PRESS RELEASE

REPORT OF THE COMMITTEE ON THE PRODUCTION SHARING CONTRACT MECHANISM IN PETROLEUM INDUSTRY

The report of the committee set up under the chairmanship of Dr C. Rangarajan, Chairman, Economic Advisory Council to the Prime Minister to look into the Production Sharing Contract Mechanism in petroleum industry, submitted recently to the Prime Minister, has been made available in the public domain, on the website of the Economic Advisory Council (www.eac.gov.in). Members on the committee were Justice Jagannadha Rao, Shri B. K. Chaturvedi, Prof. Ramprasad Sengupta, Shri J. M. Mauskar and Shri Joeman Thomas; Dr. K. P. Krishnan was convener, and Shri Giridhar Aramane was secretary to the committee. Highlights of the report's recommendations are given below.

Fiscal Terms under the PSC

2. The existing PSC allows the contractor to recover his cost, before giving the Government its share in the contractor's revenues, in case there is commercial discovery leading to production. A certain proportion of the balance revenues of the contractor are shared with the Government, based on the value of an investment multiple for each year. These are biddable parameters. This investment multiple is the ratio of cumulative net cash income to cumulative exploration & development cost. Government's share increases as the multiple increases, which happens when cumulative income increases at a rate higher than the rate of increase for cumulative cost.

3. Under this system, a close scrutiny of costs becomes critical for the Government since there is incentive for contractors to book as costs expenses that do not reflect the true economic cost to the contractor (e.g., through transfer pricing). This is perceived by contractors as interference in commercial decision-making, whereas the Government and CAG view it as legitimate and necessary. Since decisions are taken in a joint committee, called Management Committee, having government and private party representatives, decisions get delayed and execution under the contract is hampered.

4. Since cost recovery is at the root of the problems experienced, it is proposed to dispense with it, in favour of sharing of the overall revenues of the contractor, without setting off any costs. The share will be determined through a competitive bid process for future PSCs. The bids will be made in a bid matrix, in which the bidder will offer different percentage revenue shares for different levels of production and price levels. The bids will have to be progressive with respect to both volume of production and price level. This will ensure that as the contractor earns more, Government gets progressively higher revenue, and will also safeguard government interest in case of a windfall arising from a price surge or a surprise geological find. Further, the underlying cause of the Management Committee and audit related problems will be removed, and the Management Committee will no longer go into issues relating to approval of budget or procurement issues. Investor interests should remain unaffected, since investors will be free to bid the Government share, and they will also have a more hassle-free operational environment.

5. The committee has also recommended that an extended tax holiday of 10 years, as against 7 years already available for all blocks, be granted for blocks having a substantial portion involving drilling offshore at a depth of more than 1,500 metres, since cost of a single well can be as high as US$ 150 million.

6. Further, the committee has recommended extending the timeframe for exploration in future PSCs for frontier, deep-water (offshore, at more than 400 m depth) and ultra-deep-water (offshore, at more than 1,500 m depth) blocks from eight years currently, to ten years.

Contract Management

7. Apart from resolution of problems currently experienced in contract management through the proposed fiscal regime under new PSCs, the committee has suggested two mechanisms for improving progress of exploration and development under existing PSCs. For policy related issues, it has suggested the setting up of a Secretary-level inter-ministerial committee to suggest policy solutions. For issues involving condonation of delay on the part of the contractor in preparing for and seeking approvals, and for minor technical issues, the mandate of the existing Empowered Committee of Secretaries (ECS) can be expanded. The ECS has earlier been empowered, with CCEA approval, to condone delays in the exploration phase only.

Audit

8. Issues currently being raised in audit would no longer arise under the proposed fiscal regime for new PSCs. Apart from this, after consulting CAG, it has been recommended that the list of blocks be periodically made available to the CAG for selecting those that it would directly audit. CAG would select blocks on the basis of financial materiality, and would focus on blocks in the exploration and development phase, when costs incurred are higher. Other blocks would be ordinarily audited by CAG-empanelled auditors, although CAG would continue to have its statutory freedom to directly audit even these. Further, it has been recommended that CAG perform the audit within two years of the financial year under audit, as prescribed under the PSC. Also, for PSCs beyond a high financial threshold, a concurrent audit mechanism may be considered.

Gas Price Mechanism

9. At present, there is APM gas, and some quantity of non-APM gas. The difficulty in gas valuation for determining Government's share is that there is no single gas price. India has long-term supply import contracts as well as spot market imports, and the range of prices has significant spread. However, the re-gasification infrastructure limits imports. The domestic gas too does not have adequate transportation infrastructure to enable creation of a domestic market. Internationally, gas hubs and balancing points exist in major regional markets, of which US's Henry Hub and UK's National Balancing Point / NBP (which is connected to continental Europe) are the largest. For the Asia-Pacific, Japan's Custom Cleared rate for crude oil is a benchmark rate, although unlike the US and Europe, it represents an import price rather than a producer price.

10. The PSC provides for arm's length pricing and prior Government approval of the formula or basis for gas pricing, subject to policy on natural gas pricing. Since no market-determined arm's length price currently obtains domestically and nor is this likely to happen for several more years, a policy on pricing of natural gas has been proposed. The proposed policy would provide for estimation of an unbiased arm's length price based on an average of two prices, which can be interpreted as alternative estimates of an arm's length price for the Indian producer. The relevant price in this context would be the price producers receive in other gas-producing destinations. One price would be derived from the volume-weighted net-back price to producers at the exporting country well-head for Indian imports for the trailing 12 months. The other would be the volume-weighted price of US's Henry Hub, UK's NBP and Japan Custom Cleared (on net-back basis, since it is an importer) prices for the trailing 12 months. The arm's length price thus computed as the average of the two price estimates would apply equally to all sectors, regardless of their prioritisation for supply under the Gas Utilisation Policy.

11. The suggested formula will apply to pricing decisions made in future, and can be reviewed after five years when the possibility of pricing based on direct gas-on-gas competition may be assessed.

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