Advocates & Legal Advisors

A Comparison of the Royalty Tax System and the Contractual System

by Andreas I. Kitsios and Christoforos I. Kitsios

June 2013

Contact Information

Emmanouel Roides, Kirzis Center, Block D, Office D15, 1st Floor, 3031, Limassol, Cyprus

t: +357 25 361080
f: +357 25 375229
e: info@aiklaw.com
w: www.aiklaw.com

OVERVIEW

An International Oil Company ('IOC') must get permission from the owner (the host State) to explore and develop its hydrocarbons. Permission is granted through various arrangements. In this publication, we are concerned with Concessions and Production Sharing Contracts (PSCs). Concessions belong to the royalty/tax system and PSC to the contractual system. Under PSC, the host State represented by an agent, usually a NOC, grants contractual rights to an IOC to explore and develop its natural resources in a designated area. Concessions however, are licences granted by statutory grant of rights which may be complemented by contractual provisions.

Concessions and PSCs, share similarities but many differences as well, as to the level of control on operations, involvement of the State in operations, division of revenues, costs recovery and so on, for which an analysis will be made below.

COMPARISON

Certainty

A PSC, which is of contractual nature, is more attractive to IOCs when a stabilisation clause is inserted therein. A stabilisation clause ensures continuity and guarantees certainty which is very important, especially for IOCs seeking to operate in a risky jurisdiction. Notably, although

PSCs, give the opportunity to insert a stabilisation clause, they can still be uncertain as regards the governments take through taxes, if large number of administrative levies exist. Concessions on the other hand, are granted mostly under legislative frameworks and hence, are more uncertain in comparison to PSCs.

Ownership

Under Concessions, State owns the hydrocarbons and the title is transferred to the IOC when petroleum enters the IOC's well. Under PSCs though, the title of the hydrocarbons belongs to the state which ultimately shares the revenues the IOC in line with the specified contractual procedure provided in the PSC. Importantly, although ownership of hydrocarbons under PSCs remains to the State, it offers to the IOC the opportunity to book in its accounts the petroleum reserves discovered and proved. This means that ultimately, an IOC will be able to enhance its share value and use the reserves as security to loan agreements. Hence, the fact that the ownership of hydrocarbons does not pass to the IOC like under Concession Agreements, should not be an issue.

Operations

Under Concessions, typically, few interventions or limitations exist over the development activities of the IOC. IOC is given wide discretion on its activities, save some government consents on important issues. Under PSC, the IOC is managing the development, but usually the operations are supervised by a State's committee, which reviews and approves working programmes and the relevant budget. Intervention in the day to day management under PSCs is usually higher.

Benefits Division

Under a Concession, when production starts, the title of hydrocarbons passes to the IOC which then profits from selling the hydrocarbons. In consideration, the IOC pays royalties and taxes to the government. A sliding-scale system can be used for royalties and for taxes as well, like in PSCs. Taxes, include income tax and usually a special tax. Following royalties, an IOC is allowed to recover its costs, usually without a recovery cap like under PSCs. From the viewpoint of the IOC this would mean faster recovery of its costs.

On the other hand, under a basic PSC, the resource allocation process differs a lot from Concessions:

i. First a royalty is usually payable, which the IOC has to pay in cash or in kind a fee on gross production, even though the title of hydrocarbons never passes to the IOC. An IOC should negotiate to get a sliding scale on royalties so in case the field is marginal, the royalty be lower and increase only when production increases. In particular, when the reserves are large, a low fixed royalty is favourable to an IOC but if marginal, a sliding scale. All however, depend on the level of the royalty, that being either sliding or fixed. In addition, an IOC may be benefited if payment is in cash and the posted price (value of output) is lower than the market price. In some PSCs royalty is deductable from income taxes and in others royalty is considered as expenses. It is preferable to negotiate that the royalty be deductable from income taxes rather than being considered as expenses for various reasons.

ii. Following royalties, an IOC is usually, allowed to recover its costs (cost oil). Notably, a cap is almost always imposed on costs recovery. An IOC should negotiate that any remaining costs will be allowed to be brought forward and deducted. The level of cost recovery is really important to the IOC in order to recover promptly. Moreover, a clause providing that the IOC will recover cost oil incurred during development phase, with interest on it, would be beneficial to the IOC and is strongly suggested.

iii. Following 'cost oil' and some production-related taxes like VAT, 'profit oil' comes up. Profit oil is the remainder of the revenue of the production which is shared at an agreed rate between the IOC and the State. In particular, profit oil, is shared between the IOC and NOC, according to working interests and participation agreement at specified share, which usually employs a mathematical formula. There may be a sliding scale which changes according to the daily production or 'R factor'.[1] Profit oil may be considered to be analogous to the special tax levied under concessions.

iv. Last, the government can impose an income/corporate tax on the share of the IOC's profit oil like in concession.

[1] R factor is the accumulated receipts actually received by the IOC divided by accumulated capital expenditure and operating costs. Under R factor, government's share of profit oil increases as the R-Factor increases.

Common features for both concessions and PSCs are the signature and production bonuses, capital uplifts, domestic market obligations, ring-fencing provisions and tax or royalty holidays.

CONCLUSION

Although concessions and PSCs are different in their main dispositions, they provide an almost mathematically equivalent result as regards the IOC’s take. The view that PSCs are more favourable to States, in contrast to an IOC, is a misconception. What counts in the end is what the agreement actually contains in its articles.