



## Production Sharing Agreements

Analysis of use of PSAs and discussion of topical transparency issues

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# OVERVIEW

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- 1. PSAs – Overview**
- 2. Cost recovery - cost oil**
- 3. Profit Oil**
- 4. Production sharing**
- 5. Crude Oil Sales**
- 6. Relation to national legislation**
- 7. Risk profile**
- 8. Publication of PSAs**
- 9. Publication of Payments**
- 10. Publication of audit results**
- 11. Discussion**



- From political and legal perspectives:
  - Important differences between mining and petroleum industry sectors.
- Nevertheless; the oil, gas and mining industries
  - The main commercial players operate internationally
  - Despite local variations – the value chains are (more or less) same; stakeholders face many of the same challenges in different countries
  - The international aspects of the industries has to a large degree affected industry practices and the legal framework
  - Modern regulatory frameworks/contracts address similar issues and opt for similar solutions – especially in petroleum industry
- These similarities mean:
  - It is logical for supreme auditors to discuss Extractive Industries in general
  - Experience from one sector may be transferrable to the other
- This presentation focuses on aspects of the petroleum industry
  - Particularly, on production sharing contracts, abbreviated PSAs



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## UPSTREAM PETROLEUM VALUE CHAIN



Arntzen de Besche • 27.08.2015

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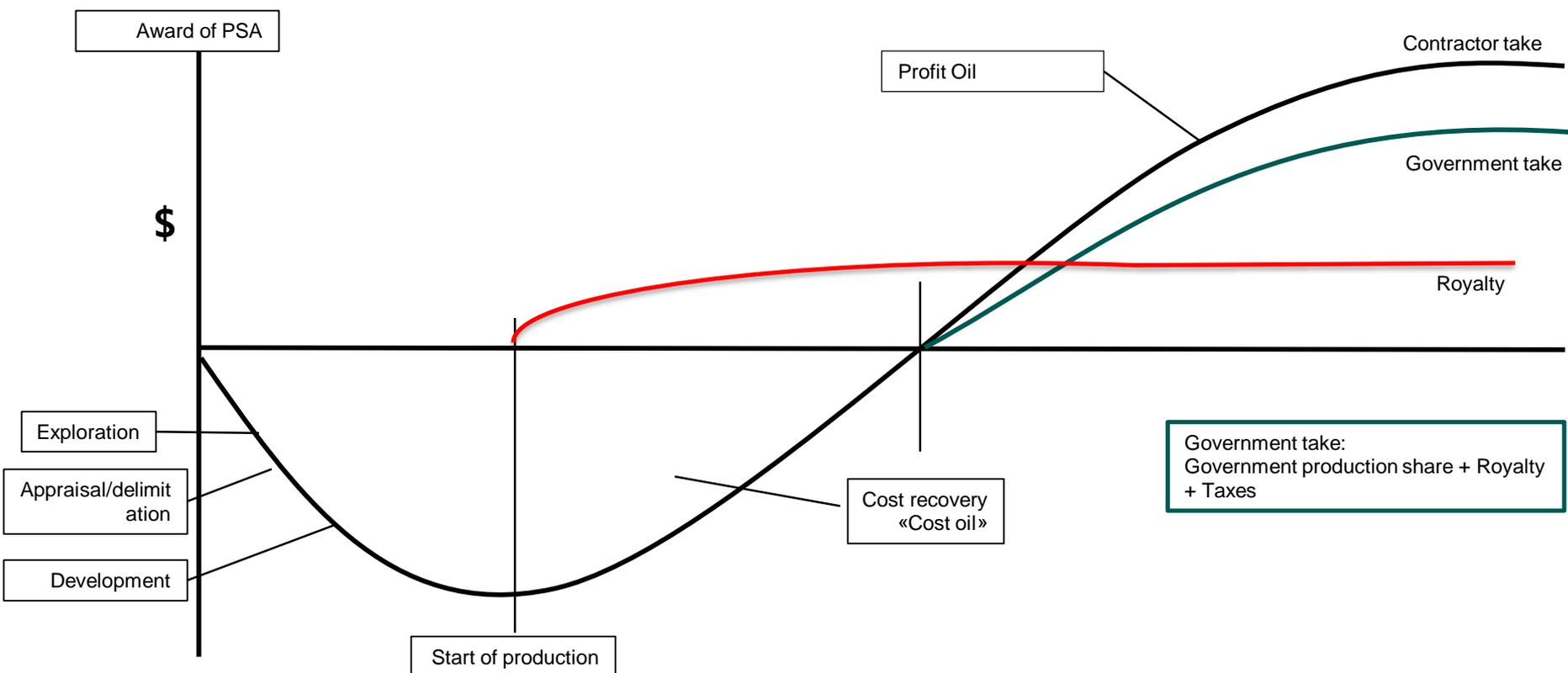
- For all of these activities, there are a myriad of contracts
- Many (most) contracts entered into in connection with a petroleum project can impact taxes/cost recovery and as such the total government take

# CHARACTERISATION OF PSA

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- A Production Sharing Agreement
  - «A Contractual arrangement made between a foreign oil company (contractor) and a designated state enterprise (state party) authorising the contractor to conduct petroleum exploration and production within a certain area (contract area) in accordance with the rules of the agreement» (*Bernard Taverne, Delft Technical University, 1996*)
- Hence the task of the Government will be to put in place
  - a commercial instrument that will
    - regulate the activities of the specific Contractor,
    - define the concrete terms of operations, and
    - establish the arena of communication between the Government and the Contractor
- In the national context a Production Sharing Agreement:
  - must be interpreted on the background and within the legal framework provided by the petroleum legislation, including any implementing regulations, other relevant legislation and applicable standards
  - is usually referred to as a PSA, sometimes a PSC (Production Sharing Contract). The terms are interchangeable, and do not denote differences in principle

# PRODUCTION SHARING – ILLUSTRATION



# CONTENT OF A PSA - FIVE GROUPS OF CLAUSES:

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1. Identifying and Regulatory Provisions
  - Parties, Authority (Grant of Rights), Contract Area, Contract Period (Exploration Period, etc), Area Relinquishment, Work Programme
2. Financial Provisions and Production Disposition
  - Funding, Rights to sell Crude, Exchange rights and obligations
3. Cost Recovery, Production Sharing and Taxes on Income and Profits
  - This is main part in the following
4. Organisational and co-operative aspects
  - Operatorship, Supervision of Operations, Co-operation between Contractor and State Party, State Participation
5. Legal and non-operational Matters
  - Guarantees, Liabilities and Insurance, Assignment of Interests, Title to Assets, Confidentiality/Publication, Dispute Settlement, Amendment of PSA, Termination of PSA, Applicable Law, Approval and Ratification

# PSA STRUCTURE – TWO EXAMPLES

## **Ghana Model Petroleum Agreement:**

- Definitions, scope, contract area
- Exploration, period and minimum programme
- Relinquishment
- Management; joint management committee, rights and obligations
- Commerciality – sole risk
- Sharing mechanism – measurement and pricing
- Taxation
- Special provisions on natural gas
- Domestic Supply Obligations
- Inspections, safety and environmental
- Miscellaneous:
  - stabilization
  - accounting and auditing
  - procurement
  - employment and training
  - force majeure
  - assignment
  - duration
- Arbitration
- Accounting guide

## **Angola Model Production Sharing Agreement:**

- Definitions, object of agreement, duration
- Exploration; period and extension
- Production period
- Operator
- Costs and expenditures, recovery, production sharing
- Lifting and disposal
- Work obligations
- Commerciality
- Budgets and plan; exploration and production phases
- Guarantees and bonuses
- Records, reports and inspection
- Purchase obligations
- Unitization and joint development
- Transfer and abandonment
- Natural Gas
- NOCs sole risk
- Management; operating committee
- Ownership of assets
- Miscellaneous:
  - liability for loss and damage
  - recruitment, integration and training
  - assignment
  - termination
  - force majeure
- Arbitration
- Accounting and financial procedures

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# COST RECOVERY – COST OIL

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- Contractor performs petroleum activities at own risk & at own expense
  - In case of no discovery, contractor takes the loss (meaning of risk and expense)
  - In case of commercial discovery, eligible costs are recovered through cost oil taken from the production from the field in question
- Cost oil is part of production - normally with an annual ceiling (percentage of production)
- Cost oil normally includes:
  - Operational costs (opex)
  - Expensed capital costs (capex)
  - Current year depreciation
  - Investment credit (uplift)
  - Decommissioning fund allocations
  - Unrecovered costs carried forward from previous years
- Interest and bonus not normally cost recoverable
  - (but can be in some cases)

## A TYPICAL COST RECOVERY FORMULA

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1. Rules for recovering costs incurred (Recoverable costs)
2. Royalty (if applicable) shall be charged first on total production, normally calculated to the Delivery Point before recovery of costs.
3. Gross production = Volumes at Delivery point, net of any royalty
4. Recoverable Cost to be recovered from Cost Oil
  - First, recovery of OPEX
  - Then, recovery of Exploration expenses (including CAPEX)
5. Any unrecovered Recoverable Costs are carried over to next accounting year
6. Remaining Crude Oil after deduction for recoverable costs (Cost Oil), thus:  
$$(Gross\ Production - Cost\ Oil) = Profit\ Oil$$
7. Then, getting to Government's share:  
$$(Profit\ Oil - Contractor\ Take) = Government\ (Production)\ Take$$

# RANGE OF COST RECOVERY LIMITS PER YEAR

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- 30 – 40 %: Low end typical
- 45 – 65 %: Middle – upper end typical
- World average is 60 – 65 % limit
- General range is 50 – 70 % limit
- Some PSAs have no limit
  - means that entire production in a year may be taken for cost recovery
  - In such a year, Government Take is zero.



# COST RECOVERY – EXAMPLE FROM A GIVEN PSA

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- Three categories for costs recognised:
  - Exploration Expenditure
  - Development Expenditure
  - Operating Expenditure (OPEX)
- Amortization and Recovery
  - All OPEX to be recovered in year in which they are incurred
  - Exploration and Development Expenditures to be amortized over a set period (Z calendar years)
- Cost Recovery limited to 45 percent of annual oil production
  - Remaining oil (55 percent or more) to be allocated for Profit Oil Sharing
- Ring fencing for certain fields in certain blocks

# COSTS – GENERAL ISSUES

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- Does the PSA contain a general arms' length principle for costs?
  - or are actual costs incurred recoverable per se
- Is there a requirement for competitive bidding for procurement,
  - If so, selection which shall be on arm's length basis
  - except, priority may be given to local contractors, sometimes on "competitive terms" (see Local Content below)
- Audit right ?
  - For whom?
- Costs must be actually incurred

# CLASSICAL COST ARM'S LENGTH MATTERS

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- Group main office charges (Parent Company Overhead, or just Overheads)
- Group R & D and IT etc. charges
- Insurance premiums to captives
- Group service charges
- Forward contracts, or other special financial instruments
- Fictitious, or overstated invoices

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# PROFIT OIL

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- Profit oil = Total production – Cost oil (or Sales Revenue – cost recovery)
- Analogue to
  - Taxable income in a concessionary system, and
  - Service fee in a service agreement
- Profit Oil is shared between the contractor and Government
  - Is sometimes, but not always taxed
  - The Government share has similar economic effect as income taxes
- In many countries the sharing percentage is an important bidding parameter in tender competitions for new contract awards
  - Thus, the exact sharing percentages often vary between contracts even in the same country.

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# FIELD PROCESSING FACILITY AT UNITY FIELD, SOUTH SUDAN



# PRODUCTION SHARING – DIFFERENT MODELS

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- Fixed split of Profit Oil between contractor and Government
- Production volume based tiered scales
  - The higher the production, the bigger the government proportional share of profit oil
  - Unresponsive to fluctuations in oil price
- Profit based mechanism
  - An increased Contractor profitability will mean a higher government proportional share of production
  - Internal rate of return threshold (IRR-basis, or R-factor)
  - Responsive to fluctuations in oil prices and cost basis
  - More efficient and more flexible
  - “A sharper and more accurate tool, to be used with care”
- Current international trend: Profit based mechanisms gaining ground
  - Adequate for balancing the interests of Host Country and IOC (stability and flexibility) – more sustainable
- About 80 % of PSAs worldwide are based on tiered steps with Government share of Profit Oil increasing with increased production volumes
  - Often sectioned in tranches (sometimes called «sliding scale»)

# PSA PRODUCTION SHARING (VOLUME BASED EXAMPLE)

<b>Production level tier barrels/day</b>	<b>Government share (percentage)</b>	<b>Contractor share (percentage)</b>
1 – 20,000	60 %	40 %
20,001 – 40,000	65 %	35 %
40,001 – 80,000	70 %	30 %
80,001 – 100,000	75 %	25 %
100,001 - >	78 %	22 %

# RATIO FACTOR (R-FACTOR)

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- Objective:
  - A more equitable sharing between Government and contractor based on profitability
- Design
  - Both revenue and costs are included in calculation
  - The R-factor deals with all variables that impact project economics
    - Calculated in each accounting period
    - Several thresholds are established
      - Once a threshold is crossed, a new share will apply
    - Example of simple R-factor formula:

$$R = \frac{\textit{Contractor's cumulative revenue}}{\textit{Contractor's cumulative cost}}$$

# EXAMPLE OF PROFIT SPLIT BASED ON R-FACTOR

R-Factor	Contractor's share	Government share
< 1	95 %	5 %
1.001 - 2	90 %	10 %
2.001 - 3	85 %	15 %
3.001 - 4	70 %	30 %
4.001 - 5	60 %	40 %
5.001 <	50 %	50 %

$$R = \frac{\text{Contractor's cumulative revenue}}{\text{Contractor's cumulative cost}}$$

R = 1 means that the contractor has achieved payout (break-even)

R < 1 means the costs are not recovered, i.e. the contractor gets a high share

The R-factor is cognisant of all factors that impact project economics

Contractor's potential upside from price increases is diminished, but downside is also protected

If costs increase, the R-factor mitigates negative impact for contractor (Government's risk)

If costs are reduced, both contractor and Government benefit

# PROFIT OIL SPLIT – A SUMMARY

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- A profit based mechanism
  - R-factor (payout formula), or
  - Internal rate of return (IRR) thresholds – not discussed here
  - Responsive to fluctuations in oil prices
  - More efficient and more flexible
  - Suitable for a long-term contract like a PSA
  
- Production volume based sliding scales
  - Provide Government with greater share of profit oil at high rates of production
  - Unresponsive to fluctuations in oil prices
  - More practical or easy to apply
  - Nearly 80 % of PSAs worldwide use this volumetric mechanism
  - Inflexible

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# SALES OF GOVERNMENT PRODUCTION ENTITLEMENTS AND PRICING

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- Host country obtains petroleum in kind, e.g. through royalty, production shares .The host country can either
  - Sell its share of petroleum itself;
  - Instruct the NOC to do it; or
  - Instruct the Contractor to do it
- Host country sells petroleum: Market prices (But who is able to get the best price?)
- Contractor sells on behalf of host country:
  - Usually a requirement that it shall be on same terms as the Contractors petroleum
  - But very important to ensure that sales are at arm's length
    - The contract price should be sole consideration for sale
    - Terms not affected by commercial relationship other than the sales and purchase contract itself
    - Neither seller or any person connected with seller has directly or indirectly any interest in subsequent resale or disposal of petroleum
  - What of the common practice of the Contractor selling to an affiliate?
- PSAs often include pricing/valuation of crude oil and gas clauses - why?
  - Determine taxation, cost recovery, production sharing, sales on domestic market, royalty valuation

# VALUATION OF CRUDE OIL

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- Market prices must be the basis
  - But, some agreements have approximations to «market prices»
- In some (landlocked) countries, the production process is integrated with transportation to shipping port
  - Market price is obtained at the point of delivery (shipping port)
  - Then, a «net-back» calculation can be prescribed:
    - Net-back Crude Oil Price = [Export Crude Oil Price] minus [Tariff]
    - Tariff element would include:
      - Transportation and processing tariffs
      - Other explicitly relevant costs and sometimes transit fees, customs duty, etc where applicable
  - Such net back method may be
    - Detailed in PSAs
    - Does not include additional costs agreed
- What is role of Auditor with respect to valuation?
  - Verification of correct pricing
  - Verification of correct cost recovery

# EXPORT CRUDE OIL PRICE - EXAMPLE FROM A PSA

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- Determined quarterly
- Weighted average price actually realised FOB Delivery Point in US Dollars
- Arm's length export sales to third parties
  - Same standard applies for sales to affiliates
- Quarterly Reports:
  - Full supporting documentation, including invoices, for each cargo with pricing, payment terms, receipts, detailed price calculations
  - Presented by oil company and Minister respectively
  - Procedure for disagreement

# METERING REQUIREMENTS – QUALITY ADJUSTMENT

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- Metering requirements Most PSAs (and transportation agreements) specify
  - Background: Need to verify basis for Government Take
- Quality adjustment procedures
  - Necessary where different petroleum streams are commingled in processing, transportation and storage systems
- Quality adjustment is usually regulated in transportation and processing agreements
- What is role of Auditor in this system?
  - Control of Regulator's performance in monitoring the operators' metering system.
- Why is metering important?
  - Errors in metering will affect value distribution and government income

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# RELATION OF PSAs TO NATIONAL LEGISLATION

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- The relationship between national legislation and PSAs:
  - PSAs are entered into within the framework of the law of the land,
- A PSA is a private law instrument
  - The contract awards rights to explore and produce petroleum, in accordance with applicable legislation
  - Trend: More terms fixed in legislation - less freedom of contract for State?
- Particular issue: Effect of new legislation on existing agreements
  - Will the new legislation change the terms bilaterally agreed in a contract?
  - Or will the contract prevail – in accordance with the traditional legal maxim of *pacta sunt servanda*?

# CONTRACTUAL STABILIZATION PROVISIONS

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- Meant to address political risk, i.e. to restrain governments from subsequent intervention in PSAs by exercise of state powers
- Various structures and scope, including
  - «Freezing» the state of the law: In general or selected areas (e.g. tax laws)
  - “Intangibility clauses”: Clauses that merely state that the State may not unilaterally modify or terminate the PSA
  - Renegotiation clauses
- Enforceability not a settled issue, various views including:
  - Contract subject to international norms, including pacta sunt servanda
  - Stabilization (freeze) clause derogation from principle of sovereignty
    - Permanent sovereignty of natural resources cannot be waived
    - Sovereignty lawful ground of termination - Compensation (expropriation)



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# RISK PROFILE

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- Legislation:
  - Often approval mechanisms present opportunities for soliciting bribes
- Reporting requirements:
  - Inadequate reporting systems may obscure facts and prevent control
- Accounting practices:
  - Poor accounting makes oversight difficult and prevents control
- Special topic: Local content
  - A very popular element in national legislation in many resource rich countries
  - But, local content requirements have been a major source of irregularities:
  - In some countries, such requirements have created straw man companies, that
    - siphon off value for benefit of undeserving agents and middle men
    - obscure where value is created
    - prevents optimal extraction of resources
    - makes resource administration more difficult
- Risk mitigation: Requirements for publication of payments made and payments received (cf. EITI)

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# PUBLICATION OF PSAs – TRANSPARENCY

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- How to handle disclosure or non-disclosure of information found in a PSA?
- The legal aspect:
  - Publication requirement in new legislation and EITI principles
  - Publication requirement under the legal tradition of the HC?
  - Does the PSA include confidentiality/non-disclosure provisions?
- Broadly; two different scenarios:
  - “Older” contracts
    - Often subject to strict non-disclosure provisions
      - Stabilisation clauses – may new requirements be imposed on existing contracts?
      - Principle of retroactivity – may also pose limitations for implementing new requirements.  
Depends on HC legal tradition
  - “New” contracts
    - Model contracts (Model Production Sharing Agreements (MPSA))
    - Transparent award of licences

# «OLD» CONTRACTS: CONFIDENTIALITY CLAUSES

- Both companies and governments argue that confidentiality clauses prevent disclosure of contract information
- Main features of confidentiality clauses:
  - Often standard form – similar to those widely used in commercial contracts
  - Covers a broad range of information –
    - All information between the parties are regarded as confidential unless otherwise specified
  - Exemption: Public information, disclosure required by law
  - Duration - no limitations
    - May also apply after termination of the contract

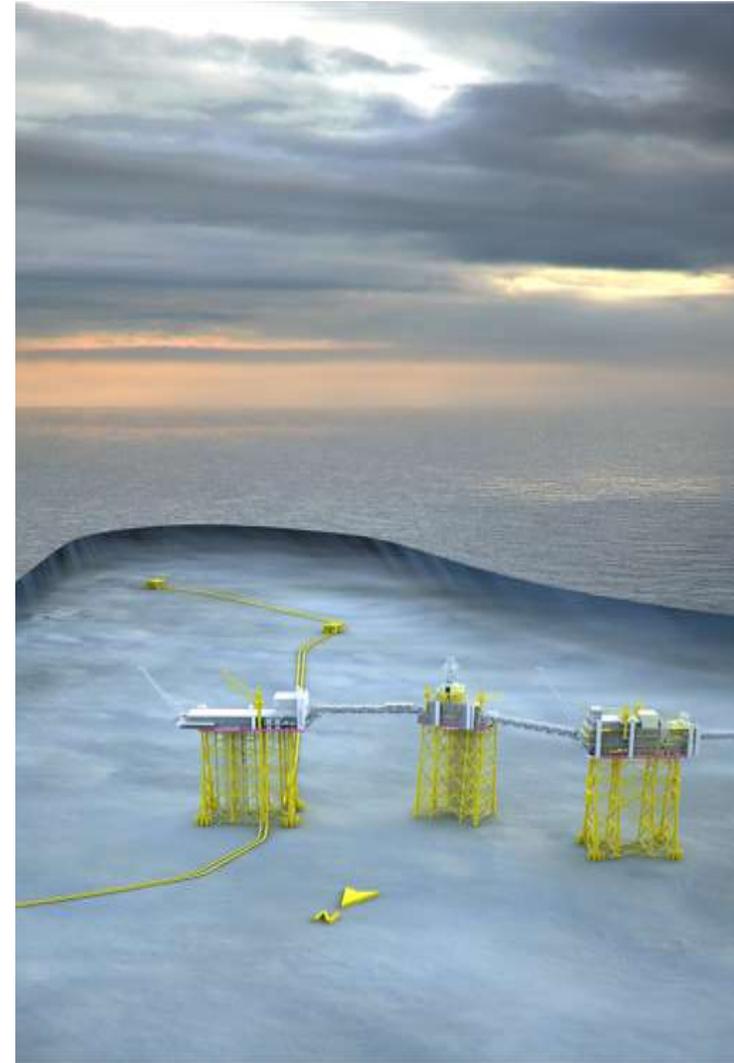


Illustration: Statoil

# «OLD» CONTRACTS: CONFIDENTIALITY CLAUSES

- Although confidentiality clauses may exclude disclosure of contracts - this is not always the case
  - Exemptions, as mentioned
  - Always subject to interpretation of the clause under the legal regime of the HC
  - May be published after mutual consent of the parties, or if covered by exemptions under the contract
- Many of the confidentiality clauses in PSAs have wording identical to clauses found in purely commercial contracts
  - PSAs differ from these contracts – different subject matter and context - Fit for purpose?
- Breach of contract – what are the consequences?
  - Depends on provisions of the contract and/or the legal tradition (e.g. penalties or termination of the contract etc)
  - Legal action – may be a consequence, but not always



# ARE "BUSINESS SECRETS" A GOOD DEFENCE?

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- Companies often argue that a PSA include a wide range of business secrets or commercial sensitive information and should be kept confidential
- No official legal definition of "sensitive information", but the term "trade secrets" is defined in Black's Law Dictionary as follows:
  - "A trade secret may consist of any formula, pattern, device or compilation of information which is used in ones business, and gives [the holder] an opportunity to obtain an advantage over competitors who do not know or use it."
- This implies that one must make a distinction between merely disadvantageous information and information that have economic value or that may cause economic harm if known

# WHAT IS A BUSINESS SECRET?

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- What kind of information may be regarded as sensitive information in a PSA?
- What will be regarded as confidential information is subject to interpretation of the confidentiality clause in the PSA
- Company point of view may be:
  - The contract may include information on work obligations that may be used by other companies in future tenders
  - In accordance with new developments of moving regulatory requirements from contract to legislation the PSAs comprise purely commercial information that should be kept confidential - including financial terms
  - The contract may include company specific information and this information will not contribute to the goal of fighting corruption

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# PUBLICATION OF PAYMENTS

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- If the HC has implemented publication requirements as a part of their legal framework for the petroleum industry certain payments to the government will be known to the public
  - Need to be evaluated based on substantive law of the HC
- EU
  - [Adoption of Directive 2013/34/EU on the annual financial statements, consolidated financial statements and related reports of certain types of undertakings](#) (Chapter 9: Report on payments to governments)
- US
  - Dodd Frank Act
  - United States Securities and Exchange Commission (SEC)
- EITI standards – requirement 4
  - Used as a recommendations for implementing requirements into national legislation

## PUBLICATION OF PAYMENTS (II)

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- The EITI standard recommends *inter alia* that the following information should be made publically available:
  - I. The host government's production entitlement (such as profit oil);
  - II. National state-owned company production entitlement;
  - III. Profit taxes;
  - IV. Royalties;
  - V. Dividends;
  - VI. Bonuses, such as signature, discovery and production bonuses;
  - VII. Licence fees, or rental fees, entry fees and other considerations for licences/ and or concessions; and
  - VIII. any other significant payments or material benefit to the government

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# PUBLICATION OF AUDIT RESULTS

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- If PSAs are not publicly disclosed, will this prevent publication of audit results?
  - Will depend on
    - local law (incl. regulations and contracts)
    - on what basis the information was acquired, and
    - how information from the audit is presented to the public
- Where information and data have been disclosed in spite of a confidentiality undertaking, certain parts of the basis for a particular audit result may need to be suppressed in the audit report.

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# THANK YOU FOR YOUR ATTENTION

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# ANNEX: PUBLICATION AND CONFIDENTIALITY

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- Example from South Sudan:
  - Text from the Petroleum Act, 2012

- PSAs normally stipulate that each party shall treat data and information as confidential, and not disclose such to any third party without the other party's prior approval
- But, Section 77 (2) of the South Sudan Petroleum Act, 2012 says otherwise:

- (2) The Ministry shall publish in the Gazette and by any other appropriate means to inform interested persons:
- (a) calls to tender under Section 18 of this Act;
  - (b) notice of the grant of licences and petroleum agreements and the grounds for the grants, and a summary of the terms of the licences and agreements;
  - (c) a summary of the plan for development and operation;
  - (d) notice of the termination of licences and petroleum agreements; and
  - (e) all key oil sector production, revenue, and expenditure data.

- Furthermore, section 79 (1) of the same Act requires of the Minister:

**79. Ministerial disclosure and publication**

- (1) The Minister shall make available to the public, both on the Ministry website and by any other appropriate means to inform interested persons:
- (a) all key oil sector production, revenue, and expenditure data, petroleum agreements and licenses;
  - (b) regulations and procedures related to the petroleum sector;
  - (c) justification of award of petroleum agreements, the beneficial ownership information for the contractor and documented proof of the requisite technical competence, sufficient experience, history of compliance and ethical conduct and financial capacity of the contractor ;
  - (d) annual production permits;
  - (e) any model petroleum agreement referred to in Section 71;
  - (f) the key parameters of each petroleum agreement, to the extent such parameters differ from an already published model petroleum agreement, including the cost oil management and limits, the production-sharing formulas and mechanisms any bonuses, taxes or fees, royalties, any exemptions or favourable tax treatment and any stability clauses; and
  - (g) except for the information and data referred to in Section 76 (5), information relating to petroleum activities, including information on petroleum agreements and relevant treaties as prescribed in the regulations.

- Section 76 (5) of the same Act provides two exemptions from the publication requirements:

- (5) Information received pursuant to this Section shall not be made public if such information:
  - (a) contains proprietary data belonging to the government, license or contractor; or
  - (b) must be kept confidential in order to maintain a climate of competition between the licensees and contractors participating in petroleum activities;