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RE-EXAMINING PRODUCTION SHARING AND LICENCE SYSTEMS: SIMILARITIES, DIFFERENCES AND RATIONALES

By

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Abstract

A license is a permission that authorizes an activity the conduct of which would otherwise be unlawful. Only the state, or a person to whom the state has delegated authority, can grant petroleum licenses. Therefore, the power to grant such licenses stems from the legal status of ownership, not from the authority of the state. Nonetheless, in some happenstances, a state may decide to enter into a Production Sharing Agreement (PSA) other the issuance of a license. Thus, this paper seeks to examine the similarities and differences between a PSA and license/tax regime while highlighting the rationales for choosing either of these systems with the aim of advising the governments, and regulatory bodies in emerging and developed economies on the most appropriate regime.

1 Introduction

Whenever a state suspects that it may have natural resources within its continental shelf, it is always faced with the dilemma of ensuring that it generates as much revenue as it can from its natural endowments while incentivizing International Oil Companies (IOCs) to participate in the exploration for, development and production of hydrocarbons. Thus, the choice between a licence/tax regime, service contract and a PSA becomes necessary. However, this paper shall focus on PSA and licence regimes.

APSA is a contract between a State and an IOC, in which an IOC agrees to take geological risk, provide finance and technical skills in order to explore for oil and/or gas in consideration that upon successful discovery, the State will reward the IOC(s) with a share of the petroleum resources.[1] Firstly, an IOC is often expected to pay royalty on gross production to the State before it is given 'cost oil' to cater for the cost of the petroleum exploration while the 'profit oil' is shared between both parties (the State receives either the share of the oil and gas produced or an equivalent in cash). An IOC often pays tax from its share of the profit oil.[2]

On the flip side, a license is an authorization given by a State to an IOC to explore, develop and produce hydrocarbons at its cost for a specified period. Upon successful discovery, the State is entitled to receive royalty and taxes from the profit generated. It is worth noting that in modern form of licensing system, the relationship between the government and the licensee has been modified to permit the government to exercise a direct control on petroleum operations(example, submission of development plan, annual programme and budget to the government by the licensee); the government may participate with the licensee in case of a commercial discovery, to jointly develop and produce a field,[3] thereby enabling the National Oil Company (NOC) and its personnel to gather the needed

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[1]Chukwuma Samuel Adesina Okoli, 'Production Sharing Agreements and Licences: A Distinction without a Difference?' [2012] *International Energy Law Review* 1.

[2] Allen and Overy, 'Guide to Extractive Industries Documents: Oil and Gas, World Bank Institute Governance for Extractive Industries Programme' (*Allen and Overy*, January 2013) <https://www.allenovery.com/global/-/media/sharepoint/publications/sitecollectiondocuments/geiprogram.pdf?la=en-gb&hash=2F1773051C1304034AFA76F3E6618DE7>accessed8 September 2023.

[3]Honoré LeLeuch, 'Contractual Flexibility in New Petroleum Investment' in N. Beredjick & T.W. Wälde (ed), *Petroleum Investment Policies in Developing Countries* (Graham and Trotman Ltd 1998) 86.

experience and expertise to be able to take over operations in the future.[4]Essentially, this paper is tailored at identifying the similarities and differences between PSA and licence system and the rationales behind choosing one system over the other.

2 Similarities between Licence/Tax Systems and PSA

A common characteristic in a PSA and licence system is that in both regimes, the contractor/licensee bears all the financial risks and provides all necessary capital, equipment, technical assistance, and personnel.

In both systems, royalty is often paid by an IOC on gross production to the State while income taxes are paid by IOCs in accordance with the applicable tax system of the State. Though, some PSAs may require the NOC or State to pay income tax on behalf an IOC.[5]

Similarly in both systems, the contract area may be relinquished during the contract term, unless the work programme has not been completed.[6] The purpose of relinquishment is to encourage the Contractor/Licensees to surrender acreage(s) they do not want to exploit and to enable them to concentrate on the acreage they actually decide to keep.[7]

Also in both systems, depending on the terms of the contract, the equipment and facilities purchased by an IOC to be used within the country becomes the property of the State the moment they are imported into the country(example: Angola, Indonesia) or when the Contractor notifies the State that it no longer requires the assets, and the State elect to acquire the assets at no cost (example: Cambodia); or at termination of the agreement and the State requesting such transfer (example: Timor-Leste).[8] Thus, to avoid these pitfalls, contractors make use of subcontractors and where possible lease, rather than purchase equipment.[9]

Both systems provide for confidentiality clauses (i.e prior consent before disclosure of confidential information to third parties). Also, force majeure provisions are often included to cater for circumstances beyond the control of either party, which could cause a party to renege from its obligations.

Furthermore, States can utilise PSA and licence systems as vehicles to create jobs for her citizens. Thus, in promoting local content, Contractors and Licensees are mandated to utilise local infrastructure and human capital within the State and to transfer technology to local professionals.[10]

Additionally, rentals which are annual charges apply to PSAs and licenses. Rental payments fall due each year on the Licence or PSAs anniversary and are charged at an escalating rate on each square kilometer that the License covers at that date.[11] In the same vein, in a licensing or PSA regime, a contractor is required to relinquish areas that have not been exploited at the end of the exploration phase.[12] However, there are certain differences between these regimes.

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[4]Law Teacher, 'PSC and Licencing Systems' (*Law Teacher*, 31 May 2019) <https://www.lawteacher.net/free-law-essays/english-legal-system/psc-and-licensing-systems.php> accessed 8 September 2023.

[5]Allenand Overy(n2).

[6] Oil and Gas Authority, 'Oil and Gas: Petroleum Licensing Guidance'(*GOV.UK*, 4 December 2012) <https://www.gov.uk/guidance/oil-and-gas-petroleum-licensing-guidance>accessed 8 September 2023.

[7]Allen and Overy(n2).

[8]Daniel Johnston, *International Petroleum Fiscal Systems and Production Sharing Contracts* (PennWell Publishing Company 1994) 23.

[9]Allen and Overy(n2).

[10] Oil Commandments 1971, Commandments no. 1,3,6,7 and 8; Nigerian Oil and Gas Industry Content Development Act2010, s3;41(2).

[11]OGA(n5).

[12]Allen and Overy(n2).

3. Differences between the Two Systems

The major distinguishing factor between a PSA and licensing is the production sharing element which forms the central part of a PSA. In a PSA system, a State partakes in sharing the 'profit oil' with the contractor(s) while in a licensing/tax system, a State only levy tax on the profit made by the Licensee.[13]

Furthermore, in a license, the ownership of oil and gas is transferred to the licensee at the well head whereas in a PSA, it is owned by the State and passes to the contractor(s) at the point of export or at an agreed point of delivery.[14] Thus, PSAs in a way aids to respect sovereignty while balancing the mutual benefit of investors and States.[15]

Another feature that distinguishes a PSA from licensing system is that under a PSA, contractual relations arise between two legally equal parties, each having rights and obligations, the violation of which shall entail their legal liability,[16] while licence system does not create a contractual relationship *per se*. It is merely an authorisation to explore, develop and produce extractives of which the profit earned is usually taxed by the State after the initial payment of royalty.

In a PSA, an IOC serves as a contractor to the State. An IOC agrees to spend its money on exploratory survey and drilling with the consideration that upon making discovery, it shall recoup expenses from the 'cost oil', while the 'profit oil' shall be shared with the State and its share of the profit oil will be taxed. Nonetheless, in a licence/tax regime, the licensee's profit is subject to general tax legislation and not shared with the State.[17]

The PSA system guarantees tax stability and offers the potential investor the opportunity to evaluate project and to ascertain the taxes payable during the course of the project. This is done by providing a stabilization clause in the contract or a Negotiated Economic Balancing Clause which recognises the interests of both parties.[18] However, a licensing system does not guarantee tax stability.

Additionally, in a licensing system, the rules on taxation, use of labour and the terms of using the oil field appear to be strict.[19]Also, the licensee is in little or no position to use his petroleum field for securitisation.[20] Conversely, in a PSA, the rules on the bidding process, taxation, imports, exports and use of land may be relaxed and an IOC is in a better position to use his petroleum field as securitisation, example: for a bank loan or mortgage.[21] Again, a PSA is usually given for a long period while a licence is not.

4. Rationales for Choosing between the Two Systems

There are several reasons why either of these regimes may be adopted by a State. The main advantage of a PSA over a licence regime is that a PSA is contractual and the State remains the owner of the resources, with the contract establishing the applicable compensation arrangements and level of State

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[13] Bernard Taverne, *Petroleum, Industry and Governments: A Study of the Involvement of Industry and Governments in the Production and Use of Petroleum* (2nd edn., Wolters Kluwer Law & Business 2008) 255.

[14]Tengku Nathan Machmud, *The Indonesian Production Sharing Contract: An Investor's Perspective* (Kluwer Law International 2000) 37.

[15] John Paterson, 'Production Sharing Agreements in Africa: Sovereignty and Relationality' in Z. Yihdegoetal. (eds), *Ethiopian Yearbook of International Law 2018* (Springer Nature 2019) 144.

[16]Law Teacher (n4).

[17] Ibid.

[18] Federal Republic of Nigeria, Model Production Sharing Contract for 2005 Bid Round, Clause27.3; Sonangol, Model Production Sharing Contract, December 2007, art 37 (2); Paterson (n 10), 136.

[19] Bate C Toms, 'Ukrainian Lawon Oil and Gas Exploration and Production' [2003] *International Energy Law Review*21.

[20]Kristoffer Svendsen, 'The Russian Regime for Subsoil Use, Energy and Environmental Policy in the High North' [2008] *Environmental Law Report* 292.

[21]R Worall and S Diyachenko, 'Recent Amendments to the Legislation on Production Sharing Agreements in Russia, Ukraine and Azerbaijan' [2000] 6 *International Energy Law Review* 138.

involvement in the asset.[22] Also in a PSA, the State takes minimal risk on its part and is able to reap the benefits of its natural resources without having to spend its own time and money. In many cases, the State may not have the technology needed to explore for and produce extractives. Hence, requesting the help of an IOC who has the requisite technology is usually necessary in order for the State to exploit its natural resources.[23]

Conversely, most developed countries (example: UK, Norway) are usually more concerned with efficient tax and auditing systems. Thus, licences are proven to play a better role because it is a better mechanism to enforce regulatory and administrative measures on investors while exploiting its natural resources.[24]Nonetheless, PSAs are more lucrative for developing countries because the State receives from the outset a share of 'profit oil' whether or not the contractor is yet generating profits. Therefore, there is more of a sense of the State being in control of its own natural resources under the PSA model and the State receives value earlier in this model than under a licence regime.[25] Furthermore, a State may adopt licence over PSAs in order to bolster competition. In a licence regime, the State ensures that in the bidding process the almost depleted sedimentary basins are awarded to trusted investors with technical expertise and finance. This is evident in the short timetable given to investors in licensing regimes to explore for, develop and produce extractives.[26]

Again, PSAs are adopted by States because of its flexibility and adaptability. Under this regime, it is very easy to 'tailor' the production split to local conditions and the real petroleum interest of each State. However, a typical licence regime does not have the same flexibility.[27]

5. Conclusion

The production sharing concept was designed to give the government a greater degree of control over the operations of IOC. However, in practice, there is no significant difference in respect of the degree of control between a PSA and a Licence/tax regime. The reason for this is that under the two systems, an IOC, which assumes the financial risks, is generally responsible for the management of the petroleum operations.[28] Thus, the level of control and revenues between the State and IOCs is based on the implementation of the models and not the model itself.

Basically, retaining control and ownership of oil and gas in the ground, obtaining direct foreign investment, freeing up scarce capital resources, flexibility, long term technology and skills transfer are among the reasons for using PSAs while competition, efficient taxation, auditing, and resource management are the rationales for using licensing regimes.

Having considered the similarities, differences and rationales of PSA and Licence, this paper recommends the licensing system as the preferred contractual arrangement to regulatory authorities in emerging economies who have decades of experience with hydro-electric power generation, because like Norway, such emerging economy will be quite 'diversified' and 'developed'. Thus, it can wait to levy taxes after profit is realised by the Licensee and has the technology to participate in oil exploration by establishing a National Oil Company. On the other hand, developing economies are advised to adopt PSAs owing to their desire to derive early profits from their natural endowments.

[22]Allen and Overy(n2).
[23] Ibid.
[24]Okoli (n1),3.
[25]Paterson(n10),123.
[26]Okoli(n1).
[27]Leuch(n3).
[28]Ibid.