levied after net revenue and this is also considered a government receipt. In cases where there is State Participation, the consideration for government receipt is debatable as the State functions as an active investor. Some companies include it in government take and others do not.

The next figure shows the situation where Costs are under the Cost Recovery Limit, resulting in excess cost, which, in this example, goes directly into profit to be split between Contractor and Government.
It should be noted that the sample calculations are only representative of the key elements in a PSC and variations are common across countries.

SUMMARY

PSC fiscal regimes have some common standard features that make them quite different to RT regimes. This paper describes these key features along with a host of other common fiscal features. It provides a worked example of the standard calculation sequence.