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A COMPARATIVE REVIEW OF MODERN CONCESSION CONTRACT (MCC), AND PRODUCTION SHARING CONTRACT (PSC)

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Abstract

The importance of Oil and gas to the growth and development of world energy supply cannot be over emphasized. There are four basis arrangements to develop petroleum between host countries and the multinational oil companies: they are modern concession contract (MCC), production sharing contract (PSC), participation agreement, and the service agreement. This paper is principally concerns with Petroleum Upstream Contracts and arrangements. Upstream' are all the services required to find and produce the oil and gas. Therefore, the focus of this paper is to examine the two basic systems of modern concession and production sharing contract arrangements, and then see how host countries can make legal and contractual terms as attractive as possible to foreign investors, while still protecting the critical interests of their states.

Keywords: Company, Concession contract, Production shaing contract

1. Introduction

Government and companies negotiates their interests in one of the two basic systems: Concessionary and Contractual. Modern concession contract (MCC) is a contract between the host state and the contractor which grants exclusive right to contractor to explore and produce mineral resources in a given area of land for a certain period.¹ Concessionary system allows private ownership of mineral resources. The rights to produce the minerals will be granted in exchange for a royalty payment and income taxation from the company, and host state has a very little or no control on its activities.² Under the concession contract, production of oil and gas is allocated to the contractor, and the contractor acquires ownership of the production at the

¹ An example of the rights typically granted to Contractor under a Concession can be found in the Danish 5th Round Model License, 1997, which provides that, this License confers upon the Licensee the exclusive right to explore for and to produce hydrocarbons, as defined in section 1, within the area referred to under section 2.

² N. Pongsiri, 'Partnerships in Oil and Gas Production- Sharing Contracts' [2005] IJPSM Vol. 17, No 5 at 432.

wellhead, although, with host state retain ownership of the resources that remain in the subsoil.³

The most common type of contractual arrangement is the production sharing contract (PSC). The PSC represents one of the modes which bring in a foreign company as a contractor to provide technical and financial services for exploration and development operations. Foreign company have the right to receive a share of production or revenues from the sale of oil and gas in accordance with an agreement.⁴ In a PSC arrangement, "it was said that the government has a high participating interest, normally 60-85 per cent, and the right to assign its own staff to the joint operating company from the beginning."⁵ Thus, in its simplest form, the PSC has variety of elements, including provisions covering cost recovery oil, profit oil split and income tax. The contractor provides the entire investment capital and the ring fence is limited to the contract activity.⁶ Additional taxes and payments will usually be provided for in PSCs including royalties, bonus payments, state participation, resource rent tax, investment credits, re-investment obligations, domestic supply obligations.⁷

Under PSC the government retain ownership of mineral resources.⁸ The principle is that mineral resources represent such a valuable resource that they should be vested in the state for the benefit of all the state's citizens and not owned by individuals.⁹ And, the state body has management control, whilst the contractor has operational control.¹⁰ In most PSC systems, the facilities put in place by the contractor within the host government domain become the property of the state either the moment they are landed¹¹ in the country or upon startup or commissioning. Sometimes, the title to the assets does not pass to the government until the attendant costs have been recovered.¹² But the title of the hydrocarbons remains with the state.¹³ Equipment

³ King & Spalding LLP, 'An Introduction to Upstream Government Petroleum Contracts: Their Evolution and Current Use' (2005) Vol. 3, No1 at p16.

⁴ N. Pongsiri (n2)

⁵ Ibid at 435

⁶ M. Hasan, 'Indonesia's Petroleum Contracts: Issues and Challenges?' [2005] I.E.L.T.R Vol.3, No 1 at p4

⁷ H. Yumiseva, 'Can production Sharing Contracts Promote Transparency in the Management of Oil income? The Case of Equatorial Guinea' (2005) I.J.P.S.M Vol.3, No1 at p5.

⁸ S. Stern, Russia's Production Sharing Contract Regime (2005) Vol.3, No 1 at 4

⁹ An example is Article 4 Kyrgyz Petroleum Law 1998 provides that all geological resources of oil and gas present in the Kyrgyz surface are the exclusive property of the state.

¹⁰ TM Pitt, *Oil and gas law- Indonesian style* [2000] IELTR, 9, 229

¹¹ An example is that of Indonesian PSC

¹² An example of this could be seen under Mongolia PSC art 15.1

¹³ N. Pongsiri (n2) at p433.

purchased and imported by the contractor become property of the State.¹⁴

It is essential to note that Production Sharing Agreement (PSA) or MCC adopted in one country is different to another in many respects, including the terms of the contract, the presence or absence of regular payments for subsurface use, the fixing of a ceiling on costs or reimbursable to the investor.¹⁵

However, this essay essentially considers the question of what is the most favourable Petroleum upstream contract between the MCC and PSC. Broadly speaking, the most favourable legislative framework between a MCC and PSC would be determined bearing in mind the following important issues: financial payments, domestic market supply, the economic, social and scientific benefits, bidding and discretionary systems.

2. Financial Payments

Under this subsection, the main focus is to look at the financial payments under the MCC and the PSC. For the state to achieve their desired foreign currency revenue, it depends solely in the way Petroleum fiscal regime is drafted. This petroleum fiscal regime may be in the form of legislation or in contractual framework or a combination of the two.

Originally, what makes Traditional Concession different from that of the MCC is that, the host state solely received royalty as a financial benefit, and later royalty and taxes.¹⁶ The modern concession's terms for compensation are considerably more generous than those of the early concession. However, under MCC financial payments includes royalty, taxes, income, signature bonus, annual benefit, annual bonus and charges. For example, the fiscal regime of Thailand's MCC comprises a surface reservation fee, royalty, income tax, and the Special Remuneratory Benefits (SRB). Royalty is paid quarterly and it is sliding scale of rate. The Thai fiscal terms have become more attractive and appropriate. In term of the MCC financial payments, Thailand has the most interesting one because their taxes relates to oil and gas but in Costa Rica for example taxes are not peculiar to the production of oil and gas.¹⁷ For instance, Thailand's SRB provide for supplementary taxation in cases where profits accruing to foreign investors exceed certain limits. The objective of tax diversification is to increase the host countries' revenue in relation to the profitability

¹⁴ http://www.beg.utexas.edu/energyecon/new-era/case_studies/Fiscal_Terms_for_Upstream_Projects.pdf, accessed on 7/5/2015.

¹⁵ I. Bantekas, J. Paterson, M. Suleimanov, *Oil and Gas Law in Kazakhstan: National and International Perspectives* (Kluwer Law International, 2004)p205

¹⁶ H. G. Broadman & E. J. Wilson, "Trials and Tribulations of Third World Petroleum Development: Lessons and Advice for Prospective Producers", in K. Khan ed., *Petroleum Resources and Development*, 262-263.

¹⁷ See Clause 25 Model Contract of Costa Rica

of petroleum operations. As it was argued, the purpose of the SRB is to pass to the Thai government a share of the additional profits arising, for example, from substantial increases in the price of petroleum, bonanza discoveries, and very low cost discoveries.¹⁸

However, under the PSC financial payments has to be considered as well to see which system will work perfectly for the government of various host states. The PSC was pioneered in Indonesia in 1967 and is still used there; therefore Indonesia's PSC will be a good example to be considered here but in term of financial payments it is not necessarily the best in favour of every host countries. Hence let take Mongola for example, Mongolia's PSC contains, royalty, which required contractors to pay within 30days from the end of each calendar month or, as otherwise approved by the government representatives.¹⁹ However, contractors are oblige to provide for signature bonus under Mongolia's PSC in favour of the government, this will be payable upon the confirmation of the contract by the Republic of Mongolia.²⁰ Also, is the production start up bonus, which require contractor to pay within thirty days after the date of the first commercial discovery. Mongolia's PSC, however, require certain sum to be payable to the government as a production bonus, after average daily quantity of Contract Crude Oil for any Calendar Month exceeds 10,000 Barrels; 20,000 Barrels; 30,000 Barrels; and 40,000 Barrels.²¹

However, based on what we have examined under MCC and PSC from Thailand and Mongolia for example, one could easy conclude that financial benefit of PSC system in Mongolia is much more better and will go a long way in satisfying the interest of any host states. The reason being that, in the case of concession, the states' interest are restricted to royalties and taxes, and the licensee or concessionaire, will be free to produce and sell oil and gas without any limitations.²² Whereas, PSC system is usually open to negotiation, that is, state can modify existing legislation and applies the new rules to existing contractual agreements such as increases in taxation of the contractor and changes in the split of revenue if state feel that it's not earning enough from the contract. Hence, the state has a discretionary power to include royalty, its share of profit oil and income tax in the production sharing agreement. Additional taxes and payments that will usually be provided for in PSCs including bonus payments, and resource rent tax, training bonus and other charges and fees. Therefore, financial payments in PSC system seems to be the best compare to the MCC, as this can increase the host countries' revenue in relation to the profitability of petroleum operations.

¹⁸ Z Gao, *International Petroleum Contract* (Kuwer, 1994) p44
¹⁹ Art VIII Model PSC of Mongolia
²⁰ Ibid at Article 10(1)(a)
²¹ Ibid at Article 10(1)b and c
²² N. Pongsiri, (n2) at p436

3. Domestic Market Supply

Domestic supply obligation is one of the several provisions which are designed to make the contractors' operations serve domestic economic development. The purpose of this provision is for the host states to retain certain portion of petroleum exploited to satisfy local consumption.²³ This provision may be either mandatory or discretionary, but it is substantially based on the negotiation and agreement between the state and the investors.

4. The Economic, Social and Scientific benefits

For the government of any host states to be able to develop its economy and raise the standards of living of its people through the maximum use and benefit from the country's Petroleum resources. It is essential to consider the issues like local empowerment, local supply of goods, employment and training, technology transfer scholarships, grants and social and welfare benefits etc.²⁴ This provision are usually refer to as 'special advantage and what constitute special advantages is principally depended on its objective irrespective of whether a MCC or a PSC framework is used. This is an issue for negotiation between the parties, the reason is that neither the petroleum acts nor the model contracts have any specific provisions for this advantages.²⁵ For instance, the government of the host states may want to draft their petroleum fiscal regime in such a way that it will require the Investors to use and purchase goods supplied, produced and manufactured in the country, give preference to such supplier, producers or manufacturers, employ and train the citizens of the host states and cooperate with the companies in the state to enable them develop skills and technology to service the petroleum industry. But these local preferences for manpower, goods and service must satisfy the condition of international competitiveness.

The local preference clause certainly has significant political, social and economic implications, which in country like Thailand and Indonesia²⁶, the real value of such requirements remains in doubt because it has only a very limited capacity to produce petroleum equipment.²⁷ That is, this issue of giving preference to local goods and services might not make a big difference if the host state in question does not have any necessary equipment to produce goods and services.

²³ TM Pitt, *Oil and gas law- Indonesian style* [2000] IELTR, 9, 228.

²⁴ Z Gao, *International Petroleum Contract* (1994)p36

²⁵ *ibid*, Z Gao at 37.

²⁶ Contractors needs not worry about Indonesia's preferential requirements to use domestic goods, because no exploration equipment is made locally and mostly are imported.

²⁷ *ibid*, Z Gao at 93.

In a concessionary system, Turkmenistan's law provides that the contractor must give preference to goods produced or available in Turkmenistan and services which are rendered by Turkmenistan's citizens provided such services are offered on terms equal to imported goods. Also the contractor must train Turkmenian citizens for staff positions, including administrative and executive management.²⁸

In Ukrainian PSC law, Local content rules regarding the use of Ukrainian goods and services and personnel to apply, but the exact obligations of the investors are determined in the negotiation of the contract. However, Art. 8.5 of the PSA Law states that priority should be given to the use of materials of Ukrainian origin where they are of "equal price, terms of completion and quality as those of world standard" and that the personnel for any project should mainly be Ukrainian and that provisions should be made for their training.²⁹

5. Bidding System

Our main focus here is to examine the process of awarding petroleum rights that would provide fairness, transparent and therefore minimize corruption. Generally, individual negotiation and competitive bidding are the two methods of obtaining exploration and petroleum rights.³⁰ The only difference between the two systems is the way the information is being handled. Individual negotiation is premised on secrecy while bidding system is based on information disclosure.

Normally, individual negotiation occur when either the investor or state approach the other to negotiate for the granting exclusive right to explore petroleum. However, the reason why individual negotiation may not be a better option for some host states is that, the process encourages secrecy on which corruption may arise as a result. However, competitive bidding system require applicants to meet certain requirements to participate in the bidding process. The winner of the bid would be determined on the basis of competitive sealed bids. The bid may be based on the percentage of royalty which an applicant may be willing to offer or the cash bonus offered by the applicant for the license.³¹

According to John McMillan, the openness of the auction can prevent the suspicion of undue influence, impropriety or even corruption that sometimes arises when

²⁸ JB Varanese and JH Hines, 'Turkmenistan's Oil and Gas sector: Overview of the Legal Regime for Foreign Investment' [2001] IELTR, 1, 8. P9

²⁹ S. Diyachenko and R. Worral, Recent Amendments to the Legislation on Production Sharing Agreements in Russia, Ukraine and Azerbaijan(2000)IELTR 141,6.

³⁰ JS Dzienkowski, 'Concessions, Production Sharing, and Participation Agreements for Developing a Country's

Natural Resources' in EE Smith and others, *International Petroleum Transactions* (2nd edn Rock Mountain Mineral law Foundation, Colorado 2000) 393.

³¹ E. Smith et al, *International Petroleum Transactions*

decisions involving large sums of money are made behind the closed doors.³² Therefore, one of the advantages of the bidding system is the transparency, as it was pointed out that auctioning forces the government to be explicit about its criteria, since in an auction the rules must be stated fully in advance.³³

6. Discretionary System

An alternative to the competitive bidding process is to allow the sovereign some discretion in awarding the license. This is usually referred to as a discretionary bidding system. Award takes place at the sole discretion of government, the criterion being usually a commitment by the investors to carry out a certain level of work. The objective of host state is to design a fiscal regime system where exploration and development rights are acquired by those companies who place the highest value on them. An example of this type of system is used in the United Kingdom. The aim of British government is to increase control over British oil reserves and recouping what it viewed as enormous and unwanted profit by oil companies as a result of increases in oil prices.³⁴

7. Conclusion

In examine both PSC and MCC using examples from different countries make us to realise that, there isn't that much differences between the two concepts of petroleum arrangements.

The fundamental differences between the two systems stem from different attitudes towards the ownership of mineral resources and the production sharing mechanisms.³⁵ The common feature of the PSC forms of arrangement is that they affirm the status of the host country as the "undisputed owner of the natural resources to be developed".³⁶ However, according to Asante, it was argued that "Notwithstanding the undoubted political significance of ownership, some commentators have suggested that the functional implications of the new forms of contractual arrangements are not markedly different from those of a concession."³⁷

It appears that the problem is not restricted to the absence of well-defined governmental objectives, but where such objectives exist, there is problem of

³² J. McMillan, *Why Auction the Spectrum?*(1995)Vol. 19, No3 at p194.

³³ *Ibid* at p196

³⁴ E. Smith, J dzienkowski et al., *International Petroleum Transactions* (2nd edn 2000)p406

³⁵ N. Pongsiri, (n2) at 432

³⁶ S.K.B. Asante, "Restructuring Transnational Mineral Agreements" (1979) 73 *American J. I.L.* 335 at 360

³⁷ *Ibid* at 359

implementation.³⁸ A well drafted PSC is, however, capable of providing a balance of "mutual equivalence of contractual advantages" between the host countries and investors. This approach to oil development contracts will enable the host countries to be able to derive greater benefits by controlling its oil industry and, thus, be able to serve its economic development purposes. The investors, on the other hand, are allowed a reasonable return on its investment under conditions of economic and legal security.³⁹

It was said that state participation in the oil industry has not resulted in any radical changes in investor's behaviour. All modern oil contracts illustrate that ownership does not automatically imply effective control and that the function of management can be separated from ownership.⁴⁰

But even adoption of PSC system does not guarantee high pay, because a system such as the Indonesian PSC contract with the 85%/ 15% split in favour of the state, the contractor may still earn more than the state. The reason is that of the reimbursement pay for the cost oil.⁴¹ Some countries use more than one system during transition period. Countries like Nigeria and Peru are examples, which offer both concessionary system and PSC.

³⁸ H. G. Broadman & E. J. Wilson, 'Trials and Tribulations of Third World Petroleum Development: Lessons and Advice for Prospective Producers', in K. Khan ed., *Petroleum Resources and Development*, 262-263.

³⁹ M. Mughraby, 'Permanent Sovereignty over Oil Resources' (Beirut, 1966), 190.

⁴⁰ E. J. Usoro, 'Foreign Oil Companies and Recent Nigerian Petroleum Oil Policies' (1972) 14 *Nigerian J.E.S.S* 301 at 304

⁴¹ D. Johnston, *International Fiscal Systems and Petroleum Sharing Contract* (Penn Well Books 1994)p10