

**PRODUCTION SHARING CONTRACT IN INDIA  
ITS EFFECTIVENESS IN THE EXPLOITATION OF HYDROCARBON RESOURCES**

**By  
RAJKUMAR**

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DR.SREEJITH (ASSOCIATE PROFESSOR)  
DR.VENUGOPAL (PROFESSOR)**

**UNIVERSITY OF PETROLEUM AND ENERGY STUDIES**

**THESIS COMPLETION CERTIFICATE**

This is to certify that the thesis on "*Production Sharing Contract in India: Its Effectiveness in the Exploitation of Hydrocarbon Resources*" by Rajkumar(SAP 500010394) in partial completion of the requirements for the award of the Degree of Doctor of Philosophy (Law) is an original work carried out by him under our joint supervision and guidance.

It is certified that the work has not been submitted anywhere else for the award of any other diploma or degree of this or any other university.

*Aligopal BS*  
Dr. Venugopal B.S.  
22/7/2015

Name & Signatures

*A. Singh*  
Dr. S. S. S. P. S.  
22.7.15

## DECLARATION

I, **Rajkumar** hereby declare that the thesis entitled "**Production Sharing Contract in India: Its Effectiveness in the Exploitation of Hydrocarbon Resources**" submitted to the University of Petroleum and Energy Studies, Dehradun in partial fulfilment for the award of the Degree of Ph.D. (Law), is my own work and that, to the best of my knowledge and belief, it contains no material previously published or written by another person nor material which has been accepted for the award of any other degree or diploma of the university or other institute of higher learning, except where due acknowledgment has been made in the text.

Signature & Name: *D. K. Rajkumar*  
Date: *22.7.2015*

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## **LIST OF ABBREVIATIONS**

AIR	All India Reporter
Art.	Article
Cal.	Calcutta
CIT	Corporate Income Tax
CNG	Compressed Natural Gas
E & P	Exploration and Production
EEZ	Exclusive Economic Zones
ERR	Effective Royalty Rate
FPWC	Financed Public Works Contract
FY	Financial Year
IOC	International Oil Company
JV	Joint Venture
LNG	Liquefied Natural Gas
LPG	Liquefied Petroleum Gas
Mad.	Madras

MOU	Memorandum of Understanding
MW	Mega Watt
NELP	New Exploration Licensing Policy
NPV	Net Present Value
NGL	Natural Gas Liquids
NOC	National Oil Company
ONGC	Oil & Natural Gas Limited (India)
PSA	Production Sharing Agreements
PSC	Production Sharing Contract
PRRT	Petroleum Resource Rent Tax
PSU	Public Sector Undertaking
RJBL	Restricted Joint Bidders List
RoR	Rate of Return
SA	Service Agreement
Sec.	Section

#### **TECHNICAL TERMS**

CIT	Corporate Income Tax
E&P	Exploration, Development and Production

EPC	Engineering, Procurement, and Construction
ERR	Effective Royalty Rate
FPWC	Financed Public Works Contract
FY	Financial Year
IOC	International Oil Compan(ies)
JVs	Joint Ventures
LNG	Liquefied Natural Gas
LPG	Liquefied Petroleum Gas
MOU	Memorandum Of Understanding
MW	Mega Watt
ONGC	Oil & Natural Gas Limited (India)
NPV	Net Present Value
PRRT	Petroleum Resource Rent Tax
RJBL	Restricted Joint Bidders List
RoR	Rate Of Return
SA	Service Agreement
UKSC	U.K. Continental Shelf

## **EXECUTIVE SUMMARY**

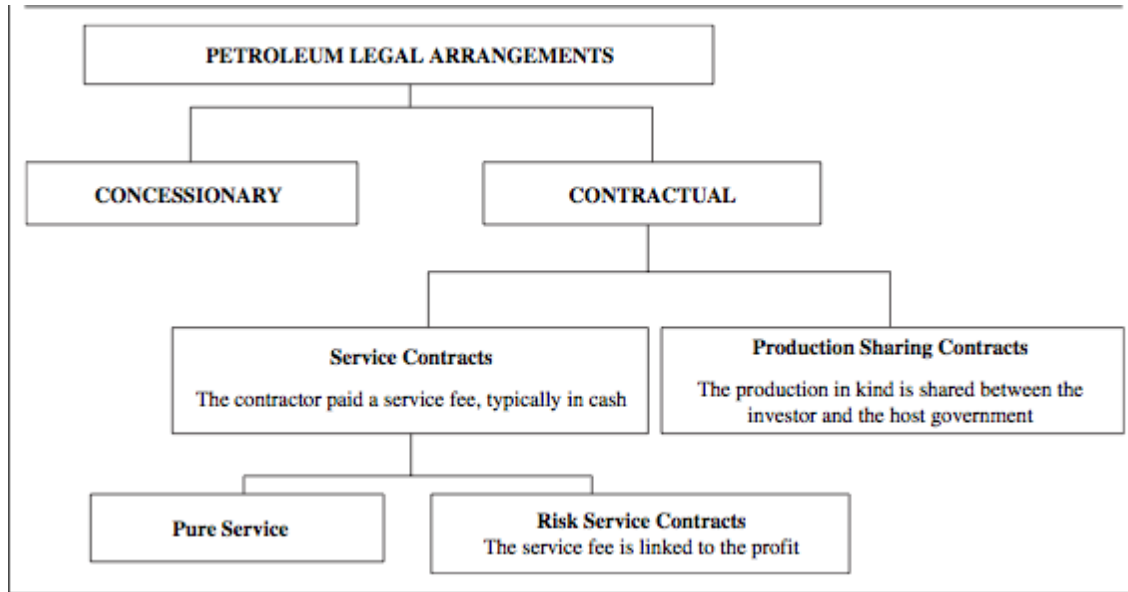
While a country's energy resources base is a gift of nature, transforming these resources into salable commodity like crude oil requires investment and effort. Whether governments choose to invest directly or allow private investors to do so, their primary reason differs in foundation. For the host government the primary concern is to maximize social benefits derived from the exploitation of the resource base, while the International oil companies operate with an appetite for supernormal profits as oil and gas sector is associated with high risk-high returns. In practice however defining what constitutes the maximum benefit to which party is essentially a profound question which helps explaining the variety of objectives pursued by either party – governments or oil companies over time. The governments with different choices of regimes to pursue, in order to exploit their natural resources efficiently, have a challenging task in deciding which and how the companies should be awarded the exclusive rights to explore, develop, and produce their resources, and on what conditions such rights should be awarded. Hence, for every country, not only there is a certain excitement and quest to create wealth, there have always been another, humbler, but hardly secondary motivation, the desire for self sufficiency. Adding to this, the importance of oil as an international commodity, such urgency has warranted for some of the most challenging times in the world's history tapestries. And in more recent times there has been yet another, by extension of the last, as desire has turned to necessity: the need to secure the resources to maintain economic growth; the energy to fuel the world. This combination of instinct, desire, and necessity for exploration, creates



a mission for minds put together to provide energy security. Over time, various legal systems have been developed to address the rights and obligations of host government and of private investors. These can be grouped under two families: concessionary systems and contractual systems. **Figure 1. Characterizes such petroleum legal arrangements** Earlier the oil and gas exploration was only marked by one multi-faceted system of concessions where the host government granted some of the most unprecedented rights to the international oil companies however, following the independence of former colonies and the United Nations resolution in 1960 that affirms the "permanent sovereignty over natural resources", this type of contract was more and more criticized by developing nations and hence came the phenomenon of PSA which was greatly approved. Today, about 10% of the oil and gas production is done through such agreements by developing countries. But the predicament to the success of still stands in question. In India, the oil and gas regime is set to move from such production sharing (profit sharing model) to the new and improved Revenue-sharing which will make it necessary for the oil companies to compensate the government based on level of output produced and not on the investments made in the particular block. Though a shift in regime may not directly result in more revenues for the Government, it ensures that as the contractor earns more, the Government gets progressively higher revenue. Besides, it will also safeguard the Government's interest in case of a windfall arising from a price surge or a surprise geological find. It is still highly debatable whether The proposed method will create greater transparency and foster a hassle-free operational environment encouraging investments. It is also forecasted after the Rangrajan and Vijay Kelkar report on PSC that the 10<sup>th</sup> edition of licensing round (NELP X) will be offered only after there is clarity on the fiscal regime. Globally, more matured E&P countries (the UK, the US, Canada) follow a revenue sharing regime, while developing E&P sectors follow a profit sharing mechanism (Oman, Kazakhstan). It is also believed that the current system involve cumbersome processes to reach an agreement, but would a revenue sharing model would eliminate this and leave the operator to

optimize investment as well as operations on a prudent basis is still an open ended question which would change the core dynamics of the playing field of oil and gas sector in India.

**Figure 1. Petroleum Legal Arrangements**



In order to identify the goal of having a Production Sharing Agreement we need to look in to deeper into the causes that influenced the creation of this type of legal tool. The comparatively young oil industry, in its modern sense, came into existence in 1859. In simple terms, it can be said that because oil exploration as well as its development and production require an appropriate level of experience, governments who own oil deposits and the oil companies with the available technological advances decided to collude in order to gain benefits from this profitable business. The objective of a host government is to maximize wealth from its natural resources for the benefit of its citizens, while the oil company seeks equity and the highest possible profit margin. For this reason the government's perspective is put in closer context since the objective of Government is to capture the maximum economic rent through a PSA which can

be achieved by designing an efficient fiscal system. Once this is determined, the next step is to determine all feasible means or, in other words, alternatives to meet the contractual obligations. This study offers an overview of the Petroleum legal framework of countries since oil discoveries in 18th century with an emphasis on the possible reasons for the creation of, or changes to, the country's petroleum legislations. The contractual regime and some of the important petroleum laws of the history of upstream petroleum industry of the country will be expounded duly. Besides, a concise account of the present legal atmosphere and Petroleum Laws in force is given. This paper also assesses possible alteration to contractual procedures. The study shows how the petroleum legal policy of the country has been moving toward pragmatism as a result of growing needs for foreign investment as more time passes from the early foundation of New exploration and licensing policy of 2000. On the same grounds, it concludes that changes to the present legal framework i.e., OALP are very likely to happen although a full-blown return to Production Sharing Agreements is a non-issue due to the negative connotation they carry in the country.

The object of this study is to analyse the production sharing contract mechanism currently existing in the upstream sector in India in a comprehensive fashion so as to identify the lacuna that plague the current mechanism of production sharing contract in India. The study would also include an understanding of production sharing contract in the upstream sector by attempting to trace the origin of production sharing contract and its effectiveness in the upstream sector in India.

The scope of this study would be to identify the history behind and the origins of production sharing contracts in upstream sector including its political background and then study the contract in the Indian scenario and finally identifying its shortcomings. In order to identify the history of production sharing contracts, the full range of host government contracts between the international oil company (IOC) and the host government, including: production sharing contracts (PSCs),

royalty and tax contracts (concessions), service contracts and risk service contracts, as well as hybrids having elements of two or more of these three basic genres would be analysed. The study would then move on to identify the different modes of exploration and production agreements followed by the developed nations and the developing nations viz. Western industrialised countries have normally established a regime based on licences, while developing countries follow risk contracts and PSCs. The study, in order to better understand the reason behind India following the PSC regime, would then move over to the reasons behind the preference of PSC in developing countries and shall identify the rational behind the usage of PSCs and various factors such involved behind such decision.

Thus, after a through understanding of the functionality of PSCs including that of the most important factor, viz. the financial aspects of a PSC, which is one of the most important factor in the determination of the form of contract, the focus of the study would be on the Indian scenario with a special focus on the model production sharing contract of the Director General of Hydrocarbons, Ministry of Petroleum and Natural Gases, Government of India. The Indian PSC deals with numerous aspects of the exploration and production phase in detail and the scope of this study would include a systematic analysis of all the articles of the PSC in detail in order to understand the same and to identify its shortcomings.

The study would conclude with the identification of the short comings in the Indian model of production sharing contract, which is often referred as a system of red tapism, and would also make necessary recommendations and suggestions for the improvement in the system so as to ensure that the country is both investor friendly and also having a sound legal regime for the exploration and production activities.

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## **CHAPTER 1**

### **INTRODUCTION**

Petroleum in general refers to crude oil and natural gas or in simple terms oil and gas. The terms oil and gas are mixtures of hydrocarbons which are molecules, in various shapes and sizes, of hydrogen and carbon atoms found in the small, connected pore spaces of some underground rock formations referred to as reservoirs.<sup>1</sup> The petroleum reservoirs are generally several hundreds to thousands of feet below the surface. Crude oil and natural gas are believed to be the remains of plants and animals, mostly small marine life, that lived many millions of years ago.<sup>2</sup> From petroleum we get numerous useful products such as:-

- Transportation fuels, such as petrol, diesel, jet fuel, compressed natural gas (or CNG) and propane;
- Heating fuels, such as propane, liquefied petroleum gas, heating oil, and natural gas;
- Sources of electricity, such as natural gas and residual fuel oil burned to generate electricity; and
- Petrochemicals from which plastics as well as some clothing, building materials, and other diverse products are made.<sup>3</sup>

In the oil and gas industry different mixtures of hydrocarbons have different uses and more importantly they are of a varied economic value. Crude oil refers to hydrocarbon mixtures produced from underground reservoirs that are liquid at normal atmospheric pressure and temperature. Natural gas refers to hydrocarbon mixtures that are not liquid,

but gaseous, at

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<sup>1</sup> THE CONCISE OXFORD ENGLISH DICTIONARY, 13d.

<sup>2</sup> *see*, <http://www.eia.gov/tools/faqs/faq.cfm?id=40&t=6>, last visited on 4<sup>th</sup> October 2014.

<sup>3</sup> *Id.*

normal atmospheric pressure and temperature.<sup>4</sup> The gas mixtures consist largely of methane (the smallest natural hydrocarbon molecule consisting of one carbon atom and four hydrogen atoms). Natural gas usually contains some of the next smallest hydrocarbon molecules commonly found in nature of Ethane, Propane, Butane and Natural Gasoline.<sup>5</sup> These four types of hydrocarbons are collectively called natural gas liquids, which are also referred to as NGL. When removed from the natural gas mixture, these larger, heavier molecules become liquid under various combinations of increased pressure and lower temperature. Liquefied petroleum gas, which is also referred to as LPG, usually refers to an NGL mix of primarily propane and butane typically stored in a liquid state under pressure.<sup>6</sup> However, in some instances, the term LPG is also used loosely to refer to NGL or propane.

Oil and gas are discovered and produced through wells drilled down to the reservoirs. The process generally starts with an exploratory well, which is one that is drilled in order to discover or delineate petroleum reservoirs. In the event of a successful discovery the estimated volumes of recoverable oil and gas within the petroleum reservoir are called oil and gas reserves is computed. Reserves are classified as proved, probable, or possible, depending on the likelihood that the estimated volumes can be economically produced. Subsequent to a successful discovery a development well is drilled on. A development well is one that is drilled for the purpose of production of a portion of the previously discovered oil and gas. A large producing reservoir may have one or more producing exploratory wells and several producing development wells.

## 1.1 OIL AND GAS SECTOR

The petroleum industry, commonly referred to as the oil and gas industry, has four major segments:



**Exploration and Production:** Exploration and production activities or E&P, is the activity by which petroleum companies, which are often referred to as “oil

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<sup>4</sup> see, <http://oilprice.com/Energy/Crude-Oil/What-Is-Crude-Oil-A-Detailed-Explanation-On-This-Essential-Fossil-Fuel.html>, last visited on 4<sup>th</sup> October 2014.

<sup>5</sup> *Supra* n. 1.

<sup>6</sup> *Id.*

and gas companies” or simply “oil companies”, explore for underground reservoirs of oil and gas and produce the discovered oil and gas using drilled wells through which the reservoir's oil, gas, and water are brought to the surface and separated.

- **Hydrocarbon Processing:** Hydrocarbon Processing is the process wherein the crude oil refineries and gas processing plants separate and process the hydrocarbon fluids and gases into various marketable products. Refined products and NGL may be processed further in petrochemical plants for making petrochemicals. Some petrochemicals may, in turn, be sent to the crude oil refineries for mixing or processing with other liquid hydrocarbons to make various refined products, such as gasoline.
  
- **Transportation, Distribution, and Storage:** Transportation, Distribution and storage of the hydrocarbon products would involve the means by which petroleum is moved from the producing well areas to the crude oil refineries and gas processing plants. Crude oil is generally moved by different means such as pipeline, truck, barge, or tanker. Natural gas is moved by generally pipeline or specialised tankers by the sea in the form of Liquefied Natural Gas (LNG), wherein the natural gas is transported across the oceans and seas by chilling the mixture to a liquid state at -160 degrees centigrade for hauling in special tankers with high pressure, cryogenic containers. Refined products and natural gas are similarly transported by various means to retail distribution points.

Out of the above-mentioned three important activities, the Oil and Gas upstream sector comprises of the entire exploration and production activities involved in the sector while the other three segments are referred to as the downstream sector.

## 1.2 UPSTREAM SECTOR

The Exploration and Production activities in the Oil and Gas Upstream sector are extremely cost intensive and high-risk operations and are generally carried on by certain oil and gas companies. In almost all countries in the world, except for a few, as in the case of United States of America, hydrocarbon resources are treated as public assets and thereby are solely dealt with by the concerned government who act as the custodian of such public asset.<sup>9</sup> However, in Countries like the United States, the ownership of the reserves found below the surface of the land belongs to the owner of such land and thereby making the owner of the land the owner of the hydrocarbon reserve found beneath such land and the government the owner in case of off shore reserves. Thus, in general sense, in a majority of cases, the government is responsible for the entire E & P activities done in that country, their continental shelves and Exclusive Economic Zones (EEZ) in case of off shore E & P activities. Governments have three options to develop their natural resources whereby they can either create state companies for exploration, development, and production, as in the case of countries like Saudi Arabia, Mexico, Venezuela, Iran, Oman, etc., or they can invite private investors to develop the natural resources, as in the case of countries like United States, United Kingdom, Russia, Canada, etc., or they can use a combination of these two systems and thereby creating an hybrid system as in the case of countries like India, Indonesia, Nigeria, and Kazakhstan.<sup>10</sup>

The governments in order to achieve this mandate upon it to explore and produce the petroleum products in a manner so as to benefit its citizens who are the real owner of such natural resources generally enter into contracts with the Exploration and Production companies. In such a

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<sup>9</sup> See, *Reliance Natural Resources Ltd. v. Reliance Industries Ltd.* Civil Appeal 4273 of 2010 on the file of the Hon'ble Supreme Court of India

<sup>10</sup> See generally, <http://www.oxfordenergy.org/wpcms/wp-content/uploads/2010/11/WPM25-ProductionSharingAgreementsAnEconomicAnalysis-KBindemann-1999.pdf>, last visited on 5<sup>th</sup> October 2014.

situation, the Exploration and Production Company is generally referred to as the Contractor and the government is referred to as the Host Government. Under a Host Government Contract, typically the government is expected to use its regulatory power to protect the public interest, for example, the E & P activity finally serves the need and necessity of the citizens of the country, that oil spills don't damage public drinking water. Yet a host government is also expected to create a positive investment climate that promotes economic and job growth while establishing investment laws and penalties for their violation.<sup>11</sup> Thus, it is imperative that the host governments will have to learn on how to balance these competing needs and still act in a manner beneficial to the citizens of that country. Further complicating matters is the fact that as a signatory to any contract, the government acts like a normal business seeking to maximize its revenues. This places the government in a very awkward situation of having to regulate itself. Governments of resource-rich developing countries also face the challenge of negotiating with major oil companies, which have the advantage of employing hundreds of well-skilled legal representatives. Thus, owing to these factors, it is imperative that the contract, irrespective of its nature, that the government enters into with the contractor for the purposes of E & P activities is worked out with a great deal of care. The Contract terms determine how much a producing nation earns from its natural resources, and often, whether a government will have the regulatory authority to enforce environmental, health, and other standards that apply to the contractors. Another most important reason to focus on contracts by a great deal is especially due to the opportunities for corruption that exists in the huge investment costs and vast profits involved in most energy deals.<sup>12</sup> The chances of rampant corruption exists in the oil and gas industry especially because of the fact that normally so little information is made public about negotiations and contract terms and hence there is a great potential for abuse on both sides of the table. In several instances, companies bidding for potentially lucrative deals have sometimes made illegal payments, often disguised, to government officials or their representatives to curry favor. One of the main issue in combating corruption is that it is extremely difficult and almost next to

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<sup>11</sup> *Id.*

<sup>12</sup> *See*, [http://www.transparency.org/topic/detail/oil\\_and\\_gas](http://www.transparency.org/topic/detail/oil_and_gas), last visited on 6<sup>th</sup> October 2014.

impossible to determine whether a particular company was chosen for its competitive bid or competence, or its close relationship with a government official. If the government official is also the regulator, the opportunity for corruption is even greater. Criminal investigations involving this kind of corruption have been pursued in Angola, Congo-Brazzaville, Kazakhstan, and elsewhere.<sup>13</sup> Thus, it is very much necessary that the government exercises due caution in order to enter into a proper host government contract and thereby ensure that the public assets are not exploited by any means and in fact are utilized in a manner that the resources are not exploited for the benefit of a few and they are beneficial for the people of the nation.

### **1.3 HOST GOVERNMENT CONTRACTS**

The Host Government Contracts are primarily classified into different types based on the role of the parties to the contract and also on the basis by which the payment for such E & P activities is being made to the government. Some of the prominent types of host government contracts are Concession or License Agreements, Joint Venture Agreement, Production Sharing Contracts, etc.,<sup>14</sup> Different sets of countries follow different agreements based on their needs and circumstances. The Concession or License Agreements, which is one of the oldest form of agreement in the E & P sector involves grant of Exploratory, Development and Production rights based on grants by the Host Government in return for a royalty. The Joint Venture Agreements are agreements whereby the parties enter into a joint venture and both the contractor as well as the host government make equal investment or as per their agreement and share profits, if any, in the same way. However, the Joint Venture Agreements are one of the least popular forms of agreements, as they are not favored by a majority of host governments given that it involves assumption of risks and also considerable costs in the form of investment on the part of the government. Finally the Production Sharing Agreements wherein the Host Government more or less acts as a partner in profits only. The Host Government does not make any investment in the project and all the associated risks including that on the investment is on the contractor.

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<sup>13</sup> [http://www.ey.com/Publication/vwLUAssets/EY-Managing-bribery-and-corruption-risk-in-the-oil-and-gas-industry/\\$FILE/EY-Managing-bribery-and-corruption-risk-in-the-oil-and-gas-industry.pdf](http://www.ey.com/Publication/vwLUAssets/EY-Managing-bribery-and-corruption-risk-in-the-oil-and-gas-industry/$FILE/EY-Managing-bribery-and-corruption-risk-in-the-oil-and-gas-industry.pdf), last visited on 6<sup>th</sup> October 2014.

<sup>14</sup> Alexander, Frank C., Jr., *et. al.*, “*Production Sharing Contracts and Other Host Government Contracts*”, Chapter 20, Rocky Mountain Mineral Law Institute, Proceedings of the Rocky Mountain Mineral Law FourthSixth Annual Institute, 2000.

<sup>15</sup> *Id.*

However, in the event of generation resulting in profits, the Host Government is entitled to a share in profits. Apart from the share in profits, the host government also collects a royalty/ license fee and charge taxes on the contractor and thereby making it the most profitable form of agreement on paper for the host government.<sup>17</sup> The Production Sharing Contract is a hybrid form of contract and is one of the latest forms of contract to have been evolved in the E & P sector. This paper shall deal with the Production Sharing Contract in detail with a special emphasis on the Contractual Issues in a Production Sharing Contract in India by reviewing the Indian Production Sharing Contract regime and thereby attempting to identify its shortcomings and lacuna.

#### **1.4 HISTORY OF PSC**

PSC's were first introduced in Indonesia in 1966. In Indonesia, after independence nationalistic feelings were running high and foreign companies and their concessions became the target of increasing criticism and hostility. In response to this the government refused to grant new concessions. In order to overcome the subsequent stagnation in oil development, which was a disadvantage to both the country and the foreign firms, which were primarily involved in the E & P business at that point of time, new petroleum legislation was brought in. PSC's were regarded as acceptable because the government upholds national ownership of resources.

The major oil companies were initially skeptical and opposed to this new contract form, as they were reluctant to invest capital into an enterprise, which they were not allowed to own or manage, which was the norm until then under the other forms of Host Government Contracts such as Concession Agreements or Joint Venture Agreements. More importantly, however, the major oil and gas companies involved in E & P activities did not want to establish a precedent which might then affect their concessions elsewhere. The first PSAs were therefore signed by an independent smaller Oil and Gas Company who showed a greater willingness to compromise and accept terms that had been turned down by the majors. Furthermore, it has been argued that the independent smaller companies saw this as an opportunity to break the dominance of the big oil companies and gain access to high quality crude oil. Thus challenged, the major oil and gas

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<sup>17</sup>*Id.*



companies involved in the E & P sector too were pushed to the wall and thus were forced to bite the bullet and entered into PSC's only to realize later on that and found that in reality it was only the foreign firm engaged in the PSC in the form of the Contractor and involved in the E & P activities usually manages and operates the oilfield directly. Thus, seeing the success of the PSC and its beneficial factor to both the Host Governments as well as the oil company involved in the E & P activity, the Indonesian origin PSC soon spread across the globe to almost all oil-producing regions with the exception of Western Europe where only Malta offers this type of contract.<sup>20</sup>

The Indian Production Sharing Contract came as the direct result of the New Exploration Policy Regime of the Ministry of Petroleum and Natural Gases, Government of India. This paper shall concentrate on identifying the contractual issues that the Indian PSC possess and thereby recommending adequate changes to the regime so as to rid the lacuna and the contractual issues plaguing it.

A detailed introduction to all these host government agreements together with their general advantages and disadvantages and terms in brief shall be discussed in the forthcoming chapter of this paper. The Second Section of this paper while discussing the background of PSC and an introduction to the PSC regime would be broadly divided into three sub sections wherein the first sub section would deal with an overview of all the host government E & P contracts including concession agreements, JV's and PSC and also discuss in brief about each of their advantages and disadvantages and also the terms that are in common for the said agreements. The second sub section would deal with the historical background of the PSC discussing the historical and political reasons for the emergence of the PSC regime. The final sub section would discuss the various terms of a PSC that are exclusive or of at most importance in a PSC.

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<sup>20</sup> *Id.*

This paper in the Third Section would deal with the review of the Indian Model Production Sharing Contract, initially tracing the history of the Indian E & P sector and the PSC regime under NELP. The section would be further subdivided into two sub sections wherein the first sub section would be in depth and detailed study on each of the provision of the PSC in place in India. The other sub section would deal with contractual issues plaguing the Indian Production sharing Contract and deal with an array of contractual issues such pertaining to environmental regulations, which discuss of a non-existent international standards, to the issues pertaining to gas pricing to the issues riddling the disputes resolution clause of the PSC. The subsection would also deal with the issue of the PSC having a very limited applicability and its non applicability for E & P activities pertaining to hydrocarbons such as coal bed methane, Shale Gas, etc.

## CHAPTER 2

### 2. PRODUCTION SHARING CONTRACT

**Article 297**<sup>21</sup> asserts India's sovereign rights over the minerals. Slow and phased privatization process has been under implementation for more than a decade in India. There have always been political constraints and although there is a clear policy and mechanism of Production sharing contract (PSC) to continue the process, implementation roadblocks continue to be a major setback for effective regime operations.

Today, Production-Sharing Agreements (PSAs) are among the most common types of contractual arrangements for petroleum exploration and development since 1966 when they were first introduced in Indonesia.<sup>22</sup> In Indian scenario they were considered after 1990 to widen the horizons of our national policy and balancing socialistic interests with capitalistic endeavors to strengthen national policy on oil and gas exploration. After independence nationalistic feelings were running high and foreign companies and their concessions became the target of increasing criticism and hostility. In response to this, the government refused to grant new concessions. In order to overcome the subsequent stagnation in oil development, which was a disadvantage to both the country and the foreign firms, new petroleum legislation was brought in. PSAs were regarded as acceptable because the government upholds national ownership of resources. In order for oil companies to make rational investment decisions, the framework conditions must be predictable and transparent. This is the general basis for any incentive system.

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<sup>21</sup> IND. [India] [Constitution] 1950, as last amended by JANUARY 2, 2013/ PAUSA 12,1934 (SAKA) , Art. 297(India)  
**Article 297 of The Constitution of India, 1949 reads that-**

*297. Things of value within territorial waters or continental shelf and resources of the exclusive economic zone to vest in the Union*

*(1) All lands, minerals and other things of value underlying the ocean within the territorial waters, or the continental shelf, or the exclusive economic zone, of India shall vest in the Union and be held for the purposes of the Union*

*(2) All other resources of the exclusive economic zone of India shall also vest in the Union and be held for the purposes of the Union*

*(3) The limits of the territorial waters, the continental shelf, the exclusive economic zone, and other maritime zones, of India shall be such as may be specified, from time to time, by or under any law made by Parliament*

<sup>22</sup> G.H. BARROWS, WORLDWIDE CONCESSION CONTRACTS AND PETROLEUM LEGISLATION, 32 (Penn Well Books, 1983)(2001)

However, the change from nationalization to Production Sharing may affect the transparency of the system. This may again affect the willingness of foreign companies to invest in the Indian oil industry. Even so, the Indian Government has initiated this process in order to increase the capital flow from the investing companies to the Government so that the petroleum can benefit the population to a larger extent.

According to the **Rangrajan Committee report**, *“The exploration and production policy for hydrocarbons is a cornerstone of our energy security, since India has a large and growing demand for energy and substantial hydrocarbon reserves that remain to be explored, appraised and developed. Production Sharing Contracts (PSCs) entered into between the Government and oil companies for the purpose of exploration and production of hydrocarbons constitute the principal means of achieving our overall policy objective of greater self-reliance in this sector.”*<sup>23</sup>

Presently, many developing countries are unable to extract their hydrocarbon resources at a reasonable cost because they lack the technical know-how, management expertise and/or capital to do so.<sup>24</sup> As a result, they rely on IOCs to explore and develop these resources.<sup>25</sup> With multiple parties involved, managing resources becomes more complicated, due to the conflicting interests between IOCs and the host governments. The IOC needs to recover its costs and would like to keep as much profit as possible. The host government, on the other hand, wants to maximize its revenue as much as possible while making sure that the IOC remains interested in investing in the host country.<sup>26</sup> This divergence in objectives yields the need of legislative arrangements that

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<sup>23</sup> Report of the Rangrajan Committee, *“The PSC Mechanism in Petroleum Industry”*, MINISTRY OF PETROLEUM AND NATURAL GAS, 2012 [http://eac.gov.in/reports/rep\\_psc0201.pdf](http://eac.gov.in/reports/rep_psc0201.pdf) last accessed on 4/03/2015.

<sup>24</sup> D Johnston, ‘*Changing Fiscal Landscape*’, 1 Journal of World Energy Law & Business 31–53(2008).

<sup>25</sup> Ernest E. Smith, *International Petroleum Transaction*, 2 edition, Ed .Rocky Mountain Mineral Law Foundation, 448 (2000).

<sup>26</sup> E SUNLEY, T BAUNSGAARD & D SIMARD, REVENUE FROM THE OIL AND GAS SECTOR: ISSUES AND COUNTRY EXPERIENCE- FISCAL POLICY FORMULATION AND IMPLEMENTATION IN OILPRODUCING COUNTRIES (International Monetary Fund Publications, Services) (2003).

allocate the costs and benefits over a project's lifetime; which are included in the PSC. As such, a PSC uses the concept of contractual partnership to enhance oil and gas development.

## **2.1 BUSINESS MODEL OF PSC**

In a PSC, the foreign company provides the capital investment, first in exploration, then in drilling and in the construction of infrastructure. Once hydrocarbon is produced, the foreign company may have to pay royalty charged on gross production to the government. The IOC can recover some of its costs at a pre-specified percentage of production, the so-called '**cost recovery**'. Once costs have been recovered, the remaining profit is divided between state and company in agreed proportions. The company is taxed on its profit share. Sometimes the state also participates as a commercial partner in the contract; in this case, the state provides its percentage share of capital investment, and directly receives the same percentage share of cost recovery and profit share. The IOC's share of the profit is then subdivided according to the production sharing terms.

The Production-sharing is the most popular system for both host governments and the oil corporations. It provides the host government with profit shares without the risk of direct investment. In theory, the host state has ultimate control over the hydrocarbon resources, while an international oil company or consortium of companies perform the exploration and production under a contract. In practice, however, the state's hands are tied by restrictions in the law, regulations and contract. As such, this agreement saves the host government political image and gives the company commercial satisfaction. The PSC provides a share of reward to the host government and a share to the IOC. The PSC can be considered an efficient contract; in the sense that neither party can improve its pay-out without making the other party worse off.

When designing PSCs, a trade-off between stability and flexibility exists due to considerable geological and economic uncertainties<sup>29</sup>. Geological uncertainty derives from the uncertainty about the amount of the exploitable reserves. Economic uncertainty is due to the lack of knowledge about production costs and future hydrocarbon prices.

PSCs must foresee a degree of flexibility so that both host governments and IOCs may adapt their main measures to unforeseen events that may affect their relations. Therefore, PSCs must be sufficiently credible to stabilize anticipations but they must be able to adapt to changing environmental conditions. Though contracts can vary widely in their details, all must establish two key issues: how profits (often called “rents”) are divided between the government and participating companies and how costs are to be treated. What complicates negotiations is the high level of uncertainty caused by incomplete or even faulty information. Typically, neither the oil company nor the host government knows with certainty at the time of signing the contract how much it will cost to explore and develop a field, whether future oil or gas prices will justify that cost, or how much oil or gas there is in a field. Nine out of ten exploration efforts result in a loss.

Companies will seek to protect themselves against possible losses, which drive up investors’ internal costs. Contract negotiation requires skillful bargaining to find a reasonable and mutually acceptable balance between the interests of an investor and a government. Often, host governments turn to international financial and legal experts to advise them during these negotiations. One of the first decisions that governments must make is to select the type of contractual system it will use to establish the terms of the development process: a concession or license agreement, a joint venture (JV), or a production-sharing agreement (PSA).

Each form of contract has its advantages and disadvantages, especially from a commercial point of view. The details of the contract can vary greatly even between similar types of contracts. To add to the confusion, the provisions of license-concession agreements and PSAs have also come to resemble each other. Governments and investors should release the terms of their agreements. If they decline to do so, questions need to be raised about the need for confidentiality since there is no intrinsic reason why such agreements should be kept from the public.

The very first attempts of the Countries in signing PSAs were mostly driven by a desire to receive profits from the natural resources they have. The low level of evaluation of profits and costs and the inefficient fiscal regime of these agreements are the reasons why, nowadays, PSAs have been significantly improved and have more detailed contents. This means that the key

subject in a PSA is the financial issue of the deal. Putting these two issues in context, i.e., the political and economic situation of the country as well as the level of experience in the petroleum industry and depth of concentration in financial matters, the paper seeks to ask the question, ‘is it economically preferable for an Oil Producing Country to use Production Sharing Agreements?’ In answering the above question, it is imperative to use the example of various Governments if it wishes to improve its current situation, as well as for any oil company operating in the international arena, which is interested in investing in India’s petroleum industry. The research is done on the basis of up-to-date information, taking into account the changed political and financial concerns of the state and a revised scale of views and interests of international game players. The report provides with adequate and consistent background information and comparative analysis of the contractual regimes by way of referring to many reports, web sources and scholarly articles. Therefore the author has used a range of tools borrowed from economic analysis and matched elements of this process with the key factors of the research question.

Besides, a concise account of the present legal atmosphere and Petroleum Laws in force is given. This paper also assesses possible alteration to contractual procedures. The study shows how the petroleum legal policy of the country has been moving toward pragmatism as a result of growing needs for foreign investment as more time passes from the early foundation of New exploration and licensing policy of 2000. On the same grounds, it concludes that changes to the present legal framework are very likely to happen although a full-blown return to Production Sharing Agreements is a non-issue due to the negative connotation they carry in the country.

Also, preliminary analysis of literature shows that the Exploration activities in India is recognized as a complex phenomenon, as a consequence of more deep-seated problems of policy distortion, institutional incentives and governance. Whilst acknowledging that an assumption relates to a future occurrence, it was acceptable to concur that there is a degree of uncertainty. In order to minimize the possibility of detracting from the credibility of an analysis the author has

used the most pertinent assumptions and those closest to reality. Hence the parameters are set

as follows:

*Reliability of the system in terms of its probable failure rate:* Due to the fact that the oil industry is a highly profitable business cost arising from the abandonment of contracts is very unlikely.

*i) Accuracy:* It is very important to have correctly estimated data. Any error in calculating operating costs may lead to undesired results.

*ii) Ecology:* The burning issue of ecological aspects is another big source of costs for the government.

*iii) Economics:* Economic costs mostly arise from the limited number of domestic employees available due to their lack of experience in this industry. However, this category has more relevance when determining the benefits of a PSA. Any failure to adhere to particular financial clauses may lead to major disputes and the failure of payments such as taxes. As a result, all of these will influence the budget deficit. This category is considered to be one of the most important sources of costs for the government.

*iv) Moral, Safety and Security:* Costs for the government may include different ethos of the investor, a different approach to work and employees. The number of accidents and hazards involved are other issues that may incur costs for the government. Benefits coming from these types of petroleum regimes are also different because fiscal terms fixed for each type of regime have their own specific exceptions and norms. Usually the first inflow of income that goes to the state budget is from royalty and bonus payments. Thereafter we have all other taxes, such as

income tax, social tax, etc. that are subject to be collected. In addition to the positive effects the author suggests that some of the disadvantages of PSA are examined. The reason for this is that these disadvantages are at the root of costs.

Accordingly, the main priority in India's oil policy has always been to increase production and to attract foreign investment for the exploration and exploitation of additional sources and existing



ones. Since NOC companies lacked the capital and technology necessary for such a costly, risky and complex undertaking, foreign companies were allowed to conduct the exploitation and exploration of oil. As a practical matter, **PETROLEUM PROSPECTING** - the industry's jargon for finding oil - is not an easy task. Subterranean information is gathered and subsequently interpreted to determine the existence of locations where the necessary geologic elements forming a reservoir are present. Today's modern technology has significantly reduced the randomness of petroleum prospecting using satellites, which enable the mapping of oil fields with remarkable accurateness and a low impact on the environment. In India, as in many other countries with oil reserves potential, the government has sought to reduce the activity's inherent high degree of uncertainty by shaping the legal and economic environment that E&P companies have to operate in, making it more profitable and attractive for them. This study seeks to accurately represent this environment from not only the notions embraced in judgment by the prospective investor but also the challenges faced by the government in addressing the arrangements under PSC, starting with the structures of the basic transactions, referred to herein as "PSC", through which most commonly, Exploration companies participate in the oil industry. The contractual agreements are standardized and allow little tailoring to fit individual company needs. In this paper, several aspects concerning the recent changes in the regulatory framework in India would be discussed. Even though the Production Sharing has shown to be a very successful formula for developing countries, there exist other systems with many of the same desirable characteristics<sup>30</sup>. The overarching goal of this paper is to present a systematic approach in structuring hydrocarbon contracts. It is concerned with the terms and conditions of production sharing contracts (PSCs) offered by government, to contractors (eg international oil companies— IOCs) for the extraction of their natural resources. This is achieved in the paper through the following four tasks.

Provide statistical analysis and discussion of the various PSCs (or hydrocarbon laws) collected.

1. Provide a Legal model that maps PSC parameters to government take, which will be used to perform sensitivity analysis on the various PSC parameters and their impact on government take.
2. Assess the influence of three factors (political/economic risk level, status of hydrocarbon reserves and water depth) on the PSC parameters.

3. Suggest plausible ranges for India and other countries, so there is a better understanding of the initiatives of policy makers in the hydrocarbon sector.

## CHAPTER 3

### 3. MINERAL OWNERSHIP – INCEPTION OF A CONTRACTUAL REGIME

**3.1 MINERAL OWNERSHIP-** Control over minerals has been considered vital for political and economic reasons for the state in most societies. The presence of a resource curse like in India strengthens the need to carefully select the taxation system to finance the government's expenditure. The Oil and gas industry has been a focus for government regulation and control over the centuries whether it has been state or privately owned. Mineral rights today come in three forms, namely minerals, royalties, and taxes. All are similar in that they share on a pro-rata basis in the production of oil & gas from the lands they cover, and also in that they do not share in the costs associated with drilling and producing the same oil & gas. Beyond those similarities, there are inherent differences. The public and private arrangements under which oil production is authorized have gone through a variety of phases since the emergence of petroleum as an internationally traded commodity in the middle decades of the last century.

**3.2 EARLY ORIGIN OF CONTRACTUAL FORM** - Historically, rights in oil were granted by means of "concessions" which authorized a company to explore, develop, and market petroleum for a specified number of years<sup>31</sup>. The earliest grants, such as those made by various sovereigns in the Middle East, often covered an entire country and lasted several decades<sup>32</sup>. In exchange for an initial payment and a right to some fraction of the value of any oil produced, the country or its ruler transferred all managerial and decision- making rights over oil exploration and production to the company or consortium of companies that received the grant. Decisions over when, or even whether, to explore and drill for oil were left entirely to the company. Alternatively, a company might acquire what it deemed to be the equivalent of fee simple ownership in much of a country's oil reserves, as Standard Oil argued it had done in Mexico. Such sweeping grants of power over what was often a country's single most valuable asset rarely endured unscathed for the originally stated duration. In an effort to regain control over their mineral resources, some

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<sup>31</sup> D. Barberis, *Negotiating Mining Agreements: Past, Present and Future Trends*, LEIDEN: KLUWER LAW INTERNATIONAL, (1999)

<sup>32</sup> Note. *From concession to participation: Restructuring the Middle East oil industry*, N.Y.U.L.REV. 48:774. (1973).

countries, such as Mexico and Iran, resorted to a single dramatic act of expropriation<sup>33</sup>. In *Venezuela*<sup>34</sup>, for example, expropriation of oil company assets occurred as a relatively gradual process lasting several decades. In Saudi Arabia and several other Middle Eastern countries, the original concessions were modified by on-going renegotiations that resulted in significantly different arrangements.<sup>35</sup> The formation and growing power of the Organization of Petroleum Exporting Countries (OPEC), which represented the interests of several similarly situated countries, helped significantly to expedite the process.<sup>36</sup>

**3.3 COMPANY REIGN OF CONCESSIONS** - Our understanding of the modern concession and other contractual forms for exploiting natural resources may be understood as a reaction against some of the excesses of the traditional concession<sup>37</sup>. Importantly, the financial bargain struck between the host government and the foreign company was highly uneven, at times teetering on the verge of the unconscionable. Companies paid small sums to the host government for the rights over its natural resources. Typically, the compensation was not tied to the value of the resource itself<sup>38</sup>. It was, however, tied to volume produced. For example, the Oil Concession of 1934 between the State of Kuwait and the Kuwait Oil Company Limited (United Kingdom) states: “(d) For the purpose of this Agreement and to define the exact product to which the Royalty stated above refers, it is agreed that the Royalty is payable on each English ton of 2.40 lb. of net crude petroleum won and saved by the Company from within the State of Kuwait-that is after deducting water sand and other foreign substances and the oil required for the customary operations of the Company’s installations in the Sheikh’s territories” (*Oil Concession of 1934: Article 3(d)*). Because companies determined the volume of production, this meant that the

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<sup>33</sup> M. A. ADELMAN, *SENSE AND NONSENSE ABOUT WORLD OIL*, 169-172, (Massachusetts Institute of Technology, Cambridge, Mass.)(1991).

<sup>34</sup> Rentner, R. *NOTE: Venezuela: How A Hydrocarbons Law Crippled An Oil Giant*”, HASTINGS INT. & COMPARATIVE L. REV., 27, 351, (2004).

<sup>35</sup> Z.A. Al Qurashi, *Renegotiation of international petroleum agreements*, 261, J. of INT. ARB. , 22(4), (2005).

<sup>36</sup> DANIEL YERGIN, *THE PRIZE: EPIC QUEST OF OIL, MONEY AND POWER*, 12-52 (Free press, Re.ed.)(2011).

<sup>37</sup> David Guttman, “*Global Oil Industry Faces Broad Spectrum Of Political Risk*,” AFX INT. FOCUS, September 19, 2006.

<sup>38</sup> Neto, J.S.C., *Risk-bearing service contracts in Brazil*, J. OF ENERGY & NAT. RESOURCES LAW 3: 114, (1985).

interests of governments and companies could and often did diverge. That is, it was not always in the interests of companies to exploit resources fully.<sup>39</sup> Importantly, these parameters<sup>40</sup> allowed the company great freedom in determining the nature, scope and extent of exploration. Countries arrive at divergent views on the long-term energy outlook-and therefore differ on policy decisions.<sup>41</sup>

**3.4 NEW INTERNATIONAL ECONOMIC ORDER** - These aspects of the concession agreement did not survive decolonization, the New International Economic Order and the creation of the Organization of the Petroleum Exporting Countries (OPEC).<sup>42</sup> Expropriations and renegotiations as well as newly formed contracts saw to this. As we move towards the present-day partnership-based contractual models, there is a concerted effort to rebalance specific contracts so as to remove many of these outmoded features of the traditional concession. For most of this century, the oil industry has been characterized by the concentration of control in a relatively few companies or entities. In the earliest period, Standard Oil of New Jersey exerted near monopoly control on oil supply and price. Although "trust busting" legislation, such as the Sherman Act and the United States District Court decision in *United States v. Standard Oil Co. of New Jersey*,<sup>43</sup> led to the eventual breakup of Standard Oil, control over the market merely

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<sup>39</sup> E.E Smith, *From concessions to service contracts*, TUL. L. J., 27,493, (1991-2).

<sup>40</sup> (Oil Concession Act, 1934: Art. 2(a) and (b)). This was the case in the Kuwait contract which stated:

*"(a) Within nine months from the date of signature of this Agreement the Company shall commence geological exploration.*

*(b) The Company shall drill for petroleum to the following total aggregate depths and within the following periods of time at such and so many places as the Company may decide*

- *4,000 feet prior to the 4th anniversary of the date of signature of this Agreement.*
- *12,000 feet prior to the 10th anniversary of the date of signature of this Agreement.*
- *30,000 feet prior to the 20th anniversary of the date of signature of this Agreement. "*

<sup>41</sup> ALAN S. MANNE, *INTERNATIONAL ENERGY WORKSHOP: A SUMMARY* (Department of Operations Research, Stanford University, Stanford, California) (1995).

<sup>42</sup> JOEL C. GIBBONS, *ENERGY PRICES AND CAPITAL OBSOLESCENCE: EVIDENCE FROM THE OIL EMBARGO PERIOD*, 29-43 (American National Bank and Illinois Institute of Technology, ed.12, Cambridge Press)(1994)

<sup>43</sup> 253 F. Supp. 196 (1966).

shifted to a group of large, vertically integrated oil companies known collectively as the "Seven

Sisters" or simply "the Majors."<sup>44</sup>

### 3.5 THE CONCESSION PERIOD

During this early period the typical international arrangement for authorizing petroleum development was the concession<sup>45</sup>. Several characteristics of these early arrangements are especially noteworthy. For example, many of the Middle Eastern concessions were apparently granted directly by the ruler of the '*sheikdom or sultanate*' or by a minister acting directly on his behalf. In many instances, the process seems to have been analogous to that engaged in by an American landowner negotiating with a company over an oil and gas lease. The recipients of the concessions were almost invariably consortia with partially overlapping membership. This interrelationship of the major oil companies in almost all of the concessions resulted in joint off take agreements, which limited the total amount of production from the major concessions.<sup>46</sup>

Because these agreements essentially limited each company to a set amount of oil, which it could market, the incentive to drill new wells into an established and proven reservoir might be relatively slight. Nothing in the early concessions or the oil companies' agreements with the sovereigns prohibited such conduct.<sup>47</sup>

**3.6 EARLY GRANTEE RIGHTS** - The grants were similarly sweeping in terms of the operational rights transferred to the companies. The companies were free to drill or not to drill on any of the lands granted. Production of any oil discovered was left to the option of the grantee that was under no obligation to release unexplored and undeveloped territory.<sup>48</sup> The host countries retained no right to participate in managerial decisions,<sup>49</sup> including decisions on drilling and development, even though the only financial benefit received by the countries or their rulers after

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<sup>44</sup> A. Kolo, and T.W Wälde,, *Renegotiation and contract adaptation in the international investment projects: Applicable legal principles and industry practices*, TRANSNATIONAL DISPUTE MGMT J., 1(1)-1, (2004).

<sup>45</sup> Elkins, Z., Guzman, A. and Simmons, B., *Competing for capital: the diffusion of bilateral investment treaties 1960-2000*, INT. ORG., 60,(2006).

<sup>46</sup> Y OMOROGBE, *THE OIL AND GAS INDUSTRY: EXPLORATION AND PRODUCTION CONTRACTS*, LAGOS (California, Malthouse Press) (1997).

<sup>47</sup> EXTRACTIVE INDUSTRIES TRANSPARENCY INITIATIVE, Source Book, (2005).

<sup>48</sup> S.Rose-Ackerman and J.,Tobin, *Foreign direct investment and the business environment in developing countries: the impact of bilateral investment treaties*, YALE L. & ECO. RESEARCH PAPER, NO. 293. (2005).

<sup>49</sup> Atef Suleiman, *The Oil Experience of the Middle East Emirates*, 6 J. ENERGY & NAT. RESOURCES L. 1, 3 (1988).

the initial consideration had been paid was the right to royalty. As indicated earlier, the concessions were intended to last a long time. Generally they were for fixed time periods that were rarely less than sixty years. The 1933 concession that the King of Saudi Arabia granted to Standard Oil of California for 50,000 pounds of gold was for a sixty-six year term and ultimately covered as much territory as the D'Arcy grant.<sup>50</sup> The Abu Dhabi and Kuwaiti concessions were both for seventy-five years. There were always some exceptions, of course. **SUCCESSING YEARS** - The concessions granted in the period following the 1911 Mexican revolution were for a period that could not exceed thirty years and contained cancellation clauses in the event the company failed to comply with its obligations.<sup>51</sup> Perhaps most striking, especially when viewed from the vantage point of the last decade of the twentieth century, the "*government Take*" under the old concessions was extremely small. The host country, or ruler, usually received an initial consideration, roughly analogous to the modern oil lease bonus, and some form of royalty. Under some concessions, the royalty was a specified fraction of production. The original D'Arcy concession in Persia provided for a sixteen percent royalty.<sup>52</sup> Few others were that generous to the host country. The concessions that the Mexican government granted over its own publicly-owned territory prior to the Revolution generally set the royalty at ten percent.<sup>53</sup> Other arrangements provided for a royalty calculated as a flat rate per ton rather than as a percentage of production or the value of the sale price of production. Thus, both the **Ruler of Abu Dhabi and the Sultan of Muscat and Oman** received three rupees per ton of oil produced from their respective concessions;<sup>54</sup> the Arabian concession set the royalty at twenty-one gold shillings per ton.<sup>55</sup>

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<sup>50</sup> GOVERNMENT OF SAUDI ARABIA, DEVELOPMENT OF RESOURCES DOCUMENT (1972).

<sup>51</sup> ROSCOE B. GAITHER, EXPROPRIATION IN MEXICO: THE FACTS AND THE LAW, 4 (University press, 2nd. Ed. 1888) (1949).

<sup>52</sup> ROBERT O. ANDERSON, FUNDAMENTALS OF THE PETROLEUM INDUSTRY 40 (1984). The company formed to exploit D'Arcy's concession was the forerunner of British Petroleum. In 1933, negotiations between the country and the Anglo-Persian Oil Company reduced the area covered by the concession to 10,000 square miles and extended its term to 1933.

<sup>53</sup> J. SILVA HERZQ FLORES, HISTORIA DE LA EXPROPIACION DE LAS EMPRESAS PETROLERAS, 18-32 (1964)

<sup>54</sup> This has been estimated to equal approximately eight cents per barrel. *Id.*

Perhaps the following comment provides the best perspective on the concession system, especially as it existed in the Middle East: *"It must be recalled that in those days, concessions were granted by Sovereigns with sometimes little authority, often under foreign political dominance. Also, the countries concerned were backward, some- times nomadic, and in no case possessed a legal framework liable to govern such things as petroleum operations. Therefore, in order to fill that void, concessions were not only tilted in favor of multi-national corporations] but also written in such a way that they constituted self- sufficient charters for those areas of the world where existed no infrastructure of any kind, nor any government control or capabilities of any sort. Hence, it is hardly surprising that the word "concession" became mentally associated with "underdevelopment" and "political dominance;" this explains from a psychological standpoint, the hostility shown toward this type of agreements.*"<sup>56</sup>

**3.7 OTHER ARRANGEMENTS FOR E&P RIGHTS** - Although the concession was the typical form used to authorize oil development, other types of arrangements were also in use. In many instances, deviation from the concession format was the result of differences in legal regimes. By the turn of the century, the concept that ownership of subsurface minerals, including petroleum, inhered in the sovereign was widespread, but it had not reached the degree of near universal acceptance afforded it today. Hence, in many parts of the world, private ownership of petroleum in place was still possible, and the con- cession, which had been developed as an agreement between a sovereign and an oil company, was often not appropriate for an agreement between purely private parties. Therefore, where private ownership was possible, the arrangement used was likely to be either the oil and gas lease, which is a variant of the traditional concession,<sup>57</sup> or

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<sup>56</sup> KEITH W. BLINN ET AL., INTERNATIONAL PETROLEUM EXPLORATION & EXPLOITATION AGREEMENTS, LEGAL, ECONOMIC, AND POLICY ASPECTS 56 (1986).

<sup>57</sup> In many ways the early concessions and early oil and gas leases were strikingly similar. This was especially true with respect to the scope of rights granted and the size of landowner's "take." It often held true for duration. Fixed term leases, varying in length from 50 to 99 years, were common in the late nineteenth and early twentieth centuries. James A. Veasey, *The Law of Oil and Gas*, 18 MICH. L. Rev. 652, 655-56 (1920).



the outright sale of under- ground minerals, which was the basis for extensive oil company claims in Mexico.<sup>58</sup>

### **3.8 PRESENT OPERATIONAL CONTRACTUAL SYSTEMS**

Today, extraction contracts are premised on transnational public- private partnerships Together, a transnational group of governments and companies generally share control over the financing, exploration, production and marketing of natural resources in varying degrees. For example, a foreign government may involve itself in a project through an export credit agency that advances loans to a project company.<sup>59</sup>Through the involvement of export credit agencies, foreign governments may influence project decision-making. This influence may be amplified in situations in which several export credit agencies are involved in a single project and coordinate their activities. At times, intergovernmental organizations may also be involved in a project.<sup>60</sup>

The involvement of the export credit agencies and the international financial institutions will carry with it their own respective project documentation, often in the form of loan agreements. The nature and form of the overarching partnership, however, varies according to contract type. Furthermore, the contractual clauses are often even more important in defining the nature of the partnership than the contract type.<sup>61</sup>

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<sup>58</sup> Ernest E. Smith & John S. Dzienkowski, *A Fifty-Year Perspective on World Petroleum Arrangements*, 24 Tex. INT'L L.J 13, 23-30 (1989)

<sup>59</sup> BADI H. BALTAGI, U.S. GASOLINE DEMAND: WHAT NEXT?, 129-140 (University of Houston,Houston, Texas)(2000).

<sup>60</sup> F. GERARD ADAMS AND JAIME MARQUEZ, PETROLEUM PRICE ELASTICITY, INCOME EFFECTS, AND OPEC'S PRICING POLICY, 115-128, (Economics Research Unit, University of Pennsylvania, Philadelphia)(1999).

## CHAPTER 4

### 4. RISE OF NEW CONTRACTUAL REGIMES - WORLD

The basic contract types are

Modern concessions; Production-sharing agreements; Joint ventures; and Service contracts.<sup>62</sup>

Today, under concession contracts and licenses, IOCs are often given exclusive rights to explore for and produce hydrocarbons and in return are required to pay royalties, taxes, and fees to the government.<sup>63</sup> In a PSC, the IOC has similar rights, but obtains only “cost oil” and a share of any “profit oil” produced, with the state recouping the remainder in lieu of, or sometimes in addition to, collecting royalties.<sup>64</sup> The IOC also pays taxes and fees.<sup>65</sup> Under a risk-service contract the IOC explores for and produces petroleum on behalf the government and is paid a fee for its services, with a possible right to buy a portion of the production. Association or joint venture agreements involve IOCs partnering with host governments or state-owned enterprises and, as in a PSC, sharing petroleum production.

**4.1 DEPLORING PRECEDENCE OF CONCESSIONS** – Today, of course, few countries are willing to transfer to oil companies the virtually unfettered control over petroleum reserves that was found in early arrangements. One reason is the recognition of the importance of petroleum to a country's economy. Countries, such as Saudi Arabia, the United Arab Emirates--or even Norway--may correctly view oil as their most valuable export; others, such as the United Kingdom or Brazil, may view domestic production as an important element in achieving or maintaining a degree of energy self-sufficiency which is essential to the welfare of an

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<sup>62</sup> King & Spalding LLP, *An Introduction to Upstream Government Petroleum Contracts: Their Evolution and Current Use*, OIL GAS & ENERGY LAW, at 3, Mar. 2005, <http://www.ogel.org/article.asp?key=1730>.

<sup>63</sup> Michel Kerf, *Concessions for Infrastructure*, 7 (World Bank, Working Paper No. 399, 1998), available at [http://truu.worldbank.org/Documents/Toolkits/concessions\\_fulltoolkit.pdf](http://truu.worldbank.org/Documents/Toolkits/concessions_fulltoolkit.pdf).

<sup>64</sup> BERNARD TAVERNE, AN INTRODUCTION TO THE REGULATION OF THE PETROLEUM INDUSTRY: LAWS, CONTRACTS AND CONVENTIONS, 24, 28 (1994); Thomas W. Waelde, *International Energy Investment*, 17 ENERGY L.J. 191, 200, 202 (1996).

<sup>65</sup> CONTRACT FOR HYDROCARBON EXPLORATION & EXPLOITATION IN THE UCAYALI BASIN BETWEEN PERUPETRO S.A. & CHEVRON OVERSEAS PETROLEUM (PERU) LTD. (block 52) (Nov. 8, 1995)

industrialized or industrializing economy. In either event, the country will insist upon retaining some degree of control over development of reserves. A second and even more compelling reason why many countries refuse to grant traditional concessions or, indeed, even to call development arrangements concessions are closely connected with concepts of ‘**National Sovereignty**’. The United Nations Resolution on Permanent Sovereignty over Natural Resources,<sup>66</sup> the Declaration on the Establishment of a New International Economic Order,<sup>67</sup> and the Charter of Economic Rights and Duties of States<sup>68</sup> reflect a view widely held throughout the Third World that sovereignty is compromised if control over domestic oil reserves and other minerals is placed in the hands of foreign corporations.<sup>69</sup> There are different methods of exercising control. It may be done directly through a governmental agency that attempts to develop reserves itself or indirectly through the means of authorizing development. In practice, these forms and labels tend to be much less important than the specific content of a contract. However, one relevant difference is that unlike a typical concession, an IOC’s costs are generally recoverable under a PSC in the form of “cost oil.” If costs associated with remediating and compensating for environmental harm are “cost recoverable,” then the host government, not the IOC, would assume the risk of such costs.<sup>70</sup> A similar issue may arise with risk-service contracts and even with concessions that have royalty rates that are somehow indexed to costs.

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<sup>66</sup> G.A. RES. 3201, U.N. GAOR, 6th SPECIAL SESS., SUPP. No. 1, at 3, U.N. Doc. A/9559 (1974).

<sup>67</sup> G.A. RES. 1803, U.N. GAOR, 17th SESS., SUPP. No. 17, at 15, U.N. Doc. A/5217 (1962).

<sup>68</sup> G.A. RES. 3281, U.N. GAOR, 29th SESS., SUPP. No. 31, at 50, U.N. Doc. A/9631 (1974).

<sup>69</sup> David E. Pierce, *Rethinking the Oil and Gas Lease*, 22 TULSA L.J. 445 (1987).

## CHAPTER 5

### 5. PRODUCTION SHARING CONTRACT – A NEW REGIME

The Production Sharing Contract (PSC) as a chosen instrument of co-operation between a government entity and a foreign investor in oil and gas industry is relatively new. This particular form of contractual arrangement was first adopted somewhat 50 years ago, however at time of introduction; the concept was in fact naïve to countries. But this was not a foreign concept, such production-sharing had been used for hundreds of years in Indonesia in the sharing of harvest (crop sharing) between landowners and farmers. This system was understood by all, because it was widely used and accepted. Its legal basis, though, cannot be found in statutes but rather in ‘Adat’ i.e Indonesia’s customary law, existing for centuries.

**Dr. Ibnu Sutowo**, first president director of Pertamina, the Indonesian state-owned oil company, pointed out in a private interview that “*a concession was tantamount to surrendering of a nation’s sovereignty to the concessionaire*”<sup>71</sup>. Even the basis for tax payments by the majors was vague, as it was based on what was called “**posted prices**”<sup>72</sup>. As the majors fully controlled the market, it was quite understandable that a different system was called for in an independent Indonesia with a constitutional mandate demanding that the state “controls the natural resources contained in the land and the water.” Indonesia was not alone in voicing its disagreements with aligning interests of the concessions system, Venezuela, for example, actively sought support for the changes in the concession system and for changes in the tax regime, which it achieved in 1948. It was not until 1959, when the **First Arab Congress was held in Cairo**, that producing countries came together.<sup>73</sup> The writing on the wall was quite clear: the concession system had to

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<sup>71</sup> TENGKU NATHAN MACHMUD, THE INDONESIAN PRODUCTION SHARING CONTRACT: INVESTOR’S PERSPECTIVE, 497, (Kluwer Law International, Business And Economics)(2000)

<sup>72</sup> GHANMEN (1986) explains posted prices as follows-  
“when oil was first discovered by the adventurers, they would post on their rigs the price at which they were willing to sell their oil. In the business this was referred to as the “posted price”.... oil producing countries did not concern themselves with the posted price until 1948, when Venezuela modified its concession agreement with oil companies and started getting its 50% share of profits based on posted price. The posted prices are not necessarily the real prices which oil companies receive from their oil sales, known as the “realized price” ...throughout history of the oil industry, posted price determination was based on different formulas.”

<sup>73</sup> D.Zahar, *The Production Sharing Contract - Current Status*, 39, PROCEEDINGS INDONESIAN PETROLEUM ASS., EIGHTH ANNUAL CONVENTION, (1979).

simply go. It was running afoul of the national aspirations as succinctly expressed in Article 33 of the 1945 constitution.<sup>74</sup>

## 5.1 INDIAN PSC MODEL - HISTORY

THE EARLY EXPLORATION phases in India were taken over by the national oil companies. Efforts to involve foreign and domestic private sector companies in the business of exploration and production of oil and gas in India began as early as 1973. In 1974, however, Oil and Natural Gas Corporation Limited (ONGC) in Bombay High made a major hydrocarbon discovery and production therefrom started flowing two years later in 1976.<sup>75</sup> Though the initiative to involve private sector apparently went into the background, it was continued through the 1980s on a low key. Three rounds of bidding between 1980 and 1986 did not yield any concrete results. Meanwhile consumption of petroleum products kept rising and domestic production of hydrocarbons reached a plateau. Consequently, import intensity of Indian Petroleum sector became a critical factor in the management of the economy. Responding to this situation, the Government decided in 1991 to invite foreign and domestic private sector companies to participate in the development of discovered oil and gas fields and, in some cases, partially developed by the national oil companies (NOCs) viz. ONGC and Oil India Limited (OIL). The decision to involve private sector in the development of discovered and partially developed oil fields licensed to NOCs was an Adhoc measure taken to meet the then existing foreign exchange crisis. However, the Government, in 1993, introduced a policy of round-the-year bidding for exploratory blocks. A further step forward was taken in 1997 with the announcement of **New Exploration Licensing Policy (NELP)** to rationalize overall policy framework for the hydrocarbon sector. Consequently rounds of bidding were held and with the experience gained,

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<sup>74</sup> FABRIKANT (1975) notes:

*“During the 1950s as overall retrenchment took place in the petroleum industry and the exploration activities virtually ceased. Partly, this slowdown was attributed to storage of export opportunities’. But also were increasing demands for nationalization of all petroleum fields, which prompted the government to refrain from signing new concession contracts and to confine concessionaires to existing acreage. Also the formation of a state commission in 1951, inter alia, to draft ‘an Indonesian mining law in harmony with the present conditions’ all of which caused the companies to believe that they were operating in a legal twilight zone.”*

<sup>75</sup> CAG COMMERCIAL REPORT NO.6, *Performance of Production Sharing Contracts with Private Exploration and Production Companies*, (2005)[http://www.cag.gov.in/reports/commercial/2005\\_6/6\(iii\)-Production%20Sharing.pdf](http://www.cag.gov.in/reports/commercial/2005_6/6(iii)-Production%20Sharing.pdf) last accessed on 4/03/2015

the package of incentives to attract private investment, both domestic and foreign, in the hydrocarbon sector was improved upon from time to time.

## **5.2 SHIFT IN REGIME FROM NATIONALIZATION TO PRODUCTION SHARING**

**MODEL** -The global market for oil and gas exploration has evolved to the point that much of the world's surface open to exploitation has taken on some of the characteristics of a commodity. Governments compete for capital and technology to develop their hydrocarbon sector.<sup>76</sup> In order to devise and apply the appropriate policies, strategies and tactics, each must assess its position in the global marketplace and evaluate its particular situation, boundary conditions, concerns and objectives. Companies look for investment opportunities that suit their corporate strategies and risk-reward profiles. The initial decision to invest and the resulting allocation of revenue and benefits are greatly influenced by the content of existing legal arrangements and fiscal policies. High oil prices have also triggered higher demand for services and equipment, which in turn has increased their cost.<sup>77</sup> As many fiscal systems were designed when oil prices were in the US\$15-18 barrel range and finding and development costs were US\$5-9 barrel, these systems no longer efficiently capture the projects' economic rent.

**For overall growth of GDP**, the government realized, a new and advanced fiscal regime needs to be adopted. This regime can then be used to convert a government's policy into economic signals to the market, and influence investment decisions, provided that the framework is clear, is not changed retroactively, and does not discriminate among the actors. Several countries have used favorable taxation of oil and gas to support the development of the sector in addition to relevant sector reforms<sup>78</sup>. The challenge of an efficient fiscal system is to induce maximum effort

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<sup>76</sup> H. LE LEUCH, CONTRACTUAL FLEXIBILITY IN NEW PETROLEUM INVESTMENT CONTRACTS, IN PETROLEUM INVESTMENT POLICIES IN DEVELOPING COUNTRIES, (Bjeredi, K. & Walde, T. Ed.,Graham & Trotman) (1998).

<sup>77</sup> The World Offshore Oil and Gas Products and Spend Forecast 2007-11, published by Douglas-Westwood, predicts this trend to continue over the next five years, with particular emphasis on deep water floating and subsea production solutions. Operating costs are also expected to increase by more than 50 percent by 2011 as a result of increasing output and producing a higher share of more expensive oil. The impact will differ among regions.

<sup>78</sup> R.N ANTHONY, J. DEARDEN, AND N.M. BEDFORD, ANALYZING AND REPORTING FINANCIAL PERFORMANCE - IN MANAGEMENT CONTROL SYSTEMS, (IRWIN, R.D., ed.2 Illinois, US: Homewood) (1984).

from the oil companies while ensuring that the host government is adequately compensated.<sup>79</sup>

The provisions in an E&P contract, be it a PSC or a SC, are therefore a reflection of an attempt to reconcile these competing interests. In designing a fiscal system, a government has to answer the following questions:

What is the effect of the fiscal regime on oil/gas output?

Does it discourage the development of marginal fields? Does it influence the pace of development?

Does it favor early abandonment?

Is it insensitive to oil/gas price and cost variation?

In other words, how flexible, neutral and stable is the fiscal regime?

Many fiscal systems around the world make use of sliding scales for the determination of at least one of the following parameters: royalty, bonuses, profit oil/gas split, cost recovery, and taxes. Sliding scales introduce flexibility into the system by allowing it to respond. The legal basis for hydrocarbon exploration, development and production is normally established in a country's constitution.<sup>80</sup> Normally, the hydrocarbon law, formulated at parliamentary level, sets out the principles of law, while those provisions that do not affect principles of law, or that may need periodic adjustments (such as technical requirements, administrative procedures, and administrative fees), are set in regulations. Governments grant exploration, development and production rights in particular areas or blocks by means of concessions or contracts, depending on their legal systems<sup>81</sup>. Where no hydrocarbon law exists, comprehensive contractual agreements between host governments and investors are used.<sup>82</sup>

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<sup>79</sup> JOHNSTON D., INTERNATIONAL PETROLEUM FISCAL SYSTEMS AND PRODUCTION SHARING CONTRACTS (USA, Tulsa, Oklahoma: PennWell Books) (1994).

<sup>80</sup> The consistency of the legal framework with the constitutional foundation affects the security and stability of the legal framework. This issue is particularly significant because many countries' constitutions differ substantially in

the degree to which they recognize or guarantee private property rights or prohibit private parties or foreigners from acquiring property rights in general and mineral rights in particular; vest the authority to grant petroleum rights in the state or provincial governments or agencies rather than the national government, vest the authority to regulate specific matters in special agencies (i.e., environment protection) or in the executive branch (for example, taxation, foreign exchange, employment, and so on) or in the judiciary (settlement of disputes). Due to the capital intensive and long term nature of petroleum projects, certainty of rights is particularly important for private investors.

<sup>81</sup> THE ENERGY INFORMATION ADMINISTRATION'S REPORT ON FINANCIAL PERFORMANCES OF OIL AND GAS PRODUCING COMPANIES OF 1978.

<sup>82</sup> Those countries that face the uncertainty of entering the sector for the first time or in cases where the importance of the petroleum activity may not justify the design of unique policy regimes may favor this approach.



## CHAPTER 6

### 6. SECTOR SPECIFIC LEGISLATION FOR OIL EXPLORATION

Although in most countries, all matters related to petroleum exploration, development and production tend to be governed by sector specific legislation and regulation, countries that have recently reformed their hydrocarbon sector, like India,<sup>83</sup> have shown a preference for the establishment of modular legal frameworks. In these cases, all matters related to hydrocarbon rights and their use are governed by the hydrocarbon law/regulations; all matters relating to taxation are defined in the tax code/regulations; all issues relating to environment protection are defined in the environmental law/regulations; and so on. Thus, the hydrocarbon law incorporates other laws by reference. Modularity increases transparency and accountability, reduces administration costs, and facilitates compliance. Sec. 6 (1) of the OIL FIELD REGULATION AND DEVELOPMENT ACT, 1948,<sup>84</sup> gives power to the Centre to formulate such rules for conservation and development of Mineral oils. Such rules were formulated under the PETROLEUM AND NATURAL GAS RULES, 1959,<sup>85</sup> that gives the power to the Central Government to enter into an agreement (PSC) with the Licensee.

#### 6.1. UNDERLYING INTERESTS OF HOST GOVERNMENT

Offshore, exploration acreage may be in territorial or international waters. In the latter case, within recognized limits, the host government will normally have obtained, usually by international consent, certain rights in relation to those waters, which, though they may fall short of outright ownership, will still convey full regulatory powers over them. If rights are asserted, in areas where the limits of offshore jurisdiction have not yet been agreed between two governments, or where there are outstanding disputes that need to be resolved, an operator's title may be open to question, and therefore at risk. The underlying interests of the Host Government

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<sup>83</sup> H.R. BROCK, J.P. KLINGSTEDT AND D.M. JONES, PETROLEUM ACCOUNTING: PRINCIPLES, PROCEDURES AND ISSUES (Texas, US: Professional Development Institute) (2000).

<sup>84</sup> THE OILFIELDS (REGULATION AND DEVELOPMENT) ACT, 1948 (53 of 1948) (8TH Sept, 1948) available at <http://petroleum.nic.in/ordact.pdf>

<sup>85</sup> G.S.R. 1288. In exercise of the powers conferred by Sections 5 and 6 of the Oilfields (Regulation and Development ) Act, 1948 (53 of 1948) and in supersession of the Petroleum Concession Rules, 1949, the Central Government hereby makes the following rules, regulating the grant of exploration licenses and mining leases in respect of petroleum and natural gas which belongs to Government

(HG) and the Contractor (IOC) influence the features of upstream oil and gas contracts.<sup>86</sup> On the one hand the HG is motivated primarily by the need to attract risk capital and modern E&P technology and secure socio-economic national interest<sup>87</sup>. The IOC on the other hand is driven by the desire to make a sufficient return on investment. Various legal regimes have been developed to address the rights and obligations of host governments and private investors. These are usually classified into two main categories:

1. Concessions (also called licenses or tax/royalty systems);  
and 2. Contracts:

- Production sharing contracts (PSCs); and

- Service agreements (SAs).

Although these arrangements are conceptually different from each other particularly in terms of level of control exercised by the government<sup>88</sup>, ownership rights, compensation systems- they can be used to accomplish the same purpose. There is often substantial variation between concessions or contracts within a given category. Some regimes have characteristics of more than one category and are considered “hybrids.” For example, many PSCs (such as those in Indonesia, Nigeria, Malaysia, India, China, and Russia) also have royalties and/or taxes included in their standard agreements.

## **6.2 THE ALLOCATION OF PETROLEUM E&P RIGHTS**

While countries use diverse systems to allocate petroleum E&P rights, these systems can be grouped under two main categories:

□ Open door systems: Licenses are awarded as a result of negotiations between the government and interested investors through solicited or unsolicited expressions

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<sup>86</sup> King & Spalding, *An Introduction to Upstream Government Petroleum Contracts: Their Evolution and Current Use*, OGEL, January 2005 <http://www.ogel.org/article.asp?key=1730> accessed on 14/02/2015

<sup>87</sup> JENIK RADON, ‘THE ABCS OF PETROLEUM CONTRACTS: LICENSE-CONCESSION AGREEMENTS, JOINT VENTURES, AND PRODUCTION-SHARING AGREEMENTS’, (Tsalik S & A. Schiffirin 61-69) (<http://openoil.net/wp/wp-content/uploads/2011/12/Chapter-3-reading-material1.pdf> 61-99)

<sup>88</sup> V. Afualo, and J. McMillan. *Auction of Rights to Public Property*, The New Palgrave Dictionary of Economics and Law, (New York: Peter Newman) (1998).

of interest.

- □Licensing Rounds: Administrative Procedures- Licenses are allocated through an administrative adjudication process on the basis of a set of Criteria defined by the Government; and
- □Auctions: Licenses are allocated to the highest bidder.

Each category has advantages and disadvantages in terms of transparency and economic efficiency.<sup>89</sup> Within each category, countries use various allocation mechanisms. Some countries use rather rigid mechanisms with limited biddable items that affect the division of profit between government and investors. Others award their acreage on the basis of the work program bidding, with all financial elements “fixed” by legislation. In other countries, everything is negotiable.<sup>90</sup>

### 6.3 BIDDABLE OR NEGOTIABLE PARAMETERS

A wide range of contractual elements may be negotiable or biddable.<sup>91</sup> This depends on a country’s laws and regulations, as well as the chosen licensing procedure. Some countries have adopted rather rigid systems whereby only a single term or a limited number of contract terms are negotiable, while others afford much wider discretion to the sector minister, the regulator, or the other government authority tasked with the licensing of E&P rights.

It includes-

- Signature bonuses
- Royalties
- Work programs<sup>92</sup>

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<sup>89</sup> S. J. Evenett and B. M. Hoekman, ‘International Cooperation and the Reform of Public Procurement Policies’, Research Working Paper, August 2005, pp. 21-5, available at <http://www.evenett.com> (accessed 27 April 2015).

<sup>90</sup> B. Bašheka, ‘Public Procurement Reforms in Africa: A Tool for Effective Governance of the Public Sector and Poverty Reduction’, in K. V. Thai (ed.), *International Handbook of Public Procurement*, CRC Press (2009)

<sup>91</sup> L. Ausubel, and P.R. Milgrom. , *Ascending Auctions with Package Bidding- Advances in Theoretical Economics* 1(1) 142. Berkeley Electronic Press. (2002).

<sup>92</sup> Work program commitments are generally defined by the type of work, such as amount and type of seismic data to be acquired, number of exploration wells to be drilled and so on. A monetary value is normally assigned to each activity. Petroleum arrangements usually bind the contractor or the license holder to undertake the minimum work program or pay the correspondent monetary amount to the host government. When it is a biddable parameter, the standard monetary value of each unit of work may be

- Profit shares

‘Bundle bids’ have also been used to expedite the development of particular geographical areas or geographical basins,<sup>93</sup> or to facilitate the transfer of technology and know-how to small or indigenous companies, or to satisfy the demands of local constituencies. For example, the government may link the award of highly prospective deep offshore blocks to investors on the condition that they agree to invest in the exploration and development of less attractive blocks in the remote or challenged areas.

## **6.4 PRODUCTION SHARING MODEL- THE PRESENT REGIME**

### **6.5 PRODUCTION SHARING CONTRACT DEFINED**

A PSC can be widely defined as ‘a private<sup>94</sup> contract between one or more IOC and a NOC pursuant to legislation which vests a license or a general exclusive authorization in the NOC to explore for, exploit and produce hydrocarbons’<sup>95</sup>

### **6.6 ORIGIN OF PSC**

Historically, and mainly in the early part of the last century, the large oil companies were granted concessions in the various parts of the world, often spheres of British and US influence, particularly the middle east. The concessions usually included a grant of the exclusive right to exploit oil and gas with few controls, for long-term period, often over wide areas. The host government generally reserved little or no right to participate in the process of exploitation and the operation of any field subsequently developed. Though considered advantageous at the time because of the expertise of the oil companies, these concessions increasingly came to be seen as

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defined in the bidding procedure to promote transparency in bid evaluation systems.

<sup>93</sup> P. CRAMTON, “AUCTIONS VERSUS DISCRETION IN THE LICENSING OF OIL AND GAS ACREAGE - IN *THE INTERNATIONAL EXPERIENCE: MARKETS, REGULATIONS, AND THE ENVIRONMENT*. (London: Imperial College Press) (2000).

<sup>94</sup> There however remains a debate on whether a contract entered into by a government can be termed ‘private’ or public – ‘Contractual’.

<sup>95</sup> Stephenson Harwood ‘Production Sharing Contracts: An Analysis of Comparative Practice in Certain African Jurisdictions’ (11th Oil and Gas, United Nations Conference on Trade and Development Trade and Finance Conference, Nairobi, 23rd -25th May- 2007)  
[http://www.unctadxi.org/Sections/DITC/Finance\\_Energy/docs/11thAfrican/11thAfrican\\_Marc%20Hammeron.pdf](http://www.unctadxi.org/Sections/DITC/Finance_Energy/docs/11thAfrican/11thAfrican_Marc%20Hammeron.pdf) accessed on 15/03/2015

too generous. As time when by and political complexions changed there was increasing resentment on the host government and the extent of the rights granted were seen as raising issues of sovereignty.<sup>96</sup> Wherever possible- particularly where countries had been under the domination of foreign powers, and independence was subsequently attained, or where there was some form of political revolution, governments typically asserted state ownership of natural resources. The manifestations of these assertions of rights were various; there could be some kind of declaration, or perhaps, more formally, new legislations. Whatever form they took, these new rights being asserted were often incompatible with the existing infrastructure of agreements that was in place between the host government and the oil companies. These “nationalizations” were therefore effected with varying degrees of legal validity, on a scale of 1-10 probably ranging from no higher than 5 at best, all the way down to zero. The acquisition of equity in the local subsidiary of the oil major in question by reluctant agreement was one comparatively respectable way of securing control.<sup>97</sup> In other cases, concession agreements were simply declared to be at the end, notwithstanding that they often contain expressed terms to the effect that they continue in force for many more years before they could validly be terminated or re-negotiated.<sup>98</sup> Where these rights were asserted by host nations, the oil companies were put in a difficult position. It was incumbent upon them to take legal advice on the contractual position and, though the advice might have been that the host government has repudiated the contract, good in theory, it was often by no means easy to challenge its actions in practice, quite apart from that general difficulty, jurisdiction clause or dispute resolution wording in the contract was not always adequate or advantageous to the oil company. The best route for the resolution was international

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<sup>96</sup> This idea is synthesized in the phrase “the price of oil and the pace of freedom always move in opposite directions in oil-rich petrolist states” (THOMAS FRIEDMAN, *THE FIRST LAW OF PETROPOLITICS FOREIGN POLICY*, 22-24 (154 Foreign Policy, Washington 28) (2006) . Another thesis is that of Roubini and Guriev, according to which the relationship between oil and nationalization is primarily about the state’s revenue calculations. Nationalization allows the state to take a larger share of the windfalls from increasing oil prices but this entails an efficiency trade-off, hurting long-term production and revenues. States are more likely to act when oil prices are especially high and the short-term gains from increased revenue outweigh the long-term benefits from efficient oil-field development and higher taxes or revenue sharing from an IOC (i.e. when there is an extreme “oil price shock”). See Nouriel Roubini, *Is Resource Nationalism Back?*, Forbes.com (2009) and Sergei Guriev, Anton Kolotilin and Konstantin Sonin, *Determinants of Nationalization in the Oil Sector*, J. OF LAW, ECONOMICS AND ORGANIZATION 301(2011). For a complete analysis, see also Ryan Kennedy and Lydia Tiede, *Nationalization of the Oil Sector: A Political Economy Perspective*, University of Houston, (2011).

<sup>97</sup> Arvid Pardo, Ambassador of Malta to United Nations, Address at the 22nd session of the General Assembly of the United Nations (1967), U.N. GAOR, 22nd sess., U.N. Doc. A/ 6695 (September 21, 1967).

<sup>98</sup> An example is the repudiation, in April 2005, of 32 operating-service agreements by the Venezuelan Government, which claimed that they were illegal because they were not in line with the country’s laws.

arbitration, where this was provided for in the contract or where the government could be persuaded to agree. Even if the government submitted to arbitration, it was always still possible for it to raise arguments. in support of the validity of its actions, despite the an apparently clear repudiation. For example, a common way for the host government to uphold the validity of these unilateral changes was to assert the concept that the fundamental change that had occurred in the political background- a change perhaps, freely, and inviolably permitted under the constitution, or at least, unchallengeable- had changed the nature of contract itself, by creating a new background against which its terms must henceforth, be interpreted. Under this argument, the concept of repudiation was not appropriate.

## **6.6 NATURE OF PSC**

In any event party as a result of the demise of these old-fashioned concessions, and partly as an alternative to such concessions, irrespective of historical factors and despite the continuing existence and use of license regimes, PSAs have become an increasingly popular mechanism with developing countries. PSCs could be distinguished from concessions because of their purely contractual nature. Broadly speaking, the oil company invests, by invitation of the host government, in the exploitation of the area, and is rewarded, if development results, first with recovery of its costs and then with share in production, such share being determined by mechanisms in the agreement.<sup>99</sup>

The investment by the oil company is the most important factor for the host government because it usually funds the whole, or substantially the whole, of the initial cost of exploration in return for tax concessions. These are often the key factor from the oil company's key point. Upon pensate itself for the tax it has forgone and any other revenues, such as royalties, which it would

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It has been observed that "Better-performing companies, with better political risk assessment capabilities,...experienced fewer cases of expropriation, government paying default, import/export license cancellation, or currency transfer restriction than other firms in [the] sample." MATHEW SHINKMAN, THE INVESTOR'S VIEW: ECONOMIC OPPORTUNITIES VERSUS POLITICAL RISKS IN 2007-11 (World Investment Prospects to 2011: Foreign Direct Investment and the Challenge of Political Risk 84, 94 (2007)). See also Detlev F. Vagts, *Foreign Investment Risk Reconsidered: The View from the 1980s* 2 ICSID Rev.: Foreign Inv. L.J. 1(1987) and Maniruzzaman, *The Issue of Resource Nationalism: Risk Engineering and Dispute Management in the Oil and Gas Industry* 5(1) TEX. J. OF OIL, GAS, AND ENERGY LAW 79 (2009-2010).

otherwise have received, out of the income stream, then taking a share of profits in a predefined manner. PSAs came into prominence in the 1970s, though they date from the 1960s when state control of the oil industry was especially fashionable.<sup>100</sup> Countries first using them included Egypt, Syria, Indonesia, Peru and Papua New Guinea. As they matured, they evolved. Methods of calculating the government income varied. Revenues could be based on an agreed share in actual production, as that the share increased as production increased, or could be based, for example, on the company's return on investment, i.e. a proportion of the yield as a percentage of capital employed.<sup>101</sup>

**Russia** has become a fashionable exploration province, and the PSAs have developed very rapidly there. There is an accepted part of the system by majors and independents alike, whose shared aim is to limit their exposure to excessive taxes as far as possible. This risk tends to be greater under a concessions regime, but it is a fact of life recognized by all who have dealings in Russia that there will be frequent use of the term “**bureaucracy**” in connection with the Russian administration of matters legal. PSAs in Russia have thus become needlessly complex, combining elements of a concessionary system with what should be a simple contractual one. There is no alternative for the oil company but to swallow and pay homage to the insatiable Russian appetite for regulation and control. The host regimes do not necessarily prescribe that PSAs are the only means of obtaining an interest in hydrocarbons and many governments habitually reserve the right to negotiate some other form of agreement, for example, what is sometimes loosely called a “**Co-operation agreement**”, which may prescribe a number of forms of mutual assistance.<sup>102</sup>

Sometimes, again, a government will still maintain a regime reserving the right to issue exploration or production licenses giving proprietary rights in consideration for a royalty or fee, as well as entering into PSAs in specific cases. Under a PSA the party contracting with the oil

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<sup>100</sup> A.F.M. Maniruzzaman, *International Development Law as Applicable Law to Economic Development Agreements: A Prognostic View* 20 WIS. INT'L L.J. 1 (2001) and A.F.M. Maniruzzaman, *State Contracts in Contemporary International Law: Monist versus Dualist Controversies* 12 Eur. J. Int'l L. 309, 309–328 (2001).

<sup>101</sup> National Oil Corporation of Kenya, Sample Production Sharing Contract (2004) <http://nationaloil.co.ke/upstream/?flag=upstream> accessed on 1/04/2015.

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Art. 33 of the Venezuela's 2001 HYDROCARBONS ORGANIC LAW states that: "Any subsequent amendment of such conditions shall also be approved by the National Assembly with the prior favourable report of the Ministry of Energy and Petroleum and the Permanent Commission of Energy and Mines."

company may be either the government oil company will probably have an exclusive license, granted to it by the government. In such case it will probably, therefore, be liable to pay a license fee or a royalty, and may seek reimbursement for these payments from the operator. If it does, the operator may seek to negotiate a higher share of production as its entitlement under the PSA.<sup>103</sup>

## 6.7 LICENSES AND PSC CONTRASTED

A license will grant the operator a right to exploit a defined area in consideration of a fee and/or royalty and often, also a work Programme commitment. That right is normally stated to be akin to a “**profit a prendre**”, or in short, proprietary rights not merely a right of use.<sup>104</sup> It is important to emphasize that the term: ‘license’ does not in itself means that proprietary rights are being granted. It all depends upon the nature of the grant, and that is, in the detailed wording<sup>105</sup>. There will be jurisdictions where something called a license may be required to be issued in parallel with another more vital agreement, for customary or regulatory reasons, without conveying any rights of importance. It should be noted, for example, that in regimes that make habitual use of production sharing agreements (PSAs) it does not follow that licenses will not be awarded. Rather confusingly, many such regimes also grant licenses, through the operator’s right will still

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<sup>103</sup> P.E. Comeaux, N.S. Kinsella, *Reducing Political Risk in Developing Countries: Bilateral Investment Treaties, Stabilization Clauses, and MIGA & OPIC Investment Insurance* 15 N. Y. LAW SCHOOL J. OF INT’L AND COMPARATIVE LAW 1(1994).

<sup>104</sup> Maniruzzaman, *The Issue of Resource Nationalism: Risk Engineering and Dispute Management in the Oil and Gas Industry*, 5(1) Tex. J. OF OIL, GAS, AND ENERGY LAW 79 (2009–2010).

<sup>105</sup> 2010 World Investment and Political Risk—MIGA Report, fn.100. According to Maniruzzaman, "The issue of resource nationalism: Risk engineering and dispute management In the oil and gas industry" 5(1) Tex. J. OF OIL, GAS, AND ENERGY LAW 79, (2009–2010), there are comparative advantages and disadvantages of the public and private sources that international oil companies might consider for their individual requirements and situations. In such private insurance programs, various types of political risk cover may be found: confiscation, expropriation, nationalization and deprivation (CEND) risks, forced abandonment and selective discrimination, and terrorism and political violence. In this regard see also George Joffé et al., *Expropriation of Oil and Gas Investments: Historical, Legal and Economic Perspectives in a New Age of Resource Nationalism* 2 J. World Energy L. & Bus. 3, 12– 13(2009). Forced abandonment has been defined as the situation where an insured is "forced to abandon the insured interests because of the host country’s actions", while selective discrimination means "The passing of a law, etc. by the host government which has to be ‘selectively and discriminately’ applied against the project or the insured and which either ‘expressly and selectively’ prevents or restricts the operation of the project so as to the cause the ‘permanent and total’ cessation of the project’s activities, or which legally prevents the insured from participating in the benefits of the project."



arise from the PSA. In these cases the license is usually a mere confirmation of the rights derived from the PSA. Often it does not confer a separate set of rights or obligations at all. Alternatively, it may be that a full proprietary license is, in fact, issued but only to state oil company participating with the operator as a vehicle to give the state oil company the status then to contract with the operator under the PSA. A PSA grants no proprietary rights but is an agreement under which the operator is given a share of production as compensation for its investment and its assistance to the host government and exploiting its reserves<sup>106</sup>. By the time of the grant it's merely a contractual right. These different types regimes are also analyzed in the report. A third rather less popular route nowadays, is the grant of the service agreement, under which the company will again gain no proprietary rights, just a contractual entitlement, probably of a still more limited nature for example – an entitlement to barrels of produced oil at a discounted price, disliked by the oil majors as they generally cannot book these as reserves. A license, whether it is for exploitation of an area of land or a sub-sea region, or for information or data, maybe exclusive or non-exclusive. Most licenses granted by governments to exploration operators are exclusive, perhaps with stated exclusions for specific purposes only. A non-exclusive license would leave the government free to grant further licenses over the same area to third parties, and operators are not keen on other parties having equal rights over areas they have paid large sums to exploit, quite apart from the great potential for practical difficulties that could arise from that arrangement. The majority of exploration licenses, therefore, tend to be in nature of true concessions, as that term is generally understood.<sup>107</sup>

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<sup>106</sup> Nevertheless, according to A.F.M. Maniruzzaman: "One should not, however, lose sight of the fact that the [spectre] of resource nationalism has not only manifested itself in the developing world but also has influenced the [behaviour] of the resource-rich Western developed countries. In December 2005 the British government, pinched by a budget deficit, retrospectively increased, unchallenged in Parliament, the rate of tax to 50% for oil and gas producing companies in the North Sea." A.F.M. Maniruzzaman, *The issue of resource nationalism: Risk engineering and dispute management In the oil and gas industry* 5(1) *Tex. J. OF OIL, GAS, AND ENERGY LAW* 79 Risk Engineering and Dispute Management (2009–2010) .

<sup>107</sup> Mark C. Suchmann and Mia L. Cahill, *Hired Gun as Facilitator: Lawyers and the Suppression of Business Disputes in Silicon Valley* 21 *Law & Soc. Inquiry* 679, 680 (1996).

## CHAPTER 7

### 7. COMMON TERMS OF HOST GOVERNMENT CONTRACT

The concession or license agreement and the PSA have certain provisions in common as they focus on the same subject matter albeit from a different perspective. The following sections examine some of the more common provisions and instances in those terms that might lead to ambiguity or potential disputes.

#### 7.1. PARTIES

The choice of parties to any agreement should be examined carefully, especially when the parties are from different nations and when one of the parties is a government or a public institution. To the extent that a host government is a direct party to an agreement, it accepts direct responsibility and unlimited liability. But it may limit its liability by engaging one of its own enterprises as a contractual party. There is often confusion between those two related, but separate, legal entities where the state-owned enterprise is perceived as the executive arm of the government.<sup>108</sup>

For example, a host government may agree to provide sufficient electrical power for a project and if it fails to do so, it can be held liable. But if the national electric company, even if wholly owned by the government, agrees to provide the power, then only the electric company will be liable for failure to perform, and only its assets can be seized to cover compensation costs. In general, it is advisable for the government to never serve as a direct contractual partner in a commercial agreement, although this is not always possible. In oil deals, national oil companies often serve as intermediaries for the government. For these and other reasons, it is imperative

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<sup>108</sup> *Supra*, n. 8.

that a government should separate its commercial activities from its governmental or regulatory functions. It should not assume contractual liability for exercising regulatory functions.<sup>109</sup>

The oil company partners in any deal with a host government will usually create a subsidiary to serve as party to the agreement. This type of subsidiary will have limited or no assets of its own and it will not be able to rely on the financial resources of the parent company to stand behind its commitments, especially in regard to damages resulting from environmental pollution. Host governments should require a guarantee from the ultimate parent company of the subsidiary so that the host government has a reliable contractual counterparty with the resources to cover potential liabilities.<sup>110</sup>

## **7.2. ACCOUNTING METHODS**

In order to determine profits, there must be a decision on accounting methodology. The United States, UK, and France each have their own national accounting standards, and the International Accounting Standards Board is in the process of drawing up international accounting principles. The varying accounting standards leave room for discretion and interpretation, and can lead to serious disputes.<sup>111</sup> Moreover, the accounting standards do not have provisions prohibiting any particular type of expenses. Consequently how certain expenses are to be treated should be clarified in the contract to avoid potential disputes in this regard. Similarly, intercompany pricing can inflate costs and decrease government compensation.

## **7.3. RECOVERY OF COSTS**

Companies' costs are important for host government revenues because the tax that companies pay and the royalties they share with the government are based on the companies' profits. How

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<sup>109</sup> *Id.*

<sup>110</sup> *Id.*

<sup>111</sup> *Id.*

companies account for their costs determines what profits they report.<sup>112</sup> There are two types of costs: current operating costs and capital investment costs. Current costs are expensed in the year in which they are incurred and represent an immediate deduction from gross income and an immediate reduction in profits. Capital investment costs are long term and can be depreciated over a set period of time. From a government's perspective, the longer the rate of depreciation, the higher its share of the profits during the time period. A company, on the other hand, will seek to recover its costs as quickly as possible through a more accelerated depreciation. Thus, the terms that the companies use for depreciating assets can have a significant impact on government revenues.<sup>113</sup> Whether every expense is valid is a different matter, which would lead to a potential issue between the parties. For instance, issues such as are bonuses paid to expatriate employees as compensation for working in the host country a valid expense? Is the import of a foreign wine for expatriate employees a necessary expense? Should air travel be limited to economy class? Hence, a detailed expense policy is necessary.

Capital investment, whether for drilling rigs and other longer-life or "permanent" investments, is significant. Since they are useable over an extended period of time, they should be depreciated or expensed over time. The oil companies prefer to recover these costs immediately and expense them fully in the year in which they are incurred in order to lower profits for that year and pay less tax and less profit to the host government. If the government allows a rapid depreciation of capital investment, an oil company has less to lose should it decide to discontinue operations. After all, the company will already have recovered the majority of its costs.<sup>114</sup>

## 7.4. TAXATION

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<sup>112</sup> *Id.*

<sup>113</sup> *Id.*

<sup>114</sup> *Id.*

The question of how to tax production is an extremely important issue as income earned from the production and sale of a natural resource often accounts for the biggest portion of the government budget. But if the government taxes too much, it runs the danger of pushing companies out of the country to areas that offer better terms.<sup>115</sup> There are several different types of taxes the government can apply. The first is a profit tax that can come in the form of a corporate income tax or can be subsumed as part of the amount the government agrees to take from any profits. Tax inspectors collect data on production and sales volume data and the price at which the product is sold, and the inspectors audit company expenses. Oil sold to a company's subsidiary in another country may be priced lower or higher than prevailing market prices.<sup>116</sup> Thus, in countries where tax administration is weak, this kind of transfer pricing can create opportunities for tax evasion.

Another tax often imposed on oil companies is a royalty, or excise tax, which is normally a percentage of the value of the production, although it can be a set fee based on volume or quantity.<sup>117</sup> This tax is often imposed on top of other taxes. Governments like these taxes because they are easy to administer, in contrast to the corporate income tax, and their collection does not have to wait until the project becomes profitable. On the other hand, these taxes can be inefficient because they tax production without any regard to profit. However, it is imperative to note that when the project is marginal or not competitively profitable, the royalty or excise tax may discourage further investment.

Bonuses are another source of revenue that are easy to administer. A host country can require a one-time payment before the company starts exploration such as signature bonus, or continued fixed payments once production reaches certain levels like production bonus. Bonuses are fixed payments and do not take into account the success of the project or its profitability; they are

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<sup>115</sup> *supra*, n. 26.

<sup>116</sup> *Santa Elena v Costa Rica* (2000) ICSID Case No. ARB/96/1 paras 71-2, available at <https://icsid.worldbank.org/ICSID/FrontServlet> (accessed 12 June 2014).

<sup>117</sup> *id.*

usually tax deductible.<sup>118</sup> For instance, Norway designed a sophisticated system that adapts relatively well to the stage of development of a project, and awards the government a significant share of the oil rents.<sup>119</sup> The tax rules are based on the ordinary corporation tax (28 percent) and the addition of a special petroleum tax (50 percent). Both taxes are based on the companies' net profits, and all expenses relevant for the activities on the Norwegian continental shelf are tax deductible. Investments are favored by a high depreciation rate. In addition, an uplift allowance lets a company deduct 30 percent more than it invests against the special tax. For example, if capital expenditure is \$100 million, the company can recover \$130 million. Thus, the Norwegian petroleum tax system is favorable for marginally profitable projects because the uplift allowance will shelter profits from the full effect of the special petroleum tax. However, it is imperative to note that Norway has extensive experience in managing a natural resource tax system.<sup>120</sup>

## 7.5. ENVIRONMENT

Each government has an obligation to protect its environment. However, where environmental standards are covered by PSAs and license-concession agreements, environmental rules and regulations can be ambiguous, giving oil companies the right to interpret, negotiate, or even veto, albeit indirectly, environmental standards.<sup>121</sup> For example, the PSC major oil development project generally allows the contracting companies to discharge air emissions “in accordance with generally accepted international petroleum industry standards and practices.” But the problem is that there are no such standards. Moreover, if an environmental standard is simply a contractual provision, then companies, together with the government, are also interpreters of that provision and effectively can exercise a veto. It is standard for an agreement to provide that parties shall mutually interpret or agree on the meaning of unclear terms, which means the consent of both parties is required.

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<sup>118</sup> *Id.*

<sup>119</sup> *Supra*, n. 8.

<sup>120</sup> *Id.*

<sup>121</sup> *id.*

Developing countries, if they are lax on environmental standards and their enforcement, indirectly subsidize the cost of a commercial commodity by permitting their environment to be despoiled. Environmental standards are generally higher in Western countries, but there is no rational reason why they should be, especially in the oil and gas industry, where the commodities are in such demand. The problem arises when oil companies, avoiding the stringent environmental standards in one state, take advantage of more lenient legislation in other countries to discharge, for example, their toxic drilling mud.<sup>122</sup>

Oil companies prefer to pay a relatively low penalty for noncompliance with environmental standards rather than invest in costly pollution monitoring and control. Fines should be high enough to act as a deterrent. Companies usually have an obligation to restore the area upon completion of a project. While some countries like Germany strictly enforce this, other nations employ less stringent requirements.<sup>123</sup>

## **7.6.WORK PROGRAM**

A work program detailing a company's exploration or development plan can be murky, often hiding behind technical and financial considerations, including how to drill in deep water or earthquake areas.<sup>124</sup> In that regard, questions concerning how to best protect the natural environment also become an issue, partially because of the cost of installing the necessary protective equipment. Often an oil company will slow down certain projects it deems too expensive, especially in comparison to other projects that it may be developing in another part of the world. As such, it is important that the host government should insist on a work plan that

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<sup>122</sup> *supra*, n. 33.

<sup>123</sup> *Id.*

<sup>124</sup> *supra*, n. 8.

specifies clearly the circumstances under which a project could be delayed or even discontinued

and the circumstances under which it may not.<sup>125</sup>

## 7.7.STABILIZATION

Stabilization provisions protect oil companies from governmental or legislative changes affecting any contract term and grant them compensation from the host government for any added costs due to future legislative changes, unless otherwise agreed.<sup>126</sup> Originally, stabilization clauses addressed specific political risks that could affect the contract. In developing countries, the greatest worry was that the host government would nationalize the investors' assets or terminate the contract by unilateral decision.<sup>127</sup>

In the 1970s, there were several disputes between foreign investors and Libya following the nationalization of the oil companies' interests and properties in that country. The arbitrating court decided that Libya's unilateral decision to nationalize the oil companies' interests was a breach of contract that gave rise to liabilities and required remedy<sup>128</sup>. A stabilization clause is extremely disadvantageous for the government, which agrees to it because it freezes the legal and regulatory situation of the country for an extended period of time and requires the government to pay compensation if changes affect an investor. Thus the stabilization clause must be closely analyzed from a time perspective, that is what does it mean today and what will it mean tomorrow?

## 7.8.PRICE

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<sup>125</sup> *Id.*

<sup>126</sup> *id.*  
<sup>127</sup> *supra*, n. 33.

<sup>128</sup> *Id.*



How the market price of oil is determined is critical as it directly impacts the compensation of the host government, whether in the form of taxes or profit sharing. The only objective method to calculate the selling price of oil is to start with the price established by the spot market in the particular region.<sup>129</sup> Normally, a contract would specify what prices would serve as a benchmark. However, what should never be accepted without question, as an acceptable contract price is the price paid between related companies because that price is determined internally and will not necessarily reflect market rates.<sup>130</sup>

A related company is not just a company that is partially or wholly owned by the same company. It can also be a company that has contractual or other ties with the selling party, relationships that are not necessarily public or obvious. The danger for governments that tax companies based on what the companies report as the price of oil sold to subsidiaries is that this price may be well below market rates. Even a marginal difference in price per barrel, can make a considerable difference overall.<sup>131</sup>

## **7.9.TERMINATION**

A contract needs to address under what circumstances an agreement can be terminated.

Agreements can be terminated, for example, for repeated environmental violations.<sup>132</sup>

Termination should also result if companies are no longer developing the field. Provisions should

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<sup>129</sup> *Supra*, n. 8.

<sup>130</sup> *id.*

<sup>131</sup> *id.*

<sup>132</sup> *id.*

be made to ensure that at that point the host government could transfer the contract to another company that is still willing to develop the field.

#### **7.10. OUTSIDE EXPERTS**

In negotiating contracts, developing countries usually must rely on foreign experts, including, ironically, some from the international energy companies. Relying on oil and gas companies for their expertise is inevitable as no number of government officials, even if they had the expertise, can oversee every aspect of natural resource development. Outside experts must be evaluated, selected, then managed and directed. A nation's experts need to be truly independent so they can be true advisers and advocates.<sup>133</sup>

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<sup>133</sup> *Id.*

## CHAPTER 8

### 8. Advantages and disadvantages of PSC

The complexity of a PSC depends on the soundness of the legal infrastructure of a state. For example, if a country does not possess basic rules governing petroleum operations, the issues normally covered by such a law will have to be addressed in the PSC. In short, the less reliable and/or predictable a state's legal system the more issues must be covered and specified within a PSC.

**8.1. ADVANTAGES OF PSC FOR A HOST GOVERNMENT:** All financial and operational risk rests with the international oil companies. The host government does not risk losses other than the cost of the negotiations, which mainly involves fees paid to advisers. At most, the host government loses an opportunity but suffers no material loss if an exploration or development project fails. Should a project not be pursued in accordance with the terms of an exploration or development program, a government can still, if the PSC is drafted well, cancel or terminate the deal or bring in another oil company. A host government, thus, has the added advantage that it shares any potential profits without having to make an investment, unless it agreed to do so.<sup>134</sup>

If the PSC is enacted into law, it provides legal security for international oil companies, this procedure in fact is a very novel approach and has been put to use successfully by countries like Azerbaijan and other former Soviet republics. But from the point of view of a government, such an approach turns a contract, which is a flexible instrument that can be changed simply by the parties, into an “inflexible” law, which can only be amended with the approval of parliament. In many cases, the PSC is superior to, or trumps, all other present and future laws with respect to the matter addressed in it.<sup>135</sup> Thus the result is that the government effectively surrenders its right to adopt new laws and regulations in the public interest if such laws or regulations should adversely impact any rights of the oil company under the PSC.

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<sup>134</sup> *Supra*, n. 8.

<sup>135</sup> *Id.*



**8.2. DISADVANTAGES OF PSC FOR A HOST GOVERNMENT:** The theoretical flexibility of the PSC as an all-in-one document is also a disadvantage. It puts a premium on very professional negotiations and the government having access to technical, environmental, financial, commercial, and legal expertise.<sup>136</sup> In structuring the financial provisions, the government must undertake to assess the reserve potential of the oil fields, even though accurate information may not be readily available. In fact, a host government often has considerably less data and technical and commercial knowledge than the oil companies. Most importantly, if the host government will obtain a significant portion of its share or compensation directly through profits, the PSC puts the government in conflict with itself. It has to balance the desire for higher profits with the enforcement of environmental and other regulations.<sup>137</sup> However, through the terms of the PSC, the host government is at least passively a decision maker in the development of the oil fields. At the same time, a host government has granted oil companies, through the PSC, a say in the enforcement of environmental and other standards, when these standards have been incorporated as contractual provisions. A contractual provision can be more easily contested, and even violated, than a statute or regulation. The reason is simple. Breaching the provisions of the PSC, even an environmental provision, is only a contractual violation. The violating party will normally be required only to rectify the breach, perhaps even pay damages. Only if a serious or material breach has occurred is termination of the agreement a possibility.<sup>138</sup> Moreover, as a matter of fact a breaching party could argue that its breach came as a direct result of the action or inaction of the other party. A breach of a contractual provision is an extension of the contract negotiation process, a renegotiation, albeit more acrimonious. By contrast, the violation of a legal statute is an offense, subject to legislatively approved sanctions and penalties and even public condemnation. A contractual breach is a private affair.<sup>139</sup>

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<sup>136</sup> *supra* n. 26.

<sup>137</sup> *Id.*

<sup>138</sup> *id.*

<sup>139</sup> *id.*

Further, in case a PSC has been enacted into law by a country's parliament, it limits the flexibility of both parties and any changes require parliamentary approval. As the PSC is also a contract, ambiguities will have to be mutually settled by the government and the oil companies. But by making the PSC a law, as well as a contract, the government has in part transferred some of its responsibilities to the oil companies and surrendered considerable flexibility.<sup>140</sup>

Furthermore, making contracts into law creates a legal infrastructure of one-off, exceptional situations; the investment climate of a nation suffers accordingly. By adopting PSCs into law, Azerbaijan has little possibility of developing a coherent and comprehensive legal system because the PSCs will remain exceptions to any more general or principled laws.<sup>141</sup> In short, thus, the PSC is a form of positive legal discrimination or favoritism for the oil companies. Other investors, whether in tourism, banking or large scale agriculture, will invariably lobby the host government and parliament for similar special treatment. The net result is legal confusion and a general disrespect for the law.

Many contracts require companies to pay the host government a signing bonus. Subsequent bonuses may be contingent on reaching certain stages of exploration or development. Local investment provisions in a contract may actually result in being quite costly for a host country because oil companies will request concessions in the PSA for this form of private subsidization of local industry. Most of the time, it is simpler and more transparent for a government to use part of its proceeds to train workers or provide commercial credit for local entrepreneurs.<sup>142</sup>

Further since the government is typically the owner of the resource, it is legitimately entitled to keep the major share of the rents. This portion that the government keeps, or the "government take," depends on a number of factors, including how risky especially in cases such as financially, commercially, politically, and environmentally the investment is for the companies; the availability of alternative projects for those companies on a world-wide basis; and the prevailing oil market price at the time of negotiations. The level of government take can increase with a project's profitability. Thus, where the investment is successful, government revenues can increase without negatively impacting incentives to explore and to produce. In practice however,

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<sup>140</sup> *supra*, n. 8.

<sup>141</sup> *Id.*

<sup>142</sup> *Id.*

it appears difficult to design a tax system that adjusts perfectly to the rate of return actually achieved on investment in a project.<sup>143</sup> The rents from a petroleum deposit cannot be determined in advance so a company will be concerned not only about the overall impact of the tax regime, but also by the way in which the tax burden will be imposed at different points in the field's life owing to the tax structure. Thus, the PSC has its own share of disadvantages, however, its advantages over weigh its disadvantages and thereby making it a very popular mode of Host Government Contract.

## CHAPTER 9

### 9. MAIN TERMS OF PRODUCTION SHARING CONTRACT

The following main elements of such an agreement should be noted:

#### 9.1. PARTIES

The government party to the agreement is often not the government itself but the state oil company. The state oil company will have some sort of underlying agreement with the government to which the oil company is not the party. This may take the form of a license from the government to explore for, and produce, petroleum, granting proprietary rights much like a license in the United Kingdom. It can thus be seen that a licensing regime is not necessarily incompatible with a PSA regime and the two concepts could be easily combined on a vertical basis. In the Ethiopian<sup>144</sup> and Indian<sup>145</sup> Model PSCs the contract is executed by the Ministers in charge of Mines and Minister for Petroleum and Natural Gas respectively. In Tanzania<sup>146</sup>, the Tanzanian Petroleum Development Corporation is a party.

#### 9.2. GOVERNMENT WARRANTIES

The government or state company should give some degree of comfort to the oil company in relation to the interest that is being offered. This may, as a minimum, just be that no rights in the field have been given to any third party, and that it has the power to grant the rights, and perhaps that there is no litigation affecting the field.<sup>147</sup>

#### 9.3. GRANTS AND RIGHTS OF CONTRACTOR

The oil company is often described as the contractor and the government company as the operator. This is because the relationship is looked at from the government viewpoint. In reality the oil company is usually ‘**de facto**’ operator, at least initially and the description is in that sense

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<sup>144</sup> Ethiopian Ministry of Mines, *Model Petroleum Production Sharing Agreement*, [http://www.mom.gov.et/upload/Model%20Petroleum%20Production%20Sharing%20Agreement\(MPPSA\).pdf](http://www.mom.gov.et/upload/Model%20Petroleum%20Production%20Sharing%20Agreement(MPPSA).pdf) accessed on 22/02/2015

<sup>145</sup> Directorate General of Hydrocarbons, Government of India *Production Sharing Contracts* <http://petroleum.nic.in/nelp3.pdf> accessed on 13/03/2015

<sup>146</sup> Tanzania Petroleum Development Corporation, *Model Production Sharing Agreement* (2008) [http://www.tpdcc-tz.com/MPSA%20\\_2008.pdf](http://www.tpdcc-tz.com/MPSA%20_2008.pdf) accessed 20<sup>th</sup> February 2015

<sup>147</sup> M. Sornarajah, *Mutations of Neo-Liberalism in International Investment Law*, 3(1) TRADE, LAW AND DEVELOPMENT (2011): 203



rather confusing, though the right granted will probably simply be the right to conduct petroleum operations and, even if this is stated to be exclusive, the government company often remains designated operator. The grant of rights to the oil company will no doubt be stated to be subject to the government's rights to the petroleum in place.<sup>148</sup>

Next, the geographical co-ordinates of the field should obviously be defined. The government should also expressly grant all necessary permits and consents required to enable the oil company to carry out the petroleum operations in accordance with the required work Program.

If any third party consents are required which are outside the direct control of the government, it may require the oil company to take full responsibility for these and this is a danger area. It may be much easier for the government to get them than for the oil company to do so, the oil company should be permitted to appoint a subcontractor to be in charge of operations and to have the sole right to select that subcontractor. There should be an express right for the oil company to take delivery of its share of petroleum at a defined delivery point free of all further encumbrances,<sup>149</sup>

There should be an express right for the company to transport and export its share of petroleum and to construct pipelines for that purpose. Export quotas may need to be addressed. More onerously, the government may have a right to require the oil company to retain a proportion of its share for the domestic market.<sup>150</sup> This may have adverse consequences if the government has a system of controls and insist on a lower domestic price. The general rights and obligations of contractor is provided in **Article 8**<sup>151</sup>, which is as follows- *Subject to the provisions of this Contract, the Contractor shall have the following rights: a) The exclusive right to carry out*

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<sup>148</sup> Participation Agreement dated 12 January 2005 for Oil Mining Lease No. 113 among Yinka Folorunso Petroleum Company Limited, Syntroleum Limited, Lundin Petroleum BV, Palace Exploration Company, Challenger Minerals, Inc., Providence Resources PLC and Howard Energy Co., Inc. January 12, 2005', in Barrows Company.

<sup>149</sup> *Santa Elena v Costa Rica* (2000) ICSID Case No. ARB/96/1 paras 71-2, available at <https://icsid.worldbank.org/ICSID/FrontServlet> (accessed 12 June 2014).

<sup>150</sup> *Suez, Sociedad General de Aguas de Barcelona SA, and Vivendi Universal v Argentine Republic* (2010) ICSID Case No. ARB/03/19, Award, available at <http://www.italaw.com> (accessed 19 June 2014).

<sup>151</sup> MODEL PRODUCTION SHARING CONTRACT (MPSC), NELP IX, NINTH OFFER OF BLOCKS, INDIA

*Petroleum Operations to recover costs and expenses as provided in this Contract. The right shall exclude exploitation of coal/lignite bed methane (CBM) by the Contractor in the Contract Area; b) The right to use, free of charge, such quantities of Petroleum produced as are reasonably required for conducting Petroleum Operations in the Contract Area in accordance with generally accepted modern oilfield and petroleum industry practices<sup>152</sup>; c) The right to lay pipelines, build roads, construct bridges, ferries, aerodromes, landing fields, radio telephones and related communication and infrastructure facilities and exercise other ancillary rights as may be reasonably necessary for the conduct of Petroleum Operations. d) The right to use all available technical data, seismic and well information, maps, samples etc. of the Contract Area as on the Effective Date, free of charge, subject to nominal copying/reproduction costs for further Petroleum Operations. e) Such other rights as are specified in this Contract.*

#### **9.4. CARRY PROVISION**

This connotes the IOC bearing the contributory obligation of the HG towards the production costs to be recovered as a cost.<sup>153</sup> However the NOC is under no obligation to indemnify or reimburse the NOC in the event that there is no return on production. This strict approach has been incorporated into the laws of some HGs such as Tunisia.<sup>154</sup> However some countries such as India<sup>155</sup> are more lenient and permit apportionment of costs incurred by the IOC irrespective of discovery.

#### **9.5. GOVERNMENT RIGHTS**

The government will, of course, have the right to take its share of production at the appropriate time, normally when the oil company has recovered all “cost” oil. It may additionally be require the company to perform a service for it in relation to that oil, most obviously, a marketing service. Those terms are important, as additional obligations usually cost money. **DURATION**

The term of the agreement will need to be clear and will probably either be a reasonably long period, but with early termination rights, or perhaps a shorter period with a renewal provision

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<sup>152</sup> Article 8.3 MPSC, Ibid.

<sup>153</sup> Harwood, Supra 108 at 46.

<sup>154</sup> *Hydrocarbons Code under Law No. 99-93 (Tunisia) 2003, Translation*  
[http://www.etap.com.tn/uploads/telechargement/code\\_hydrocarbures.pdf](http://www.etap.com.tn/uploads/telechargement/code_hydrocarbures.pdf) accessed 23rd February 2015

<sup>155</sup> Directorate General of Hydrocarbons, Government of India.

coming into effect in the event of a successful discovery, with perhaps the obligation to relinquish unproductive areas at that time.

**Article 3**<sup>156</sup> provides for license and exploration period for petroleum extraction operations in India, 3.1 *“The Exploration Period shall begin on the Effective Date and shall be for a period not exceeding seven (7) consecutive Contract Years consisting of Initial Exploration Period and Subsequent Exploration Period. The Initial Exploration Period shall consist of the first four consecutive Contract Years with provision to proceed to the Subsequent Exploration Period of maximum three consecutive years. 3.8 If no Commercial Discovery has been made in the Contract Area by the end of the Exploration Period, the Contract shall terminate. 3.9 If this Contract is terminated in accordance with its terms, the License shall be automatically cancelled. 3.10 If at the expiry of the Exploration Period a development plan for development of a Commercial Discovery and an application for Lease is under consideration by the Management Committee or Government, the License shall continue in force with respect to that part of the Contract Area to which the application for the Lease relates.”*

## **9.6. FINANCE AND PAYMENTS**

The company’s basic obligation here is to finance all petroleum operations, at least initially, and to be empowered to borrow for that purpose. It may be necessary to have express rights to deal in foreign currency and in particular to be able to pay contractors in foreign currency. The company will also usually want the express right to receive proceeds of sale of petroleum in foreign currency.

The **Petroleum Tax Guide, 1999**<sup>157</sup> also provides for a guide which compiles the specific provisions of the laws relating to income tax, customs duty, central excise, cess, royalties and license/lease fees as applicable to activities connected with the prospecting for or extraction or production of petroleum in the upstream sector under Contracts entered into on or after 1st January 1999 in terms of the New Exploration Licensing Policy (NELP)

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<sup>156</sup> MPSC Supra 112 at 13.

<sup>157</sup> PETROLEUM TAX GUIDE-1999, MINISTRY OF PETROLEUM & NATURAL GAS GOVERNMENT OF INDIA 2007, <http://petroleum.nic.in/nelp4.pdf> (last accessed on 2/04/2015)

**Article 17**<sup>158</sup> provides for taxes, royalties, rental, and duties which become payable to the government by the contractor. It provides for the following-

1. The provisions of Income Tax Act, 1961 (section 42) shall apply in computing income tax payable by a Company on its profits and gains from the business of Petroleum Operations.
2. Deductions at the rate of one hundred percent (100%) per annum shall be allowed for all expenditures, both capital and revenue expenditures, incurred in respect of Exploration Operations and drilling operations. Company shall be entitled, for income tax purposes only, to deduct all its unsuccessful Exploration Costs in contract areas covered by other contracts from the aggregate value of Petroleum allocable to the Company from any Field(s) in the Contract Area in the manner as follows:
3. Unsuccessful Exploration Costs incurred in contract areas other than the Contract Area where a Commercial Discovery has been made up to the date of commencement of Commercial Production shall be aggregated and the Company shall be entitled to deduct such costs at the rate of one hundred per cent (100%) per annum; Unsuccessful Exploration Costs incurred in contract areas other than the Contract Area where a Commercial Discovery has been made, after the commencement of Commercial Production, shall be deductible at the rate of one hundred per cent (100%) per annum of such costs beginning from the Year such costs are incurred.
4. For any or all accumulated expenditures incurred in respect of Exploration Operations and drilling operations prior to the date of commercial production, Company(ies) shall have option to amortize such expenditures over a period of ten (10) years from the date of first commercial production.
5. Company(ies) shall be eligible for benefits available under section 80 IB of the Income-tax Act, 1961 as applicable from time to time. Companies (Lessee) shall be required to pay royalty to the Government (Lessor) for offshore areas at the rate of ten percent (10%) of the wellhead

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<sup>158</sup> MPSC, Supra 112 at 43-45.

value of Crude Oil and Natural Gas. In case of an onshore area, Companies shall be required to pay to the State Government(s) (Lessor) at the rate of twelve point five zero percent (12.5%) of the wellhead value of Crude Oil and ten percent (10%) of the wellhead value of Natural Gas. Machinery, plant, equipment, materials and supplies imported by the Contractor and its Subcontractors solely and exclusively for use in Petroleum Operations under this Contract or similar contracts with the Government where customs duty has been exempted by the Government shall be exempt from customs duties and export duties or other charges on re-exportation of the said items in accordance with applicable legislation.

The Contractor shall be liable for payment of:

- a) Annual license charges and rental fees and other charges under the Rules;
- b) Charges payable by specified industries or in connection with Petroleum Operations under applicable legislation;
- c) Payments for purchase, lease or rental of land or land rights in connection with Petroleum Operations;
- d) Taxes, fees or charges for specific services rendered on request or to the public generally; Customs duties, except for those items subject to exemption as provided in Article 17, applicable at the rates specified from time to time; and f) Stamp duties, registration fees, license fees, taxes such as taxes on property or assets (not calculated by reference to income or otherwise exempted) or other levies, fees or charges of a non-discriminatory nature and generally applicable in India or in the State where petroleum operations are being conducted.

The Direct Tax code, when replaces the present Income Tax Act, 1961, has proposed to bring a paradigm shift in granting tax incentives to undertakings engaged in business of mineral oil or natural gas. The new scheme has proposed to substitute the profit-linked incentives prevalent under the existing provisions of the Act with expenditure/investment based deductions. Further, it has provided for grandfathering of tax holiday available to oil and gas undertakings.

## 9.7. COST RECOVERY AND PROFIT RECOVERY

These are crucial elements of PSA. The oil company will depend upon the right to recover its costs from its agreed share of production in an unfettered way. If a royalty in kind is payable, the company may seek a waiver in relation to its production nature.<sup>159</sup> If this is not forthcoming it should try to negotiate a corresponding increase in its share. The definition of recoverable costs is going to be an important factor and the various categories of costs should be broken down in detail so that they are as comprehensive as possible. It is against this definition of costs that “**cost oil**” is calculated.<sup>160</sup> Following the recovery of cost oil, subsequent production is “**profit oil**”. This clause will therefore need to contain the crucial formula for calculation of the government and the company’s respective shares of production. The division may be based on straight production split but will probably be tapered so that state gets a higher share, or that tax rates increase, if cumulative production or production rates get beyond certain levels. There are various other methods of division of profits, usually geared so that they benefit the government more than oil company. For example, the oil company’s share may be capped by a certain percentage applied to its net return on investment. An example is the Ethiopian Model<sup>161</sup>, which in **Article 7.2.1** provides as follows: “*The balance of Crude Oil remaining in any Calendar Year after deduction of the royalty payments under Section 11.2 and after recoverable Petroleum Operations Costs have been satisfied to the extent and in the manner aforesaid in Section 7.1, shall be referred to as "Profit Oil" and shall be shared, taken and disposed of between the Government and the Contractor according to the following incremental scale.*” Article 15<sup>162</sup> provides - The Contractor shall be entitled to recover Contract Costs out of a percentage of the total value of Petroleum Produced and Saved from the Contract Area in the Year in accordance with the provisions of this Article.

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<sup>159</sup> European Commission, *Green Paper on the Modernization of EU Public Procurement Policy: Towards a More Efficient European Procurement Market*, COM(2011) 15 final (27.1.2011); S. Kelman, *Unleashing Change: A Study of Organizational Change in Government*, Brookings Institution Press (2005); S.KELMAN, *PROCUREMENT AND PUBLIC MANAGEMENT: THE FEAR OF DISCRETION AND THE QUALITY OF GOVERNMENT PERFORMANCE*, (AEI Press) (1990)

<sup>160</sup> MARCIA ASHONG, *COST RECOVERY IN PRODUCTION SHARING CONTRACTS: OPPORTUNITY FOR STRIKING IT RICH OR JUST ANOTHER RISK NOT WORTH BEARING* (Dundee, CEPLMP University press.) (2009)

<sup>161</sup> Ethiopian Ministry of Mines, *supra* 111 at 22.

<sup>162</sup> MPSC, *Supra* 112 at 39-40.

**Article 16**<sup>163</sup> provides for profit oil i.e. “*A party’s share of profit petroleum in a year shall be calculated on the basis of the Investment Multiple actually achieved by the contractor at the end of the preceding year for the contract area.*”

Where the Government has informed the Contractor of its intention to take its share in kind, the Parties shall mutually agree on a procedure for delivery of the Government's share of Profit Petroleum and, where relevant, the composition of the Petroleum which is to be delivered.

## **9.8. MINIMUM WORK/EXPENDITURE OBLIGATION CLAUSES**

Such clauses oblige the IOC to have completed a measure of operations (e.g. number of wells sunk) or spent a stipulated sum on the operation over a prescribed period. For example Article 4(b) the **Tanzanian Model**<sup>164</sup> provides as follows

“Description of Work: Undertake geological and Geophysical surveys and related activities as deemed necessary by the Company; shoot [\_\_\_\_\_] kms of seismic; and drill [\_\_\_\_\_] Exploration Wells.

Minimum Expenditure for this period: US[\_\_\_\_\_] million”

## **INDIA - PROCESSES INVOLVED**<sup>165</sup>

Exploration Activities involve acquiring, analyzing & interpreting seismic data and drilling of Exploration wells & Appraisal Wells over the Contract Area to locate discovery of Potential

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<sup>163</sup> Art. 16, Supra 112 at 41-42.

<sup>164</sup> Tanzania Petroleum Development Corporation, *Model Production Sharing Agreement* (2008) [http://www.tpdc-tz.com/MPSA%20\\_2008.pdf](http://www.tpdc-tz.com/MPSA%20_2008.pdf) accessed 20/03/2014

<sup>165</sup> ARTICLE 3, supra 112 at 13

Commercial Interest. The Exploration Stage comprises of 2-3 phases generally covering a period of 7-8 Years.

**Stage I** - Acquisition, processing & interpretation of seismic data

**Stage II** - Exploration

**Stage III** - Appraisal along with Technical Assessment

For each phase, a Production Sharing Contract (PSC) defines a Minimum Work Program (MWP) to be completed by the Operator of the Block. Failure to meet the MWP by the end of the relevant exploration phase would require the Operator to pay to the government an amount that would be required to complete the MWP.

**Development** - This includes drilling of wells, setting up platforms, installation facilities to produce, process & transport petroleum including pipelines up to the delivery point.

**Production**- The Production Stage comprises of activities undertaken and related cost incurred for producing petroleum after the commencement of production including operations & maintenance of facilities.

## **9.9 JOINT OPERATIONS**

There will be provisions governing the setting up and the administration of the joint operating committee, though these may be embodied in a separate joint operating agreement (JOA). These provisions will be important because each party will have a vote, and if only the government (or the government oil company) and the oil company are the parties to the operating committee vote will include approval of the annual work Programme and budget, any development plan, and, perhaps, major contracts. The designated operator will prepare the work Programme. Though the company (the contractor) is in practice performing the operations it will often not be designated as operator: that will often be the government company, though this can vary. Alternatively, a company may be set up specifically to conduct operations with a board representing both the government and the oil company.



The Indian Model requires the constitution of a **Management Committee**<sup>166</sup>, the Ethiopian Model provides for a Gas Development Advisory Committee<sup>167</sup> while the Kenyan Model provides for an Operating Committee.<sup>168</sup>

**Article 7**<sup>169</sup> provides for Operatorship, Joint Operations agreement and operating committee. The JOA appoints an Operator to the blocks & defines its Rights, Duties & Liabilities. The Operator carries out the Petroleum Operations and the other Contractors are required to regularly fund the operator in proportion to its Participating Interest in the Contract.

## **9.10. MEASUREMENT AND ACCOUNTING**

There will be need to be procedures governing the locations at which, and the methods by which, production will be measured, and the provision for the proper maintenance of accounts by the oil company.

## **9.11. TITLE**

Title to production in the agreed share will pass to the oil company at a certain defined point, but the government may require for retaining or obtaining title to other assets and equipment.

According to **Article 27.1**<sup>170</sup> The Government is the sole owner of Petroleum underlying the Contract Area and shall remain the sole owner of Petroleum produced pursuant to the provisions of this Contract except as regards that part of Crude Oil, Condensate or Gas the title whereof has passed to the Contractor or any other person in accordance with the provisions of this Contract.

*27.2 Title to Petroleum to which the Contractor is entitled under this Contract, and title to Petroleum sold by the Companies shall pass to the relevant buyer party at the Delivery Point. The Contractor shall be responsible for all costs and risks prior to and including at the Delivery*

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<sup>166</sup> Art. 6, MPSC, supra 112 at 19-22

<sup>167</sup> Clause 13.1.3 of the Model, supra 109 at 22

<sup>168</sup> Clause 4 of the Model, supra 106 at 31

<sup>169</sup> Art. 7, Supra 112 at 23

<sup>170</sup> IND. [India] [Constitution] 1950, as last amended by JANUARY 2, 2013/ PAUSA 12,1934 (SAKA), Art. 297(India), supra 1 at 177.

*Point and each buyer party shall be responsible for all costs and risks associated with such buyer party's share after the Delivery Point. 27.4 Assets purchased by the Contractor for use in Petroleum Operations shall be owned by the Parties comprising the Contractor in proportion to their Participating Interest provided that the Government shall have the right to require vesting of full title and ownership in it, free of charge and encumbrances, of any or all assets, whether fixed or movable, acquired and owned by the Contractor for use in Petroleum Operations inside or outside the Contract Area, such right to be exercisable at the Government's option upon expiry or earlier termination of the Contract.*

### **9.12. TAXATION**

Taxation is a crucial part of the agreement, which depends in large part on any favorable treatment, concessions, or exemptions, which may be extended to the oil company by the government. The provisions may be very complex. The petroleum Tax Guide 1999<sup>171</sup> provides for a Guide which compiles the specific provisions of the laws relating to income tax, customs duty, central excise, cess, royalties and licence/lease fees as applicable to activities connected with the prospecting for or extraction or production of petroleum in the upstream sector under Contracts entered into on or after 1st January 1999 in terms of the New Exploration Licensing Policy (NELP)<sup>172</sup>

### **9.13. STABILISATION**

“**Stabilization clause**” is an important feature of a PSA. This is to give the oil company some measure of assurance in relation to the uncertainties created by new legislation. The clause may provide that any such legislation will not apply to the agreement (though that is often difficult to sustain in law), or more usually, that if new laws come into effect that render the position of company more onerous, then this will be addressed by some form of adjustment, usually by the

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<sup>171</sup> A handbook of tax incentives for exploration and production of Petroleum. PETROLEUM TAX GUIDE-1999, MINISTRY OF PETROLEUM & NATURAL GAS GOVERNMENT OF INDIA 2007, <http://petroleum.nic.in/nelp4.pdf> (last accessed on 2/04/2015)

<sup>172</sup> MPSC, supra 112 at 43-45.

company acquiring additional production from government share to the extent necessary to maintain its economic position.<sup>173</sup>

Stabilization clauses need to be looked very carefully. It would be dangerous for the oil companies to regard them as guarantee that no change in law, not even nationalization, will adversely affect the contract, giving a right, for example, to claim discounted net profits that would otherwise have been received until contract termination date. Needless to say, a host government will rarely see these clauses in such black and white.<sup>174</sup> Even if the clause seems to be first sight conclusive, and simply provides that no new legislation will apply to the contract, it may not be satisfactory when the concept is examined. The government might subsequently claim that no such derogation works unless granted by regulation or decree, or that it is in any case incapable of having the desired effect. Even if it is, the argument may be that the particular change that has been made in the law has been so fundamental that the whole contract has to be looked at in the new light.<sup>175</sup>

A provision to the effect that if new laws make the position more onerous, some form of adjustment or compensation will be made, is probably more realistic, but this, if it is not to be susceptible to flexibility of interpretation, will need to be drafted as precisely as possible. This is not always achievable, and the outcome will usually be in favor of the government at the expense of the oil company. According to a 2008 study, the use of “stabilization clauses” in host-government contracts **“is widespread across industries and regions of the world.”**

Stabilization clauses come in various forms.<sup>176</sup> In their most basic form, they “freeze” the law

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<sup>173</sup> Andrea Shemberg, *Stabilisation Clauses and Human Rights. A research project Conducted for IFC and the United Nations Special Representative of the Secretary-General on Business and Human Rights* (May 27, 2014).

<sup>174</sup> Perkins, *Understanding Stabilization Clauses in International Investment Agreements*, available at: <http://www.practicallaw.com> [Accessed October 28, 2014].

<sup>175</sup> The other kinds of stabilization clauses are: Intangibility Clauses, which prevent host governments from nationalizing the project and/or amending the investment agreement without the consent of the investors. However, such provisions are of limited use because, under international law, a state can always nationalize or expropriate foreign assets within its borders subject to the satisfaction of certain conditions; and Consistency Clauses, which provide that domestic legislation adopted by the host government will only apply to the project and the investors if it is consistent with the investment agreement.

<sup>176</sup> PETER D. CAMERON, ASS'N OF INT'L PETROLEUM NEGOTIATORS, *STABILISATION IN INVESTMENT CONTRACTS AND CHANGES OF RULES IN HOST COUNTRIES: TOOLS FOR OIL & GAS INVESTORS* (2006), available at [http://lba.legis.state.ak.us/sga/doc\\_log/2006-07-05\\_aipn\\_stabilizationcameron\\_](http://lba.legis.state.ak.us/sga/doc_log/2006-07-05_aipn_stabilizationcameron_)

that applies to the investment at the time the contract is signed. A more nuanced version is often referred to as an “**economic equilibrium**” clause, which requires the government to restore the balance of risks and rewards established in a contract when it is upset by a new regulation or tax.<sup>177</sup> A stabilization clause can be strictly circumscribed to only cover very specific issues, or the parties to the contract can explicitly “carve out” areas such as environmental protection from its application.<sup>178</sup> For example, in a 1997 contract from Kazakhstan, the stabilization clause contains the caveat: *Provided, however, that no amendment to this Agreement shall be required hereunder as the result of (i) changes to Laws concerning health, safety or environmental protection that cause such Laws to be consistent with international standards for health, safety or environmental legislation and are applied on a non-discriminatory basis . . .*<sup>179</sup>

As *Lorenzo Cotula* notes,<sup>180</sup> this provision is weakened by its ambiguous reference to “international standards,” but it is still far preferable to the stabilization clauses found in many contracts and even in model agreements that are worded in such a broad manner that they can stifle any future regulation that might be perceived to undermine the profitability of an investment<sup>181</sup>, including efforts to address corruption, to safeguard human rights, and to protect the environment.

## 9.14. RELINQUISHMENT

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final.pdf; ABDULLAH AL FARUQUE, THE RATIONALE AND INSTRUMENTALITIES FOR STABILITY IN LONG-TERM STATE CONTRACTS: THE CONTEXT FOR PETROLEUM CONTRACTS 7 J. World Inv. & Trade 85 (2006); A.F.M. Maniruzzaman, *The Pursuit of Stability in International Energy Investment Contracts: A Critical Appraisal of the Emerging Trends* 1 J. World Energy L. & Bus. 121 (2008).

<sup>177</sup> TC 67–Materials, Equipment And Offshore Structures For Petroleum, Petrochemical And Natural Gas Industries, INT’L ORG. FOR STANDARDIZATION, [http://www.iso.org/iso/standards\\_development/technical\\_committees/list\\_of\\_iso\\_technical\\_committees/iso\\_technical\\_committee.htm?commid=49506](http://www.iso.org/iso/standards_development/technical_committees/list_of_iso_technical_committees/iso_technical_committee.htm?commid=49506)

<sup>178</sup> A.F.M. Maniruzzaman, *Damages for Breach of Stabilisation Clauses in International Investment Law: Where Do We Stand Today?* I.E.L.T.R. 246.(2007).

<sup>179</sup> THE REPUBLIC OF KAZAKSTAN AND JSC NATIONAL OIL AND GAS COMPANY KAZAKOIL, Art 40.2 (NOV. 18, 1997) (KAZ.)

<sup>180</sup> Lorenzo Cotulla, *Reconciling Regulatory Stability and Evolution of Environmental Standards in Investment Contracts: Toward a Rethink of Stabilization Clauses*, 1 J. WORLD ENERGY L. & BUS. 158, 174 (2008).

<sup>181</sup> See “*Understanding Stabilization Clauses in International Investment Agreements*”, available at: <http://www.practicallaw.com> [Accessed October 28, 2014].

There will be provisions of varying complexity covering the relinquishment by the oil company of its rights in the area, or certain portions thereof, as defined by the geographical co-ordinates. For example, at the end of the exploration phase, the company may be required to relinquish rights in everything apart from the designated development area or areas, if there are any. There may also be a provision for a phased relinquishment of a stated percentage of the area over a period of years. The company will also be permitted to voluntarily relinquish its rights in any part of the area provided all relevant work obligations have been satisfied. It is a measure intended to promote speedy and efficient exploration<sup>182</sup>. It is a clause that works in benefit of both parties<sup>183</sup>.

An example of a Relinquishment Clause is **Clause 7** of the Kurdistan's Model PSC<sup>184</sup> which provides as follows:

‘The **CONTRACTOR** shall surrender portions of the Contract Area as follows:

- (a) Twenty five percent 25% of the initial Contract Area, excluding any Production Areas, at the end of the first sub-period of the Exploration Period.
- (b) An additional twenty five percent 25% of the initial Contract Area, excluding any Production Areas, at the end of the second sub-period of the Exploration Period.
- (c) An additional 25% of the initial Contract Area, excluding any Production Areas, at the end of the third sub-period of the Exploration Period.
- (d) The entirety of the Contract Area, excluding any Production Areas, at the end of the fourth sub-period of the Exploration Period (including any extensions thereof’.

**Article 4**<sup>185</sup> - “*At the end of the Initial Exploration Period, the Contractor shall have option to relinquish entire area after completion of Minimum Work Programme or proceed to the Subsequent Exploration Period and retain the block by committing to carry out drilling of one*

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<sup>182</sup> Association of International Petroleum Negotiators (AIPN), *Host Government Contract Handbook For The International Petroleum Industry* (AIPN, 1999) [http://www.fmclaw.com/upload/en/publications/2007/hgc\\_handbook\\_vol\\_11.pdf](http://www.fmclaw.com/upload/en/publications/2007/hgc_handbook_vol_11.pdf) (accessed on 20/03/2015).

<sup>183</sup> Ibid.

<sup>184</sup> Kurdistan Regional Government, *Model Production Sharing Contract For Exploration And Production*

*In Kurdistan* (2007) [http://www.krg.org/uploads/documents/KRG%20Model%20PSC\\_\\_2007\\_09\\_06\\_h14m3s46.pdf](http://www.krg.org/uploads/documents/KRG%20Model%20PSC__2007_09_06_h14m3s46.pdf) <sup>185</sup>  
MPSC, supra 112 at 15.

*well each year in Contract Area ( in case of onland and shallow water blocks)/one well in 3 years in Contract Area (in case of deepwater blocks). The entire area (excluding Discovery and Development area) shall be relinquished at the end of 7 consecutive years of Exploration*

*Period.”*

#### **9.15. FORCE MAJEURE**

It may be thoughtful that there is not much in a force majeure clause that is likely to be specific to a PSA, but the oil company, may be able to establish- in addition to the normal ‘act of god’ type of definition- a category of force majeure under which the company will be relieved of its obligations to the extent that performance is prevented by the government. This is most likely to be confined to delays caused by inaction on the part of the government, probably through excessive bureaucracy in meeting time limits, rather than by positive actions incompatible with the agreement, if it is achievable at all. The latter would, at least in some cases, constitute breach of the agreement itself, but this is a sensitive area on both sides.

#### **9.16. EMERGENCY**

The government may reserve the right to purchase the oil company’s share of the petroleum in the event of a domestic supply shortfall, in which case the purchase price will become an important issue.

Article 18<sup>186</sup> of the MPSC provides for,

*18.1 Until such time as the total availability of Crude Oil and Condensate from all Petroleum production activities in India meets the total national demand as determined by the Government, each Company comprising the Contractor, shall sell in the domestic market in India all of the Company's entitlement to Crude Oil and Condensate from the Contract Area. If India attains self-sufficiency in crude oil and condensate, during any year, the Government shall advise the company(ies) accordingly by a written notice. In such an event, domestic sale obligation shall be suspended for such period as may be specified by the Government, and the Company shall have the right to lift and export its Participating Interest share of Crude Oil and Condensate during the said period, subject to any other extant policy guidelines of the Government applicable from*

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<sup>186</sup> MPSC, Supra 112 at 46

*time to time. 18.3 If Self-sufficiency ceases to exist, the position shall revert to domestic sale obligation as outlined in Article 18.1.*

## **9.17. DISPUTE RESOLUTION**

The oil company will seek to secure agreement on the needs for independent neutral arbitration, with a seat somewhat like Geneva, under an accepted body of rules like UNCITRAL.<sup>187</sup> The oil and gas industry is no stranger to disputes, owing to its international and multifaceted character. The oil and gas industry is collegiate in its dynamics, where long lasting relationships are favored and solutions are sought with minimum disruption to existing relationships and projects. Therefore, disputing parties have no desire to halt or stop their activities, and once the dispute is resolved they would normally wish to continue a commercial relationship.

Disputes usually arise when an issue occurs which has not been prepared for and agreed on in the principal agreement between the parties, whether this is a delay in the delivery of equipment, maritime boundary issues, a problem with an indigenous community<sup>188</sup> or an unexpected pipeline incident, such as the recent British Petroleum (BP) catastrophe.

**9.18. ENVIRONMENT-** Awareness of the importance of environmental issues has become more and more central to the thinking of the oil industry and regulators in the last decade. Integration of development and environment, approached in partnership between stakeholders, was the theme of **UNCED conference in Rio in 1992.**

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<sup>187</sup> *Chemtura v Canada* (2010) UNCITRAL (NAFTA) Award, paras 138-9, available at <http://www.italaw.com> (accessed 19 March 2015).

<sup>188</sup> In 2003 a large group of indigenous people in the Ecuadorian Amazon oil region filed a case against Texaco (now merged into Chevron) for environmental damage. The waste pits, supposedly cleaned up by Texaco, contain varying degrees of pollution at the surface, though Petro Ecuador itself has had a poor environmental record including a minimum of 800 oil spills since 1990. These indigenous plaintiffs, backed by the Ecuadorian government under President Rafael Correa, demanded \$27 billion in added compensation despite the binding nature of the 1998 agreement releasing Texaco from further liability.

Principle 4 of the Rio declaration captures this challenge: “*In order to achieve sustainable development, environmental protection shall constitute an integral part of development process and cannot be considered in isolation from it*”<sup>189</sup>

The global community will rely heavily in oil and gas supplies for the foreseeable future.<sup>190</sup> The challenge is to meet world energy demands, while minimizing adverse impact on the environment by conforming to current good practice.<sup>191</sup> The exploitation of oil and gas reserves has not always been without some ecological side effects.<sup>192</sup> Oil spills; damaged land, accidents and fires, and incidents of air and water pollution have been recorded intensely over a period of time. In recent times, the social impact of operations, especially in remote communities, has also attracted attention. The oil and gas industry has worked for a long time to meet the challenges of providing environment protection. Much has already been achieved but the industry recognizes that much more needs to be accomplished.<sup>193</sup>

Since the activity of exploration involves disturbance in one form or another and, since environmental concerns are proliferating, licenses and other such consents, and the contractual agreements under a production-sharing regime, have become increasingly complex and regulatory.<sup>194</sup> The broad environmental issue faced by the oil and gas exploration and production industry is manifested at both local and global levels. They include: habitat protection and biodiversity, air emissions, marine and freshwater discharges, incidents and oil spills, and soil and groundwater contamination.<sup>195</sup> The industry has responded to these issues. The challenge is

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<sup>189</sup> Report Of The United Nations Conference On Environment And Development, Annex-I, Rio de Janeiro, 3-14 June 1992, A/CONF.151/26 (Vol. I)

<sup>190</sup> R.K. Batra, *Tinkering with the profit sharing mechanism may do more harm than good*, RI-ENERGY RESOURCE INSTITUTE-2012, [http://www.teriin.org/index.php?option=com\\_featurearticle&task=details&sid=765](http://www.teriin.org/index.php?option=com_featurearticle&task=details&sid=765) Last visited on 23/02/2015

<sup>191</sup> Craig H. Allen, *Protecting the Oceanic Gardens of Eden: International Law Issues in Deep-Sea Vent Resource Conservation and Management*, 13 GEO. INT'L ENVTL. L. REV. 563 (2001), 633; Martin A. Harry, *The Deep Seabed: The Common Heritage of Mankind or Arena for Unilateral Exploitation?*, 40 NAVAL L. REV. 207 (1992); Christopher C. Joyner, *Legal Implications of the Concept of the Common Heritage of Mankind*, 35 INT'L & COMP. L.Q. 190 (1986).

<sup>192</sup> INDIGENOUS AND TRIBAL PEOPLES CONVENTION 1989, adopted 27 June 1989, entered into force 5 September 1991, ILO No. 169.

<sup>193</sup> NASSEM, K. MOHOMMAD, *ENVIRONMENT LAW IN INDIA*, (Kluwer Law international, ISBN: 9041136339, 9789041136336) (2011).

<sup>194</sup> ANTHONY JENNINGS, *OIL AND GAS EXPLORATION CONTRACTS*, 1-02(Sweet & Maxwell., Thomson Reuters) (2008).

<sup>195</sup> Concluding Observations of the Human Rights Committee: Canada UN Doc CCPR/C/79/Add.105 (7)



to ensure that all operations conform to current good practice. The continual evolution of the environmental agenda must be taken into account in consonance with international environment protection standards. Industry places much emphasis on establishing effective management systems and has gone a long way to ensure that environmental issues are key components of corporate culture, with issues related to health, safety and environment being considered together, because they have much in common<sup>196</sup>. The environmental impacts caused by the oil and gas industry are at the forefront of the public eye.<sup>197</sup> What is less known and appreciated are recent advances in drilling technology that have provided the energy industry with the means to mitigate environmental footprints while simultaneously increasing production capabilities<sup>198</sup>. The decrease of the industry's environmental footprint has primarily come from advances in pad-site design, extended-reach drilling, and multi-lateral technology<sup>199</sup>. Although not always recognized or appreciated in the public arena, the technologies and practices of drilling oil and gas wells have followed pathways of continuous improvement for many decades<sup>200</sup>. In almost every case, innovations driven by commercial factors also have brought substantial improvements in environmental safety and sustainability<sup>201</sup>. A critical area of focus in the drilling process is the proper management and disposal of drilling fluids and waste products<sup>202</sup>. A number of initiatives have been implemented to address air,

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April 2009) Para. 8; Concluding Observations of Human Rights Committee: Mexico UN Doc CCPR/C/79/Add.109 (27 July 1999) Para. 19; Concluding Observations of the Human Rights Committee: Norway UN Doc CCPR/C/79/Add.112 (1 November 1999) Para 10 & 17.

<sup>196</sup> The Australian Institute of Petroleum (AIP), *Exploration & production in the marine environment*, World Petroleum Council, 2013 <http://www.world-petroleum.org/index.php?/Environment/exploration-aproduction-in-the-marine-environment.html> last accessed on 24/03/2015

<sup>197</sup> Government Memorandum on the Petroleum Industry Bill (2009), available at [http://www.saharareporters.com/sites/default/files/PIB\\_Ebogah.pdf](http://www.saharareporters.com/sites/default/files/PIB_Ebogah.pdf) (accessed 12 June 2013). In addition, the memorandum only provided for the need to protect the environment during petroleum development, but we are yet to see how the government will implement the environmental plan to achieve effective environmental protection.

<sup>198</sup> Peters, Eric, and H. Sterling Burnet., *Will Minivans Become an Endangered Species?* Brief Analysis No. 232. Dallas, Tex.: National Center for Policy Analysis, June 4. 1997.

<sup>199</sup> Murkowski, Frank H., *Drilling Won't Make It Less of a Refuge.*, Washington Post, December 10, 2000.

<sup>200</sup> Terry L. Anderson, and Donald R. Leal. , *Free Market Environmentalism*, Boulder, Colo.: Westview, 1991. Baden, John, and Richard Stroup, *Saving the Wilderness*. Reason : 28–36 (July)2004.

<sup>201</sup> M. Klein, Terry Hertz and S. Borener. *A Collection of Recent Analyses of Vehicle Weight and Safety*, Washington, D.C.: U.S. Department of Transportation, DOT HS 807 677, May. 1991.

<sup>202</sup> Medred, Craig. *Heated Emotions in So Cold a Place*. Anchorage Daily News, November 5, C1.1996.

water, and land use impacts associated with oil and gas production nationally. These policies range from the implementation of mandatory emissions limits on oil and gas operations (e.g., under the **Air Act 1981**<sup>203</sup>, **Water Act 1974**<sup>204</sup>, and **Environment Protection Act, 1986**<sup>205</sup> etc.) to voluntary programs and actions. Some of these activities encompass **Best Management Practices (BMPs)** used by industry to reduce environmental releases. However, In spite of the many policy initiatives, program developments, and industry practices that are now addressing oil and gas environmental implications, significant environmental concerns persist. Such challenges won't be effectively resolved without enhanced communications and the active involvement of government, industry, and stakeholder representatives.<sup>206</sup> The State and other government agencies are challenged to keep pace with rapidly expanding oil and gas production as well as associated regulatory activities (e.g., rulemakings, permitting and inspections). In addition, the high volume of oil and gas projects poses unique technical and regulatory challenges for federal and state agencies alike. As such, effective regulatory oversight requires open communications, collaborative partnerships, and constant coordination. Improved environmental measurement, stakeholder involvement, and environmental management are integral to successful oil and gas production. At a national and regional level, MoEF is actively reaching out to oil and gas organizations to improve understanding, identify drivers and barriers, increase performance, and address the environmental implications of oil and gas production. In summary, however, such efforts are not well positioned with respect to implementation though, to provide greater regulatory certainty and consistency in oil and gas, oversight through enhanced data collection and analysis, improved information sharing and partnerships, and focused compliance assistance and enforcement is much needed.

## **ENVIRONMENTAL STANDARDS CLAUSES**

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<sup>203</sup> THE AIR (PREVENTION AND CONTROL OF POLLUTION) ACT, 1981, No. 14 OF 1981. Ministry of Environment and Forests (MoEF), available at <http://envfor.nic.in/legis/air/air1.html>

<sup>204</sup> THE WATER (PREVENTION AND CONTROL OF POLLUTION) ACT 1974, No. 6 OF 1974, available at <http://www.moef.nic.in/legis/water/wat1.html>

<sup>205</sup> THE ENVIRONMENT (PROTECTION) ACT, 1986, No. 29 OF 1986, available at <http://envfor.nic.in/legis/env/env1.html>

<sup>206</sup> U.S. Environmental Protection Agency, ES—7, Working Draft – September 2008.

Most, though not all, of the oil and gas contracts reviewed contained a section on the environmental standards to be applied to the project. In this regard, there are five general forms that contracts appear to follow:

- i. Reference to domestic environmental law only;
- ii. Reference to international industry standards only;
- iii. Reference to both domestic law and international industry standards;
- iv. Reference to domestic law and/or industry standards and international environmental agreements; or

i. Development of project-specific environmental standards. Some reference to domestic environmental legislation is clearly desirable from a public policy perspective. Domestic standards have been developed under a democratic system of rule, have often been designed with local environmental conditions in mind, are familiar to the agencies that are tasked with monitoring and enforcement, and are in the public domain. However, as noted previously, in many developing countries environmental regulation of the oil and gas sector is still in its infancy and it may be inadequate in some situations.<sup>207</sup> As such, reference in contracts to domestic legislation alone may be undesirable. In any event, it would appear that parties rarely adopt this form. A contract from Peru<sup>208</sup> and one from Algeria were the only contracts in the sample that referred solely to domestic environmental legislation.

In several of the contracts in the sample, the parties instead included a reference to international industry standards and failed to mention the application of domestic environmental law<sup>209</sup>. The

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<sup>207</sup> Zhiguo Gao, *Environmental Regulation of Oil and Gas in the Twentieth Century and Beyond: An Introduction and Overview*, ENVIRONMENTAL REGULATION OF OIL AND GAS 3, 4-7 (Zhiguo Gao ed., 1998).

<sup>208</sup> CONTRACT FOR HYDROCARBON EXPLORATION & EXPLOITATION IN THE UCAYALI BASIN BETWEEN PERUPETRO S.A. & CHEVRON OVERSEAS PETROLEUM (PERU) LTD. (BLOCK 52) (Nov. 8, 1995) (Peru)

<sup>209</sup> E.g., The 1994 CAIRN ENERGY PRODUCTION SHARING CONTRACT BETWEEN THE GOVERNMENT OF THE PEOPLE'S REPUBLIC OF BANGLADESH & BANGLADESH OIL, GAS & MINERAL CORPORATION, CAIRN ENERGY PLC AND HOLLAND SEA SEARCH BANGLADESH B.V. (BLOCK 16) (1994) (Bangl.) mentions the applicability of Bangladeshi law to the implementation of the contract generally (art. 28.1), but the article specifically referring to the protection of the environment only mentions "generally accepted standards of the International Petroleum Industry" (Art. 10.6). Similarly, the 2000 RSM PRODUCTION SHARING AGREEMENT FOR PETROLEUM EXPLORATION, DEVELOPMENT AND PRODUCTION BETWEEN BELIZE AND RSM PRODUCTION CORPORATION (Area A) (Apr. 3, 2000) (Belize) is governed by the laws of Belize (Art. 29.1) but the section on environment (Art. 23.1) refers only to "standards acceptable to practices of the International Petroleum Industry."

advantage from an environmental perspective of referring to international industry standards is that in some cases, they may be higher than, or cover specific issues not addressed in, domestic legislation. Furthermore, reference to international standards allows some scope for change and evolution of the environmental management regime of an investment over time, thus providing a way around a contractual requirement for stability, as will be discussed below. However, there are serious problems with referring only to industry standards, given their inherent ambiguity. The terminology “good oilfield practices”<sup>210</sup> or “good production practices” is frequently employed in environmental standards clauses, as well as in other types of provisions discussed further below, but these phrases are seldom defined.<sup>211</sup>

## **CLAUSES ON ACCESS TO PROTECTED AREAS**

Petroleum operations are particularly contentious when they are located, even partially, within wildlife reserves, parks, or areas of cultural or biological significance.<sup>212</sup> NGOs have long argued that such areas should be off limits to the extractive industries, but most governments are not ready to forgo the potential economic opportunities that the exploitation of these areas offer.

## **CLAUSES ON ACCESS TO WATER & OTHER NATURAL RESOURCES**

Petroleum operations require natural materials in their construction phase, and significant amounts of water and electricity throughout their operation. While many operations are self-sufficient in terms of energy supply, other natural resources may need to be obtained from within or outside the contract area. From an environmental and community rights perspective, as well as from an economic development perspective, it is disturbing that many governments appear to focus solely on the potential revenue that they can obtain from petroleum production and are willing to simply give away other valuable natural resources under the terms of oil and gas contracts. For example, Article 27.8 of Mozambique’s 2007 Model concession contract provides

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<sup>210</sup> Ibibia Lucky Worika, *Environmental Concepts and Terms in Petroleum Legislation & Contracts: A Preliminary Study*, IN ENVIRONMENTAL REGULATION OF OIL AND GAS 393, 398-401 (2010)

<sup>211</sup> Alexandra S. Wawryk, *Adoption of International Environmental Standards by Transnational Oil Companies: Reducing the Impact of Oil Operations in Emerging Economies*, 20 J. ENERGY & NAT. RESOURCES L. 402, 431 (2002).

<sup>212</sup> *Arctic National Wildlife Refuge, 1002 Area, Petroleum Assessment, 1998*, Including ECONOMIC ANALYSIS, U.S. GEOLOGICAL SURVEY, <http://pubs.usgs.gov/fs/fs-0028-01/> (last modified Dec. 14, 2005).

for the right of the investor “to drill for and have the free use of water and impound surface waters.”<sup>213</sup>

## **CLAUSES ON RESPONDING TO EMERGENCIES AND ACCIDENTS**

In 2008, thirty-two companies in the OGP reported 2,978 spills greater than one barrel in size, resulting in the release of 18,266 tonnes of oil into terrestrial and marine environments.<sup>81</sup> In many of the oil and gas contracts in the sample, the parties have recognized that spills and other accidents and emergencies have the potential to occur and should be planned for. As such, as a part or separate from an EIA, an emergency response plan is often required from the contractor.<sup>214</sup>

### **9.19. DECOMMISSIONING & REMEDIATION**

When an oil operation reaches the end of production, a number of costly activities must be undertaken. Onshore wells need to be plugged and structures dismantled, with materials removed and ultimately recycled or disposed of. Remediation of the local environment may also be required. Offshore installations present particularly complex issues in terms of decommissioning, although it is also in this area that international law has its most direct and significant impact on the oil and gas industry.<sup>215</sup> The extent to which decommissioning is dealt with in contracts depends somewhat on the contractual relationship between the parties and the expected life of the project. Under some arrangements, states retain ownership over production facilities and may continue operations after the termination of the contract. However, even in such instances, there may be contractual provisions covering decommissioning of installations that are not destined to be taken over by the state.

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<sup>213</sup> GOV'T OF THE REPUBLIC OF MOZAMBIQUE, EXPLORATION AND PRODUCTION CONCESSION CONTRACT, Art. 27.8 (2007) (Mozam.), <http://www.inp.gov.mz/content/download/192/790/file/Mozambique%20Model%20EPC-Public-April%202007.pdf> last accessed on 14/03/2015

<sup>214</sup> PRODUCTION SHARING CONTRACT BETWEEN THE GOVERNMENT AND OIL AND NATURAL GAS CORPORATION LIMITED (ONGC), RELIANCE INDUSTRIES LTD., & ENRON OIL & GAS INDIA LTD. (Tapt block), Art. 12.6 (Dec. 22, 1994) (India).

<sup>215</sup> Agnieszka Rawa et al., *Sustainable Decommissioning of Oil Fields and Mines* (World Bank Issues Paper, 2009), [http://siteresources.worldbank.org/INTOGMC/Resources/wb\\_ogm\\_issues\\_paper.pdf](http://siteresources.worldbank.org/INTOGMC/Resources/wb_ogm_issues_paper.pdf). Accessed on 14/02/2015.

## CHAPTER 10

### 10.PRODUCTION SHARING CONTRACT – INDIAN SCENARIO

The Indian upstream sector has been continuously evolving and has in fact undergone a sea of change in the years post independence. The oil and gas upstream sector has undergone three major policy overhaul in the said period of time wherein there has been a complete regime change, which has been witnessed. The change that has been witnessed in the sector is primarily in the field of the participation in the exploration and production activities. The primary policy regime in the upstream sector finds its source to Oilfields (Regulation & Development) Act, 1948 and the Petroleum and Natural Gas Rules 1958.

The Oilfields (Regulation & Development) Act, 1948 deals with the licensing and leasing with respect to the exploration as well as the production activities of oil and gases in India. The Act also discusses the royalty aspect as payable by the holder of a mine to the government and the same is mentioned in the Schedule to the Act as well. Similarly the Act also provides for the provision of a penalty clause and also on various other aspects such as delegation the basis on which the power to enter into a PSC has been delegated to the Directorate General of Hydro Carbons, power to inspect etc. The Petroleum and Natural Gas Rules 1958 on the other hand, apart from defining various relevant terms, the rules provides for the granting of the license and lease together with their fees, security deposit, etc. The Rules also provides for the terms and conditions of such lease or license along with the term of such lease and the rights and duties of the licensee and the lessee. The Rules also deal in detail pertaining to various other aspects such as the right of pre-emption, the rules pertaining to the suspension and cancellation of the license or lease, recovery of helium, transfer and assignment, shutting down of the well, etc. Thus, the Rules in effect are the primary basis for the Production Sharing Contract, which is in place today.

The upstream regime in India can be broadly classified into three based on the time period and the different policy that was existent in such time period.<sup>216</sup> The three eras are the Nomination

Era, which was in vogue until the end of the 1970's, the Pre NELP Era, which was in place for

the time intervening 1980 to 95 and lastly the NELP Era, which is in place post 1995.<sup>217</sup> The Nomination Era was the period when the oil and gas upstream sector was completely regulated in the country and only government players were allowed in the sector. The era saw the incorporation of the two government E & P companies viz. Oil and Natural Gas Corporation and Oil India Limited. During the said period only the two companies were permitted to undertake exploration and production activities in the oil and gas sector and the award of blocks were completely under the discretion of the government. The nomination era had a very limited success in the E & P activities in India.

### **10.1. PRE-NELP ERA**

The Pre-NELP era succeeded the nomination era and the era permitted private participation in the E & P Sector to a limited extent. The Nomination era was constantly criticized for its complete closed-door policy, which also led to lack of technology in the sector. The pre-NELP era permitted private participation in E & P in the Indian Upstream sector but however the allocation of blocks were made by the government only in the name of the either of the public sector company. In effect, any private player interested in participating in the E & P activities had to enter into a Joint Venture Agreement with either of the public sector companies. This era saw the introduction of the Production Sharing Contract in the upstream sector in India. This era met with success to a certain extent and some of the most successful blocks that are in operation currently in India were allocated during this era.

### **10.2. NELP ERA**

NELP (New Exploration Licensing Policy) era saw the complete deregulation of the upstream sector in India. The era allowed 100% private partnership in the E & P activities and unlike the pre-NELP era the license and lease were allocated in the names of the private entity itself and

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<sup>216</sup> See, *Petroleum Exploration & Production Activity Report*, Director General of Hydrocarbons, Ministry of Petroleum & Natural Gases, 2013. Available at [http://www.dghindia.org/pdf/2012\\_13.pdf](http://www.dghindia.org/pdf/2012_13.pdf), last visited on 10<sup>th</sup> October 2014.

<sup>217</sup> *Id.*

thereby scrapping the requirement of the JV with the PSU's. NELP era created a level playing field for all the players in the sector viz. both the public sector as well as the private players by the introduction of an international competitive bidding process. The NELP era has also been formulated in a way to be the most investment friendly era with the motive of promoting the upstream sector of India and saw the introduction of the current form of Production Sharing Contract. Some of the salient features of NELP are One hundred percent cost recovery whereby upon successful exploration and the commencement of production, the company is permitted to recover all the costs that it has invested in the Exploration activities. Similarly, NELP had provided for a tax holiday for a period of Seven years. This tax holiday was scrapped with the introduction of NELP 9 during March 2011. The various other features of NELP include flexible provisions pertaining to assignment of the field to other players, no imposition of custom duty, etc. These factors have made the contractual framework under the NELP era a very operator friendly. The NELP is a constantly evolving policy whereby with the each updating of the policy changes are brought about to it. The recently proposed NELP 10 is also in the process of bringing about various changes to the current system, for instance the proposed changes to the cost recovery mechanism for instance which has been proposed in the light of certain bad experience faced by the government in a few cases.

Thus, the upstream sector in India over the past sixty odd years has undergone a sea of change wherein the sector has moved from being a fully regulated and closed one to a completely de regulated sector whereby a leveled playing field has been created by the introduction of a competitive bidding process. The introduction of NELP in India has suddenly renewed the interest of various major public players from across the world to get into the E & P activities in India and thereby making the sector a highly competitive one. The PSC plays a very crucial role in the current system in place for the E & P sector in India. However, it is imperative that for a successful implementation of the nation's ambitious E & P plans, the Model Production Sharing Contract is free of any contractual issues and is not impeded with any lacuna.



## CHAPTER 11

### 11.A COMPREHENSIVE REVIEW ON THE INDIAN MODEL PRODUCTION SHARING CONTRACT

The Indian Model Production Sharing Contract under the New Exploration Licensing Policy is a standard form contract entered into between the Government of India and the Contractor for the purpose of exploration and production of hydrocarbon resources in India. The Model Production sharing contract is applicable for both onshore as well as offshore E & P activities in the country. The Model Production Sharing Contract consists of Thirty-Seven (37) Articles and Nine (9) Appendices. The Model Production Sharing Contract deals with an array of topics covering numerous aspects that pertain with the E & P activities that is to be undertaken upon the entering into the agreement post the successful allotment of the block in favor of the contractor. The Production Sharing Contract on behalf of India is entered in the name of the President of India who is represented by an official from the Ministry of Petroleum and Natural Gas.

Article 1 of the Production Sharing Contract deals with Definitions of terms in use in the contract and defines about 91 terms including several important terms such as Approved Work Programme<sup>218</sup>, Arms Length Sale<sup>219</sup>, Associated Natural Gas<sup>220</sup>, Commercial Production<sup>221</sup>, Cost Petroleum<sup>222</sup>, Deep Water Area<sup>223</sup>, Delivery Point<sup>224</sup>, Development Cost<sup>225</sup>, Discovery<sup>226</sup>,

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<sup>218</sup> Article 1.7 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010.

<sup>219</sup> Article 1.8 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010.

<sup>220</sup> Article 1.10 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010.

<sup>221</sup> Article 1.19 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010.

<sup>222</sup> Article 1.20 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010.

<sup>223</sup> Article 1.30 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010.

<sup>224</sup> Article 1.31 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010.

<sup>225</sup> Article 1.32 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010.

<sup>226</sup> Article 1.38 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010.

Environmental Damage<sup>227</sup>, Exploration Cost<sup>228</sup>, Exploration Period<sup>229</sup>, Initial Exploration Period<sup>230</sup>, Subsequent Exploration Period<sup>231</sup>, Gas<sup>232</sup>, Natural Gas<sup>233</sup>, Reservoir<sup>234</sup>, Site Restoration<sup>235</sup>, etc. Article 2 of the PSC deals with participating Interest of the parties in cases wherein two or more companies join together as a consortium and engage in Joint Operations pursuant to a Joint Operator Agreement.

### **11.1. EXPLORATION PERIOD**

Article 3 of the PSC deals with the License and Exploration period for the said allotted block. The Exploration Period shall begin on the Effective Date and shall be for a period not exceeding seven (7) consecutive Contract Years in case of Contract Areas in on land and shallow water and not exceeding eight (8) consecutive Contract Years in case of Deep water Area and Frontier Area and consisting of Initial Exploration Period and Subsequent Exploration Period. The Initial Exploration Period shall consist of the first four (4) consecutive Contract Years in case of Contract Areas in onl and and shallow water and first five (5) consecutive Contract Years in case of Deep water Area and Frontier Area.<sup>236</sup>

It is further laid down that in case of the Contractor has completed the Minimum Work Programme at the expiry of the Initial Exploration Period, the Contractor shall have the option, which shall be exercised by giving a written notice to the Government at least thirty (30) days

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<sup>227</sup> Article 1.41 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010.

<sup>228</sup> Article 1.42 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010.

<sup>229</sup> Article 1.44 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010.

<sup>230</sup> Article 1.45.1 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010.

<sup>231</sup> Article 1.46 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010.

<sup>232</sup> Article 1.51 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010.

<sup>233</sup> Article 1.64 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010.

<sup>234</sup> Article 1.80 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010.

<sup>235</sup> Article 1.84 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010.

<sup>236</sup> Article 3.1 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010.

prior to the expiry of Initial Exploration Period either to proceed to the Subsequent Exploration Period by committing drilling of one exploratory well per year in contract Area in the case of on land and shallow water blocks and one exploratory well in 3 years in Contract Area in the case of deep water blocks. Further in the case of on land and shallow water blocks, the well(s) committed can be drilled in any of the years, as the case may be, of the Subsequent Exploration Period. In case of Deep water blocks the well(s) committed can be drilled in any of the three years of the Subsequent Exploration Period<sup>237</sup> or to relinquish the entire Contract Area except for any Discovery Area and any Development Area and to conduct Development Operations and Production Operations in relation to any Commercial Discovery in accordance with the terms of this Contract, and in such a scenario the Contractor shall have no further obligation in respect of the Minimum Work Programme under Article 5.<sup>238</sup> It is pertinent to note that in the event of neither of the options provided for in paragraphs (a) and (b) to Article 3.4 being exercised by the Contractor, the Contract shall terminate at the end of Initial Exploration Period and the License shall be automatically cancelled.

The PSC lays down that in case of the fact that at the end of the Initial Exploration Period the Minimum Work Programme for that period is not completed, the time for completion of the said Minimum Work Programme shall be extended for a period necessary to enable completion thereof but not exceeding six (6) months, on the submission of a request by giving a written notice by the contractor to the Government at least thirty (30) days prior to the expiry of the Initial Exploration Period and it is necessary that the Contractor demonstrates adequate technical or other good reasons for non-completion of the Minimum Work Programme. It is pertinent that prior written consent to the said extension is obtained from the Management Committee. The period of such extension shall be deducted from the succeeding Subsequent Exploration Period.<sup>239</sup> It is imperative that by the end of the Exploration Period, in case, no Commercial

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<sup>237</sup> Article 3.4(a) of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010.

<sup>238</sup> Article 3.4(b) of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010.

<sup>239</sup> Article 3.5 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010.

Discovery has been made in the Contract Area, the Contract shall stand terminated.<sup>240</sup> Further, in the event of the Contract is terminated in accordance with its terms, the License shall be automatically cancelled.<sup>241</sup>

## 11.2. RELINQUISHMENT

Article 4 of the PSC deals with Relinquishment whereby at the end of the Initial Exploration Period, the Contractor shall have option to relinquish Contract Area after completion of Minimum Work Programme or proceed to the Subsequent Exploration Period and retain the Contract Area by committing to carry out drilling as per the terms laid down under Article 3<sup>242</sup> of the PSC.<sup>243</sup> The Contract Area excluding Discovery and Development area shall be relinquished at the end of 7 or 8 consecutive years, as the case may be at the end of the Exploration Period.<sup>244</sup>

The PSC in a very clear manner lays down that when the Contract is terminated in accordance with the provisions of Article 3 or any other under provisions of the Contract, the entire Contract Area remaining with the Contractor shall be deemed to have been relinquished by the Contractor as on the date on which the Contract is terminated.<sup>245</sup> However, it is imperative that the relinquishment of all or part of the Contract Area or termination of the Contract shall not be construed as absolving the Contractor of any liability undertaken or incurred by the Contractor in respect of the Contract Area during the period between the Effective Date and the date of such relinquishment or termination.<sup>246</sup>

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<sup>240</sup> Article 3.8 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010.

<sup>241</sup> Article 3.9 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010.

<sup>242</sup> See, Article 3.4(a) of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010.

<sup>243</sup> Article 4.1 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010.

<sup>244</sup> Article 4.2 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010.

<sup>245</sup> Article 4.4 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010.

<sup>246</sup> Article 4.5 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010.

Article 5 of the PSC deals with the Work Programme whereby it is explicitly laid down that the Contractor shall commence Petroleum Operations not later than six (6) months from the Effective Date.<sup>247</sup> This Article further, lays down the technical aspects and parameters including those such as the seismic survey to be carried out, number of wells, depth of the well in meters, etc., that are necessary for the Contractor to follow in order to complete the laid down work programme during the initial and subsequent exploration period. The article also lays down that in the even of the Work Programme for the Subsequent Exploration Period has been completed earlier than specified period, the Contractor shall meet with the Government to discuss the possibility of early relinquishment, unless and until the Contractor undertakes further work with the prior approval of the Management Committee.<sup>248</sup> The article also covers the aspects of the budgeting and the approval of the year's budget for the work programme by the management committee<sup>249</sup> and the scope and procedure laid down for the modification of the said budgeting.<sup>250</sup>

The Management Committee together with its constitution, powers and functions are dealt under Article 6 of the PSC. The constitution of the committee shall be such that the Government shall nominate two (2) members representing Government in the Management Committee, whereas each Company constituting the Contractor shall nominate one (1) member each to represent Company in the Management Committee provided that in case the Contractor constitutes only one Company, that Company shall have two (2) members.<sup>251</sup> The PSC further lays down that the members of the committee shall be nominated by the parties within a period of 30 days.<sup>252</sup> The PSC also deals with the appointment of the government members as the Chairman and Deputy

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<sup>247</sup> Article 5.1 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010.

<sup>248</sup> Article 5.7 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010.

<sup>249</sup> See, Article 5.8 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010.

<sup>250</sup> See, Articles 5.9 & 5.10 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010.

<sup>251</sup> Article 6.1 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010.

<sup>252</sup> *Id.*

Chairman and the Operator's member as the Secretary of the committee.<sup>253</sup> The PSC also lists out the necessary instances wherein the Operator on behalf of the Contractor or in case of a single Party constituting the Contractor, then that Party shall submit matters to the Management Committee for its review and its advisory functions and approval.<sup>254</sup> It has been clearly laid down that, the Management Committee shall meet at least once every six (6) months during the Exploration Period and thereafter at least once every three (3) months or more frequently at the request of any member unless agreed otherwise by all the members of the Management Committee.<sup>255</sup> The PSC lays down that the venue of the meeting shall be in India and the costs of attending the meeting shall be borne by the respective parties. With respect to voting and approval of the matters before the committee, the PSC lays down that All matters requiring the approval of the Management Committee shall be generally approved by a unanimous vote of the members of the Management Committee present as well as the views of the members received by some other mode of communication. In case, unanimity is not achieved in decision making process within a reasonable period as may be required under the circumstances, the decision of the Management Committee shall be approved by the majority Participating Interest of seventy percent (70%) or more with Government representative having a positive vote in favour of the decision.<sup>256</sup> The PSC further empowers the management committee to appoint sub committee as and when it deems necessary to deal with the aspects of legal, financial and technicalities.<sup>257</sup>

### **11.3. JOINT OPERATING AGREEMENT**

Article 7 to the PSC deals with the aspects of the Operatorship, Joint Operator Agreement and the Operating Committee. The article clarifies that there shall be no change in the operatorship without the prior written consent of the government which shall not be unreasonably withheld, however with a rider that shall bear in mind the conditions related to bid evaluation criteria of the

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<sup>253</sup> Article 6.4 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010.

<sup>254</sup> Articles 6.5 & 6.6 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010.

<sup>255</sup> Article 6.7 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010.

<sup>256</sup> Article 6.13 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010.

<sup>257</sup> Article 6.15 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010.

award in considering such changes.<sup>258</sup> The PSC lays down that the functions required of the Contractor under this Contract shall be performed by the Operator on behalf of all constituent(s) of the Contractor subject to, and in accordance with, the terms and provisions of this Contract and generally accepted modern oilfield and petroleum industry practices, provided, however, the PSC also lays down a rider that the provision shall not be construed as relieving the constituent(s) of the Contractor from any of its obligations or liability under the Contract.<sup>259</sup> The Companies constituting the Contractor shall execute a Joint Operating Agreement within forty five (45) days of the Effective Date or any such longer period as may be agreed to by Government. The PSC further envisages that said agreements shall be consistent with the provisions of this Contract and shall provide the appointment, resignation, removal and responsibilities of the Operator, the establishment of an Operating Committee comprising of an agreed number of representatives of the Companies chaired by a representative of the Operator, functions of the said Operating Committee taking into account the provisions of the Contract, procedures for decision making, frequency and place of meetings, contribution to costs, default, sole risk, disposal of Petroleum and assignment as between the Parties to the Joint Operating Agreement, etc.<sup>260</sup> The copy of the duly executed Joint Operating Agreement within thirty (30) days of its execution date or such longer period as may be agreed to by the Government, to the government.<sup>261</sup>

#### **11.4. GENERAL RIGHTS AND OBLIGATIONS**

Article 8 of the PSC deals with the General Rights and Obligations of the Parties under the PSC. The PSC envisages that subject to the provisions of this Contract, the Contractor shall have the rights pertaining to carry out Petroleum Operations to recover costs and expenses as provided in this Contract in an exclusive manner subject to the provisions of Article 12. There is also a rider to this provision in the form of the provision that the right shall exclude exploitation of

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<sup>258</sup> Article 7.2 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010.

<sup>259</sup> Article 7.3 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010.

<sup>260</sup> Article 7.4 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010.

<sup>261</sup> Article 7.5 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010.

coal/lignite bed methane (CBM) by the Contractor in the Contract Area.<sup>262</sup> The contractor is empowered with a right to use, free of charge, such quantities of Petroleum produced as are reasonably required for conducting Petroleum Operations in the Contract Area in accordance with generally accepted modern oilfield and petroleum industry practices.<sup>263</sup> the contractor is further empowered under the PSC with the right to lay pipelines, build roads, construct bridges, ferries, aerodromes, landing fields, radio telephones and related communication and infrastructure facilities and exercise other ancillary rights as may be reasonably necessary for the conduct of Petroleum Operations subject to such approvals as may be required and the applicable laws in force from time to time.<sup>264</sup> The PSC also empowers the Contractor with the right to use all available technical data, seismic and well information, maps, samples etc., of the Contract Area as on the Effective Date, free of charge.<sup>265</sup>

The Contractor obligations imposed upon the Contractor under the PSC include that except as otherwise expressly provided in this Contract, conduct all Petroleum Operations at its sole risk, cost and expense and provide all funds necessary for the conduct of Petroleum Operations including funds for the purchase or lease of equipment, materials or supplies required for Petroleum Operations as well as for making payments to employees, agents and Subcontractors,<sup>266</sup> to conduct all Petroleum Operations within the Contract Area in a diligent manner and ensure that the operations are conducted expeditiously, efficiently and in a safe and workmanlike manner pursuant to the Work Programme formulated in accordance with Contract,<sup>267</sup> to ensure provision of all information, data, samples etc. which may be required to be furnished to ensure that all equipment, materials, supplies, plant and installations used by the Contractor, the Operator, and Subcontractors comply with generally accepted standards and are

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<sup>262</sup> Article 8.1(a) of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010.

<sup>263</sup> Article 8.1(b) of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010.

<sup>264</sup> Article 8.1(c) of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010.

<sup>265</sup> Article 8.1(d) of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010.

<sup>266</sup> Article 8.3(a) of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010.

<sup>267</sup> Article 8.3(b) of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010.



of proper construction and kept in safe and good working order.<sup>268</sup> The Contractor is also obligated to follow the procedure for acquisition of goods and services, as of the Effective Date, shall be as per the Appendix-F of this Contract.<sup>269</sup> The obligation of the Contractor also extends to the responsibility of appointing a technically competent and sufficiently experienced representative<sup>270</sup> and to provide acceptable working conditions, living accommodation and access to medical attention and nursing care for all personnel employed in Petroleum Operations<sup>271</sup> The PSC furthermore obligates the Contractor to carry out such other obligations as are specified in this Contract, in particular those specified in Article 14<sup>272</sup> and to be always mindful of the rights and interests of India in the conduct of Petroleum Operations.

The Government is empowered under the PSC to reserves the right to itself, or to grant to others the right, to prospect for and mine minerals or substances other than Petroleum within the Contract Area, to provided, however, that if after the Effective Date, others are issued rights, or the Government proceeds directly to prospect for and mine in the Contract Area any minerals or substances other than Petroleum, the Contractor shall use its best efforts to avoid obstruction to or interference with such operations within the Contract Area and the third parties and/or the Government, as the case may be, shall use best efforts to ensure that operations carried out do not obstruct or unduly interfere with Petroleum Operations in the Contract Area.<sup>273</sup>

#### **11.5. GOVERNMENT ASSISTANCE**

Article 9 of the PSC deals with the Governmental Assistance wherein the circumstances under which upon application, the assistance of the government would be extended to the Contractor. The PSC lays down that the Government shall assist the Contractor in procurement or

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<sup>268</sup> Article 8.3(c) & (d) of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010.

<sup>269</sup> Article 8.3(f) of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010.

<sup>270</sup> Article 8.3(h) of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010.

<sup>271</sup> Article 8.3(i) of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010.

<sup>272</sup> Article 8.3(j) of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010.

<sup>273</sup> Article 8.2 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010.

commissioning of facilities required for execution of Work Programmes including necessary approvals, permits, consents, authorizations, visas, work permits, Licenses including Licenses and Leases, rights of way, easement, surface rights and security protection at the Contractor's cost, required pursuant to this Contract and which may be available from resources within its control.<sup>274</sup>

## **11.6. DISCOVERY, DEVELOPMENT AND PRODUCTION**

Article 10 of the PSC deals with one of the most important aspect of the Contract, viz., Discovery, Development and Production. Upon Discovery in the Contract Area, the Contractor shall inform the Management Committee and Government of the Discovery<sup>275</sup> and thereafter within a period of Thirty (30) days from the date of the Discovery, furnish to the Management Committee and Government particulars, in writing, of the Discovery.<sup>276</sup> Subsequently the Contractor shall run tests promptly within 90 days from the date under Article 10.1 (a) to determine whether the Discovery is of potential commercial interest and, within a period of sixty (60) days after completion of such tests, submit a report to the Management Committee containing data obtained from such tests and its analysis and interpretation thereof, together with a written notification of whether, in the Contractor's opinion, such Discovery is of potential commercial interest and merits appraisal.<sup>277</sup> Pursuant to the tests under Article 10.1 (c), in case the Contractor notifies the Management Committee that the Discovery is of potential commercial interest, the Contractor shall prepare and submit to the Management Committee within one hundred and twenty (120) days of such notification, a proposed Appraisal Programme with a Work Programme and Budget, which shall be reviewed and approved by the Management Committee with scope to make changes later on,<sup>278</sup> to carry out an adequate and effective appraisal of such Discovery designed to achieve both the objectives of determine without delay,

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<sup>274</sup> Article 9.2 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010.

<sup>275</sup> Article 10.1(a) of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010.

<sup>276</sup> Article 10.1(b) of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010.

<sup>277</sup> Article 10.1(c) of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010.

<sup>278</sup> Article 10.4 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010.

and, in any event, within the period specified in Article 10.5, whether such Discovery is a Commercial Discovery and to determine, with reasonable precision, the boundaries of the area to be delineated as the Development Area.<sup>279</sup> The PSC further lays down that the Contractor shall communicate in respect of a Discovery of Crude Oil advise the Management Committee by notice in writing as to whether such Discovery should be declared a Commercial Discovery or not within a period of Eighteen (18) months for on land and shallow water blocks and thirty (30) months for deep water blocks from the date on which the notice provided for in Article 10.1 (c)

<sup>280</sup> and the Contractor shall submit to the Management Committee a comprehensive development plan of the Commercial Discovery.<sup>281</sup> In cases wherein the Management Committee rejects the development plan of the Contractor, the Contractor can submit the development plan for the approval of the Government. The Government shall respond on the proposed development plan submitted by the Contractor within One hundred and Ten (110) days. In case Government also refuses to approve the proposed development plan, it shall convey the reasons for such refusal and the Contractor shall be given opportunity to make appropriate modifications to meet concerns of Government and the provisions of the foregoing Article and re-submit the plan within Ninety (90) days from the date of receipt of refusal from the Government.<sup>282</sup>

It is pertinent to note that with the primary objective of attracting investments, the PSC has been encompassed to include the clause that in the event the area encompassing the Commercial Discovery extends beyond the Development Area designated in the Development Plan, either within the original Contract Area but subsequently relinquished or, outside the original Contract Area, the Management Committee may make recommendations to the Government concerning enlargement of the Development Area, provided the same was not awarded to any other

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<sup>279</sup> Article 10.3 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010.

<sup>280</sup> Article 10.5 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010.

<sup>281</sup> Article 10.7 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010.

<sup>282</sup> Article 10.8 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010.

company by the Government or is not held by any other party or not on offer by the Government and no application for a License or Lease is pending with the Government.<sup>283</sup>

## **11.7. PETROLEUM EXPLORATION LICENSE AND MINING LEASE**

Articles 11 of the PSC deal with the Petroleum Exploration License and Mining Lease for the Off Shore and On Shore areas respectively. The PSC lays down that the Contractor shall submit an application for grant of License in respect of the Contract Area, as early as possible, but not later than fifteen (15) Business Days from the date of execution of this Contract.<sup>284</sup> The PSC envisages that upon application and approval for Lease post discovery<sup>285</sup> the government shall grant a Lease for an initial period of twenty (20) years from the date of grant thereof subject to the condition of cancellation in accordance with its terms or for termination of this Contract in accordance with its terms.<sup>286</sup> An extension by mutual agreement between the Parties for five (5) years or such period as may be agreed by the parties after taking into account the balance recoverable reserve and balance economic life of the Field/Development Area from the expiry of the initial period provided that in the event of a Commercial production of Non Associated Natural Gas the extension may be for a period of ten (10) years or such period as may be mutually agreed between the Parties after taking into account the balance recoverable reserves and balance economic life of the Field/Development Area from the date of expiry of the initial term.<sup>287</sup>

## **11.8. UNIT DEVELOPMENT**

Article 12 of the PSC deals with Unit Development, which comes into role in the event of two or more contractors operating out in areas that share a common Reservoir. In cases wherein the Reservoir in a Discovery Area is situated partly within the Contract Area and partly in an area in

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<sup>283</sup> Article 10.14 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010.

<sup>284</sup> Article 11.1 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010.

<sup>285</sup> Article 11.2 & 11.3 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010.

<sup>286</sup> Article 11.5 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010.

<sup>287</sup> Article 11.5(b) of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010.

India over which other parties have a contract to conduct petroleum operations and both parts of the Reservoir can be more efficiently developed together on a commercial basis, on receiving information in writing from any party to these contracts or any information on this from any bonafide source, the Government may, for securing the more effective recovery of Petroleum from such Reservoir, by notice in writing to the Contractor, require that the Contractor to collaborate and agree with such other parties on the joint development of the Reservoir and submit such agreement between the Contractor and such other parties to the Government for approval within one hundred and eighty (180) days and prepare a plan for such joint development of the said Reservoir, within one hundred and eighty (180) days of the approval of the agreement referred to in (b) above.<sup>288</sup> In the event of no plan being submitted within the period specified in Article 12.1 (c) or such longer period as the Government and the Contractor and the other parties referred to in Article 12.1 may agree, or, if such plan as submitted is not acceptable to the Government and the Parties cannot agree on amendments to the proposed joint development plan, the Government may cause to be prepared, at the expense of the Contractor and such other parties a plan for such joint development consistent with generally accepted modern oilfield and petroleum industry practices which shall take into consideration any plans and presentations made by the Contractor and the aforementioned other parties.<sup>289</sup> The PSC further provides for remedy to cases wherein the parties are unable to agree on the proposed plan for joint development, the Government may call for a joint development plan from an independent agency, which agency, may make such a proposal after taking into account the position of the parties in this regard. Such a development plan, if approved by Government, shall be binding on the parties, notwithstanding their disagreement with the plan. However, despite the same, if the Contractor may in case of any disagreement on the issue of joint development or the proposed joint development plan, prepared in accordance with Article 12.2 or within forty five (45) Business Days of the plan approval as aforesaid in this Article, notify the Government that it elects to surrender its rights in the Reservoir/Discovery in lieu of participation in a joint development<sup>290</sup> and in cases where the plan is adopted shall be the approved joint development

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<sup>288</sup> Article 12.1 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010.

<sup>289</sup> Article 12.2 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010.

<sup>290</sup> Article 12.3 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010.

plan and the Contractor shall comply with the terms of the said development plan as if the Commercial Discovery is established.<sup>291</sup>

## **11.9 MEASUREMENT OF PETROLEUM**

The PSC under Article 13 deals with the Measurement of Petroleum whereby it lays down that the Petroleum used for internal consumption for Petroleum Operations, flared, saved and sold from the Contract Area shall be measured by methods and appliances generally accepted and customarily used in modern oilfield and petroleum industry practices and approved by the Management Committee and the Government<sup>292</sup> with the right conferred upon the government to inspect and test the appliances used for measuring the volume and determining the quality of Petroleum at all reasonable times.<sup>293</sup> The PSC further lays down that before the commencement of production from the Contract Area, the Parties shall mutually agree on the methods to be employed for measurement of volumes of Petroleum production and the point or points at which Petroleum shall be measured and the respective shares allocated to the Parties in accordance with the terms of the Contract together with the frequency of inspections and testing of measurement appliances and relevant procedures relating thereto. Further, the PSC also provides for the scope to determine the consequences of a determination of an error in measurement.<sup>294</sup>

## **11.10 PROTECTION OF ENVIROMENT**

Protection of the Environmental is dealt by the PSC under Article 14, which starts off with a recognition of the fact that it is inevitable that some amount of damage would be caused to the environment in the Contract Area while carrying out the Petroleum Operations. In a continuation to this recognition, the PSC lays down a rider on the Contractor that in performance of the Contract, the Contractor shall conduct its Petroleum Operations with due regard to concerns with respect to protection of the environment and conservation of natural resources and shall in

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<sup>291</sup> Article 12.3 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010.

<sup>292</sup> Article 13.1 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010.

<sup>293</sup> Article 13.2 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010.

<sup>294</sup> Article 13.3 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010.

particular employ modern oilfield and petroleum industry practices and standards including advanced techniques, practices and methods of operation for the prevention of Environmental Damage in conducting its Petroleum Operations and take necessary and adequate steps to prevent Environmental Damage and, where some adverse impact on the environment is unavoidable, to minimise such damage and the consequential effects thereof on property and people and further to ensure adequate compensation for injury to persons or damage to property caused by the effect of Petroleum Operations. The PSC also lays down that the Contractor shall comply with the requirements of applicable laws and the reasonable requirements of the Government from time to time.<sup>295</sup> The PSC lays down that in case the Contractor fails to comply with the provisions of paragraph (b)(i) of Article 14.1 or contravenes any relevant law, and such failure or contravention results in any Environmental Damage, the Contractor shall forthwith take all necessary and reasonable measures to remedy the failure and the effects thereof.<sup>296</sup>

The PSC provides that if the Government in accordance with the laws has good reason to believe that any works or installations erected by the Contractor or any operations conducted by the Contractor are endangering or may endanger persons or any property of any person, or are causing or may cause pollution, or are harming or may harm fauna or flora or the environment to a degree which the Government deems unacceptable, the Government may require the Contractor to take remedial measures within such reasonable period as may be determined by the Government and to repair any such damage.<sup>297</sup> If the Government deems it necessary, it may also require the Contractor to discontinue Petroleum Operations in whole or in part until the Contractor has taken such remedial measures or has repaired any damage caused and the measures and methods so adopted by the Contractor for the purpose of complying with the terms shall take into account the international standards applicable in similar circumstances and the relevant environmental impact study carried out in accordance with Article.<sup>298</sup>

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<sup>295</sup> Article 14.1 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010.

<sup>296</sup> Article 14.2 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010.

<sup>297</sup> Article 14.3 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010.

<sup>298</sup> Article 14.4 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010.

The PSC envisages the carrying out of two environmental impact studies by the Contractor, who shall cause a person or persons with special knowledge on environmental matters in order to determine at the time of the studies the prevailing situation relating to the environment, human beings and local communities, the flora and fauna in the Contract Area and in the adjoining or neighbouring areas<sup>299</sup> and to establish the likely effect on the environment, human beings and local communities, the flora and fauna in the Contract Area and in the adjoining or neighboring areas in consequence of the relevant Exploration Period of Petroleum Operations to be conducted under this Contract, and to submit, for consideration by the Parties, methods and measures contemplated in Article 14.4 for minimising Environmental Damage and carrying out Site Restoration activities<sup>300</sup> with the first of the aforementioned studies be carried out in two parts, viz., a preliminary part which must be concluded before commencement of any field work relating to a seismographic or other survey, and a final part relating to drilling in the Exploration Period. The part of the study relating to drilling operations in the Exploration Period shall be approved by Government before the commencement of such drilling operations, it being understood that such approval shall not be unreasonably withheld. The second of the aforementioned studies shall be completed before commencement of Development Operations and shall be submitted by the Contractor as part of the Development Plan, with specific approval of Government being obtained before commencement of Development Operations.

The PSC lays down that the Contractor shall ensure that Petroleum Operations are conducted in an environmentally acceptable and safe manner consistent with modern oilfield and petroleum industry practices and that such Petroleum Operations are properly monitored and shall make available to its employees and to its contractors and Subcontractors the completed environmental impact studies are made so as to develop adequate and proper awareness of the measures and methods of environmental protection to be used in carrying out the Petroleum Operations; and

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<sup>299</sup> Article 14.5(a) of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010.

<sup>300</sup> Article 14.5(b) of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010.



the contracts entered into between the Contractor and its contractors and Subcontractors relating to its Petroleum Operations shall include the provisions stipulated herein and any established measures and methods for the implementation of the Contractor's obligations in relation to the environment under this Contract.<sup>301</sup> With respect to emergency protocol the PSC envisages that the Contractor shall, prior to conducting any drilling activities, prepare and submit for review by the Government contingency plans for dealing with Oil spills, fires, accidents and emergencies, designed to achieve rapid and effective emergency response. The plans referred to above shall be discussed with the Government and concerns expressed shall be taken into account.<sup>302</sup> Dealing with these exigencies in detail, the PSC lays down that in the event of an emergency, accident, Oil spill or fire arising from Petroleum Operations affecting the environment, the Contractor shall forthwith notify the Government and shall promptly implement the relevant contingency plan and perform such Site Restoration as may be necessary in accordance with modern oilfield and petroleum industry practices. Further, in the event of any other emergency or accident arising from the Petroleum Operations affecting the environment, the Contractor shall take such action as may be prudent and necessary in accordance with modern oilfield and petroleum industry practices in such circumstances. A failure on the part of the Contractor to comply with any of the terms contained in Article 14.7 within a period specified by the Government, the Government, after giving the Contractor reasonable notice in the circumstances, may take any action which may be necessary to ensure compliance with such terms and to recover from the Contractor, immediately after having taken such action, all costs and expenditures incurred in connection with such action together with such interest as may be determined in accordance with Section 1.7 of Appendix C of the PSC.

The PSC also deals with the environmental impact in all scenario including the expiry or termination of this Contract or relinquishment of part of the Contract Area, wherein the Contractor shall subject to Article 27, remove all equipment and installations from the relinquished area or former Contract Area in a manner agreed with the Government pursuant to

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<sup>301</sup> Article 14.6 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010.

<sup>302</sup> Article 14.7 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010.

an abandonment plan and perform all necessary Site Restoration in accordance with modern oilfield and petroleum industry practices and take all other action necessary to prevent hazards to human life or to the property of others or the environment.<sup>303</sup>

The PSC further envisages that the Contractor shall prepare a proposal for the restoration of site including abandonment plan and requirement of funds for this and the annual contribution. This will be submitted along with the annual Budget for the consideration and approval of the Management Committee. The annual contribution shall be deposited by the Contractor in the Site Restoration fund, which will be established, in accordance with the scheme notified by the Government. For this purpose, the annual contribution to Scheme shall be calculated based on unit of production method i.e. Reserve to Production Ratio.<sup>304</sup> It is however pertinent to note that the obligations and liability of the Contractor for the environment hereunder shall be limited to damage to the environment which occurs after the Effective Date and has occurred as the result from an act or omission of the Contractor.<sup>305</sup>

#### **11.11 COST RECOVERY**

Article 15 of the PSC deals with the Recovery of Cost Petroleum whereby the Contractor is made entitled to recover Contract Costs out of a percentage of the total value of Petroleum Produced and Saved from the Contract Area in the Year in accordance with the provisions of this Article.<sup>306</sup> The entire Exploration Costs incurred by the Contractor in the Contract Area upto the date of first Commercial Production shall be aggregated, and the Contractor shall be entitled to recover the aggregate of such Exploration Costs out of the Cost Petroleum at the rate of one hundred percent (100%) per annum of such Exploration Costs beginning from the date of such

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<sup>303</sup> Article 14.9 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010.

<sup>304</sup> Article 14.10 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010.

<sup>305</sup> Article 14.11 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010.

<sup>306</sup> Article 15.1 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010.

Commercial Production.<sup>307</sup> The Contractor is further entitled to recover out of the Cost Petroleum from the Contract Area the Exploration Costs, which it has incurred in any Year after the date of Commercial Production at the rate of One hundred percent (100%) per annum of such Exploration Costs beginning from the date such Exploration Costs are incurred.<sup>308</sup> The Development Costs incurred by the Contractor in the Contract Area upto the date of first Commercial Production shall also be aggregated, and the Contractor shall be entitled to recover out of the Cost Petroleum the aggregate of such Development Costs at the rate of one hundred percent (100%) per annum of such Development Costs beginning from the date of such Commercial Production.<sup>309</sup> The Contractor is further entitled to recover out of the Cost Petroleum from the Contract Area the Development Costs, which it has incurred after the date of first Commercial Production at the rate of one hundred percent (100%) per annum of such Development Costs beginning from the date such Development Costs are incurred.<sup>310</sup>

Furthermore the Contractor shall be entitled to recover in full during any Year the Production Costs incurred and the royalty payments to the Government/ State Government(s) in that year out of the Cost Petroleum.<sup>311</sup>

If during any Year the Cost Petroleum is not sufficient to enable the Contractor to recover in full the Contract Costs due for recovery in that Year then, the recovery shall first be made of royalty payments and then the recovery shall next be made of the Production Costs, then the recovery shall next be made of the Exploration Costs and the recovery shall then finally be made of the Development Costs. The PSC further provides that any unrecovered portions of Contract Costs shall be carried forward to the following Year and the Contractor shall be entitled to recover such Contract Costs in such Year or the subsequent Years as if such Contract Costs were due for recovery in that Year, or the succeeding Years, until the unrecovered Contract Costs have been

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<sup>307</sup> Article 15.2 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010.

<sup>308</sup> Article 15.3 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010.

<sup>309</sup> Article 15.4 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010.

<sup>310</sup> Article 15.5 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010.

<sup>311</sup> Articles 15.6 & 15.7 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010.

fully recovered out of Cost Petroleum from the Contract Area<sup>312</sup> and also in an explicit manner lays down the maximum amount of Cost Petroleum to which the Contractor shall be entitled.

#### **11.12 SHARE OF PETROLEUM**

Article 16 of the PSC deals with Production Sharing of Petroleum whereby the Parties to the PSC Contract are entitled to share in the Profit Petroleum in each Year in accordance with the provisions of the PSC and a Party's share of Profit Petroleum in any Year, shall be calculated on the basis of the Investment Multiple as provided in Appendix-D to the PSC.<sup>313</sup> The PSC empowers the Government to have the option to take its entitlement to Profit Petroleum other than "ANG" or "NANG" either in cash or in kind in any Year and such option shall be exercised by the Government at interval of every five (5) Years from the commencement of first Commercial Production from the Contract Area by giving a written notice to the Contractor not later than thirtieth (30th) June in the preceding Year in which the entitlement is due and the Government has exercised its option, the same shall continue unless the Government informs the Contractor otherwise.<sup>314</sup>

It is imperative to note that though the value of the Contractor's Investment Multiple at the end of any Year in respect of the Contract Area is calculated in the manner provided for, and on the basis of the net income specified in Appendix-D to the PSC, the amount of Profit Petroleum to be shared between the Government and the Contractor shall be determined for each Quarter on an accumulative basis. Pending finalisation of accounts, Profit Petroleum shall be shared between the Government and the Contractor on the basis of provisional estimated figures of Contract Costs, production, prices, income and any other income or allowable deductions and on the basis of the value of the Investment Multiple achieved at the end of the preceding Year after the approval by the Management Committee. When it is necessary to convert monetary units into

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<sup>312</sup> Article 15.8 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010.

<sup>313</sup> Article 16.1 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010.

<sup>314</sup> Article 16.4 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010.

physical units of production equivalents or vice versa, the price or prices determined pursuant to Articles 19 and 21 for Crude Oil, Condensate and Natural Gas respectively shall be used. The PSC further lays down that within ninety (90) days of the end of each Year, a final calculation of Profit Petroleum based on actual costs, quantities, prices and income for the entire Year shall be completed and any necessary adjustments to the sharing of Petroleum shall be agreed upon between the Government and the Contractor within thirty (30) days and made within thirty (30) days thereafter.<sup>315</sup>

### **11.13 TAXES, ROYALTIES, RENTALS, DUTIES, Etc..**

Article 17 of the PSC deals with Taxes, Royalties, Rentals, Duties, etc., whereby it is in the most explicit manner mentioned that the Companies, their employees, persons providing any materials, supplies, services or facilities or supplying any ship, aircraft, machinery, equipment or plant (whether by way of sale or hire) to the Companies for Petroleum Operations or for any other purpose and the employees of such persons shall be subject to all fiscal legislation in India except where, pursuant to any authority granted under any applicable law, they are exempted wholly or partly from the application of the provisions of a particular law or as otherwise provided in the PSC.<sup>316</sup> Subject to the provisions mentioned in the PSC, deductions at the rate of One hundred (100%) per annum shall be allowed for all expenditures, both capital and revenue expenditures, incurred in respect of Exploration Operations and drilling operations. The expenditure incurred in respect of Development Operations, other than drilling operations, and Production Operations will be allowable as per the provisions of the Income-tax Act, 1961.<sup>317</sup>

Further, for income tax purposes only, a Company shall be entitled, to deduct all its unsuccessful Exploration Costs in contract areas covered by other contracts from the aggregate value of Petroleum allocable to the Company from any Field(s).<sup>318</sup>

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<sup>315</sup> Article 16.5 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010.

<sup>316</sup> Article 17.1 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010.

<sup>317</sup> Article 17.2.1 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010.

<sup>318</sup> Article 17.2.2 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010.

With respect to the Lease and Royalty associated with it, the Companies (Lessee) are required to pay royalty to the Government (Lessor) for offshore areas at the rate of ten percent (10%) of the well-head value of Crude Oil and Natural Gas. In case of an onshore area, Companies shall be required to pay to the State Government(s) (Lessor) at the rate of twelve point five zero percent (12.5%) of the well-head value of Crude Oil and ten percent (10%) of the well-head value of Natural Gas. Further, in case of an offshore area falling beyond four hundred (400) meter isobath, the rate of royalty payable by Companies (Lessee) to the Government (Lessor) shall be at the rate of five percent (5%) of the well-head value of Crude Oil and Natural Gas for the first seven years from the date of commencement of Commercial Production in the Field. It is pertinent to note that the valuation of Crude Oil and Natural Gas shall be as per the Article 19 and Article 21 respectively and the royalty amount due to Government/State Government(s) shall be payable latest by the end of the succeeding Month.<sup>319</sup>

The PSC further provides that any Machinery, plant, equipment, materials and supplies imported by the Contractor and its Subcontractors solely and exclusively for use in Petroleum Operations under this Contract or similar contracts with the Government where customs duty has been exempted by the Government shall be exempt from customs duties and export duties or other charges on re-exportation of the said items in accordance with applicable legislation<sup>320</sup> with a rider that the Government shall have the right to inspect the records and documents of the physical item or items for which an exemption has been provided pursuant to Article 17.5 to determine that such item or items are being or have been imported solely and exclusively for the purpose for which the exemption was granted. The Government shall also be entitled to inspect such physical items wherever located to ensure that such items are being used for the purpose herein specified and any item not being so used shall immediately become liable to payment of the applicable customs duties.<sup>321</sup> Thus, subject to the provisions of the PSC, the Contractor shall

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<sup>319</sup> Article 17.4 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010.

<sup>320</sup> Article 17.5 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010.

<sup>321</sup> Article 17.6 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010.

be liable for payment of annual license charges and rental fees and other charges under the Rules, the charges payable by specified industries or in connection with Petroleum Operations under applicable legislation, all the payments for purchase, lease or rental of land or land rights in connection with Petroleum Operations, taxes, fees or charges for specific services rendered on request or to the public generally, customs duties, except for those items subject to exemption as provided in Article 17, applicable at the rates specified from time to time and the stamp duties, registration fees, license fees, taxes such as taxes on property or assets or other levies, fees or charges of a non-discriminatory nature and generally applicable in India or in the State where Petroleum Operations are being conducted.<sup>322</sup>

#### **11.14 DOMESTIC SUPPLY**

Article 18 of the PSC deals with the Domestic Supply, Sale, Disposal and Export of Crude Oil and Condensate, which categorically lays down that until such time as the total availability of Crude Oil and Condensate from all Petroleum production activities in India meets the total national demand as determined by the Government, each Company comprising the Contractor, shall sell in the domestic market in India all of the Company's entitlement to Crude Oil and Condensate from the Contract Area.<sup>323</sup> The PSC provides for export in certain cases wherein in case India attains self-sufficiency in crude oil and condensate, during any year, the Government shall advise the company (ies) accordingly by a written notice and in such an event, domestic sale obligation would be suspended for such period as may be specified by the Government, and the Company would have the right to lift and export its Participating Interest share of Crude Oil and Condensate during the said period, subject to any other extant policy guidelines of the Government applicable from time to time.<sup>324</sup> However, if Self-sufficiency ceases to exist, the position shall revert to domestic sale obligation as outlined in Article 18.1 of the PSC.<sup>325</sup>

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<sup>322</sup> Article 17.9 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010.

<sup>323</sup> Article 18.1 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010

<sup>324</sup> Article 18.2 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010

<sup>325</sup> Article 18.3 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010

The PSC provides that each Company comprising the Contractor shall, throughout the term of the PSC shall have the right to separately take in kind and dispose of all its share of Cost Petroleum and Profit Petroleum and shall have the obligation to lift the said Petroleum on a current basis and in such quantities so as not to cause a restriction of production or inconvenience to the other Company(ies).<sup>326</sup>

### **11.15 VALUATION OF PETROLEUM**

Article 19 of the PSC deals with Valuation of Petroleum alone and the Natural Gases are dealt with separately and not under this provision<sup>327</sup>, and envisages that the price for Crude Oil shall be determined for each Month, or such other period as the Parties may agree in terms of United States Dollars per Barrel, on import parity basis for Crude Oil produced and sold or otherwise disposed of from Contract Area, for each Delivery Period, in accordance with the appropriate basis for that type of sale or disposal specified below. Subject to the provisions of the Article 19 of the PSC, it is clearly understood that the actual prices invoiced by the Company(ies) for the sales will form the basis for the purposes of cost recovery, Profit Petroleum sharing and payment of royalty as provided in the Articles 15, 16 and 17 of the PSC respectively. The basis of valuation arrived at by this method shall apply only where Government is of the view that sale prices realised by the Company(ies) are not consistent with the price realisable at Arms Length Sales.<sup>328</sup> In the event that some or all of a Company's or Contractor's total sales of Crude Oil during a Delivery Period are made to third parties at Arms Length Sales, all sales so made shall be valued at the weighted average of the prices actually invoiced by a Company calculated by dividing the total invoice value from all such sales at the Delivery Point by the total number of Barrels of the Crude Oil sold in such sales.<sup>329</sup>

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<sup>326</sup> Article 18.4 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010

<sup>327</sup> Article 19.10 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010

<sup>328</sup> Article 19.2 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010

<sup>329</sup> Article 19.3 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010



The PSC categorically lays down that in the event that the Parties fail to reach agreement on any matter concerning selection of the crude oils for comparison, the calculation, the basis of, or mechanism for the calculation of the prices, the prices arrived at, the adjustment of any price or generally about the manner in which the prices are determined according to the provisions of this Article within thirty (30) days, or such longer period as may be mutually agreed between the Parties, from the date of commencement of Commercial Production or the end of each Delivery Period thereafter, any Party may refer the matter or matters in issue for final determination by a sole expert or arbitrator appointed as provided in Article 33<sup>330</sup> with a further explanation that if the matter is referred to the sole expert, within ten (10) days of the said appointment, the Parties shall provide the expert with all information they deem necessary or as the expert may reasonably require and further that within fifteen (15) days from the date of his appointment, the expert shall report to the Parties on the issue(s) referred to him for determination, applying the criteria or mechanism set forth herein and indicate his decision thereon to be applicable for the relevant Delivery Period for Crude Oil and such decision shall be accepted as final and binding by the Parties.<sup>331</sup>

#### **11.16 CURRENCY EXCHANGE**

Article 20 of the PSC deals with the Currency and Exchange Control Provisions deals with the need for compliance with the relevant provisions of the laws of general application in India governing currency and foreign exchange and related administrative instructions and procedures issued thereunder on a non-discriminatory basis, and further allows each Foreign Company comprising the Contractor shall, during the term of this Contract to repatriate abroad, in United States Dollars or any other freely convertible currency acceptable to the Government and the Foreign Company, the net proceeds of sales of Petroleum in India, to receive, retain and use abroad the proceeds of any export sales of Petroleum under the Contract, to open, maintain and operate bank accounts with reputable banks, both inside and outside India, for the purpose of the

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<sup>330</sup> Article 19.5 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010

<sup>331</sup> Article 19.6.1 & 19.6.2 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010

PSC, to freely import, through normal banking channels, funds necessary for carrying out the Petroleum Operations, to convert into foreign exchange and repatriate sums imported pursuant to (d) above in excess (if any) of its requirements; and finally to make payments outside of India for purchases, services and loans obtained abroad without the requirement that funds used in making such payments must come from or originate in India with a proviso that the repatriation pursuant to subparagraphs (a) and (e) and payments pursuant to subparagraph (f) shall be subject to the provisions of any treaties and bilateral arrangements between the Government and any country with respect to payments to or from that country.<sup>332</sup> The PSC further allows Indian Companies shall have right to remit their portion of expenditure in foreign currency in accordance with the exchange control provisions.<sup>333</sup>

## 11.18 NATURAL GAS

Article 21 of the PSC deals with Natural Gas wherein similar to the provision relating to the Export of Petroleum the PSC categorically lays down that until such time as the total availability of Natural Gas from all Petroleum production activities in India meets the total national demand as determined by the Government, each Company comprising the Contractor, shall sell in the domestic market in India all of the Company's entitlement to Natural Gas from the Contract

Area<sup>334</sup> with a proviso that in case of India attaining self-sufficiency in Natural Gas, during any year, the Government shall advise the company(ies) accordingly by a written notice. In such an event, domestic sale obligation shall be suspended for such period as may be specified by the Government, and the Company shall have the right to lift and export its Participating Interest share of Natural Gas during the said period, subject to any other extant policy guidelines of the Government applicable from time to time.<sup>335</sup> A rider that if the self-sufficiency ceases to exist, the position shall revert to domestic sale obligation as outlined in Article 21.1 governs the

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<sup>332</sup> Article 20.1 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010

<sup>333</sup> Article 20.4 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010

<sup>334</sup> Article 21.1 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010

<sup>335</sup> Article 21.1.1 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010

relaxation.<sup>336</sup> The PSC permits the Contractor for self consumption of the Natural Gas wherein it lays down that the Contractor shall have the right to use Natural Gas produced from the Contract Area for the purpose of Petroleum Operations including reinjection for pressure maintenance in Oil Fields, gas lifting and captive power generation required for Petroleum Operations.<sup>337</sup>

The PSC for the purpose of domestic sale obligation, envisages that the Contractor shall have freedom to market the Natural Gas and sell its entitlement as per Government Policy for utilization of gas among different sectors<sup>338</sup> and that the Government may from time to time frame policy for utilization of gas among different sectors, both for Associated Natural Gas (ANG) as well as Non-Associated Natural Gas (NANG) which would cover issues relating to gas supplies to different consumer sectors. The PSC with respect to Associated Natural Gas (ANG) lays down that in the event that a Discovery of Crude Oil contains ANG, the Contractor shall declare in the proposal for the declaration of the said Discovery as a Commercial Discovery as specified in Article 10, whether the estimated production of ANG is anticipated to exceed the quantities of ANG which will be used in accordance with Article 21.2, that is resulting in as “the Excess ANG”. In such an event the Contractor shall indicate whether, on the basis of the available data and information, it has reasonable grounds for believing that the Excess ANG could be commercially exploited in accordance with the terms of this Contract along with the Commercial Production of the Crude Oil from the Contract Area, and whether the Contractor intends to so exploit the Excess ANG.<sup>339</sup>

The PSC envisages that based on the principle of full utilisation and minimum flaring of ANG, a proposed development plan for an Oil Discovery shall, to the extent practicable, include a plan for utilisation of the ANG including estimated quantities to be flared, reinjected, and to be used

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<sup>336</sup> Article 20.1.2 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010

<sup>337</sup> Article 21.2 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010

<sup>338</sup> Article 21.3 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010

<sup>339</sup> Article 21.4.1 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010

for Petroleum Operations; and, if the Contractor proposes to commercially exploit the Excess

ANG for sale in the domestic market in accordance with Government's policy, the Contractor shall be free to explore markets for the commercial exploitation of the said Excess ANG and submit its proposals for such exploitation to the Government in accordance with Article 21.4.2.<sup>340</sup> The PSC further lays down that in cases wherein the Contractor is of the view that the Excess ANG cannot be commercially exploited and chooses not to exploit the said Excess ANG, or is unable to find a market for the Excess ANG the Government shall be entitled to take and utilise such Excess ANG free of any cost/ charge and in such a scenario the Contractor shall deliver such Excess ANG to the Government (or its nominee) free of any cost/ charge, at the downstream flange of the Gas/ Oil separation facilities and the Contractor further shall, based on sound petroleum engineering practices, install such facilities as would facilitate, insofar as practicable, uninterrupted delivery of such Excess ANG to the Government or its nominee. The PSC however clarifies that the cost of all facilities installed shall be borne by the Government (or its nominee) and also that the Government or its nominee shall bear all costs including gathering, treating, processing and transporting costs beyond the downstream flange of the Gas/ Oil separation facilities.<sup>341</sup> The PSC further lays down that any excess ANG which is not commercially exploited by the Contractor, or taken by the Government or its nominee pursuant to this Article 21, shall be returned to the subsurface structure or flared or otherwise disposed off as approved by the Government in the context of the Development Plan, provided that flaring will be resorted to only for small quantities and as a last resort.<sup>342</sup>

The PSC with respect to Non Associated Natural Gas (NANG) lays down that in the event of a Discovery of NANG in the Contract Area, the Contractor shall promptly report such Discovery to the Management Committee and the Government and the provisions of Articles 10.1 and 10.2 shall apply. It further lays down that the remaining provisions of Article 10 would apply to the Discovery and development of NANG only insofar as they are not inconsistent with the

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<sup>340</sup> Articles 21.4.2 & 21.4.3 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010

<sup>341</sup> Articles 21.4.4 & 21.4.5 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010

<sup>342</sup> Article 21.4.6 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010

provisions of this Article. Notwithstanding the provisions of Article 3, the Contractor shall be entitled to retain the Discovery Area subject to the provisions of Article 21.<sup>343</sup> Further, if pursuant to Article 10.1, the Contractor gives notification that the Discovery is of potential commercial interest, the Contractor shall submit to the Management Committee, within one (1) year from the date of notification of the above said Discovery, the proposed Appraisal Programme, including a Work Programme and Budget to carry out an adequate and effective appraisal of such Discovery, to determine (i) without delay, whether such Discovery is a Commercial Discovery and (ii) with reasonable precision, the boundaries of the area to be delineated as the Development Area. Such proposed Appraisal Programme shall be supported by all relevant data such as Well data, Contractor's best estimate of reserve range and production potential, and shall indicate the date of commencement of the proposed Appraisal Programme<sup>344</sup> and the same shall be reviewed by the Management Committee within sixty (60) days of its submission by the Contractor. The Management Committee shall offer its comments within the said period. The said Appraisal Programme together with the Work Programme and Budget submitted by the Contractor as revised or modified or amended in light of the Management Committee review and advice, shall be adopted as the Appraisal Programme and the Contractor shall promptly proceed with implementation of the said Programme.<sup>345</sup>

The PSC lays down that in cases wherein the Contractor submits a proposal for the declaration of a Discovery as a Commercial Discovery, the Management Committee shall consider the proposal of the Contractor with reference to commercial utilization or commercial development of the

NANG in the domestic market or elsewhere and in the context of Government's policy on Gas utilization and the chain of activities required to bring the NANG from the Delivery Point to potential consumers in the domestic market or elsewhere. It is further laid down that the Management Committee shall, within eighty five (85) days of the submission of the said proposal, request the Contractor to submit any additional information on the Discovery, the

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<sup>343</sup> Article 21.5.1 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010

<sup>344</sup> Article 21.4.2 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010

<sup>345</sup> Article 21.5.3 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010

anticipated markets or any other related matter that may reasonably be required to facilitate a review and Contractor shall submit the required information within thirty (30) days of the request by the Management Committee. The Management Committee will finally advise the Contractor of its review within one hundred and thirty five (135) days from the submission of proposal or within fifty five (55) days from the receipt of additional information, as the case may be, on the proposal made by the Contractor to declare the Discovery as a Commercial Discovery.<sup>346</sup> the PSC envisages that in the event of the Contractor declaring the Discovery a Commercial Discovery after taking into account the advice of the Management Committee, the Contractor shall, within one (1) year of the declaration of the Discovery as a Commercial Discovery, submit a development plan for the development of the Discovery to the Management Committee for approval. Such plan shall be supported by all relevant information including, inter alia, the information required in Article 10.7.<sup>347</sup>

In the event of rejection of the development plan of the Contractor by Management Committee, the Contractor can submit the development plan for the approval of the Government<sup>348</sup> and the Government shall convey its decision within one hundred and fifteen (115) days from the date of receipt of the proposal from the Contractor. Government is also empowered to ask clarifications/additional information from the Contractor within eighty five (85) days and shall convey its decision within fifty five (55) days from the date of receipt of such clarifications/additional information.<sup>349</sup> The PSC also provides for a right of resubmission of the proposed development plan, which shall be exercisable by the Contractor once in case of rejection by the Government and the Government will respond to such re-submitted plan within one hundred and fifteen (115) days. However, in case no such plan is submitted to the

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<sup>346</sup> Article 21.5.5 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010

<sup>347</sup> Article 21.5.6 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010

<sup>348</sup> Article 21.5.7 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010

<sup>349</sup> Article 21.5.8 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010

Government within the said period, the Contractor shall relinquish its right to develop such Gas Discovery and such Discovery shall be excluded from the Contract Area.<sup>350</sup>

The PSC lays down that in the event that the Management Committee or Government, as may be the case, approves the Contractor's development plan for the development of such Commercial Discovery, the said Gas Discovery shall be promptly developed by the Contractor in accordance with the approved plan which shall be the Development Plan<sup>351</sup> and within a two (2) years period, from the date of approval of the Development Plan by the Management Committee or Government, the Contractor shall enter into tie-up in the market for sale of Non-associated Natural Gas.<sup>352</sup> And finally lays down that the extreme eventuality of the Contractor failing commence development of such Discovery within ten (10) years from the date of the first Discovery Well, the Contractor shall relinquish its right to develop such Discovery and the area relating to such Discovery shall be excluded from the Contract Area.<sup>353</sup>

The PSC dealing with the Valuation of Natural Gas categorically lays down that the Contractor shall endeavour to sell all Natural Gas produced and saved from the Contract Area at arms-length prices to the benefit of Parties to the Contract<sup>354</sup> unless and until it is not sold to the Government pursuant to Article 21.4.5 wherein it shall be ascribed a zero value and further the Gas which is sold to the Government or any other Government nominee shall be valued on the terms and conditions actually obtained including pricing formula and delivery.<sup>355</sup> The PSC further lays down in a clear manner that in order to ensure that the gas is valued at arms length price or where arms length price is impossible to arrive at the formula or basis on which the

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<sup>350</sup> Article 21.5.9 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010

<sup>351</sup> Article 21.5.10 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010

<sup>352</sup> Article 21.5.11 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010

<sup>353</sup> Article 21.5.12 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010

<sup>354</sup> Article 21.6.1 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010

<sup>355</sup> Article 21.6.2 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010

prices shall be determined pursuant to Article 21.6.2 (c) shall be approved by the Government prior to invitation of price bids or other price discovery steps by Contractor for the sale of natural gas to consumers / buyers, within sixty (60) Business Days from the receipt of the proposal or from the date of receipt of clarification / additional information, where asked for by the Government. Furthermore it is laid down that for granting this approval, Government shall take into account amongst other relevant considerations, the domestic and international prices of comparable gas and the linkages with traded liquid fuels. Thus, the price of natural gas arrived at through the approved formula / basis shall be applicable uniformly to all the consuming sectors indicated under Article 21.3.1.<sup>356</sup>

### **11.19 EMPLOYMENT, TRAINING AND TRANSFER OF TECHNOLOGY**

Article 22 of the PSC deals with Employment, Training and Transfer of Technology whereby it lays down that Contractor, without prejudice to its rights, shall select and employ such number of personnel as, in its opinion are required for carrying out Petroleum Operations in a safe, cost effective and efficient manner. It is further laid down in the interest of the citizens of the country that the Contractor shall, to the maximum extent possible, employ, and require the Operator and Subcontractors to employ, citizens of India having appropriate qualifications and experience, taking into account experience required in the level and nature of the Petroleum Operations.<sup>357</sup>

Further the Operator is obligated to offer a mutually agreed number of Indian nationals the opportunity for on-the-job training and practical experience in Petroleum Operations during the Exploration Period with a view to ensuring employment of nationals of India and gradual and progressive reduction of foreign personnel.<sup>358</sup> Similarly, in the interest of the nation the PSC also envisages that at the request of the Government, the Foreign Companies shall separately endeavor to negotiate, in good faith, technical assistance agreements with the Government or a company nominated by Government for this purpose setting forth the terms by which each Foreign Company constituting the Contractor may render technical assistance and make

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<sup>356</sup> Article 21.7 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010

<sup>357</sup> Articles 22.1 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010

<sup>358</sup> Articles 22.2 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010



available commercially proven technical information of a proprietary nature for use in India by the Government or the company nominated by Government.<sup>359</sup>

### **11.20 LOCAL GOODS AND SERVICES**

Article 23 of the PSC deals with Local Goods and Services wherein it is envisaged that in the conduct of Petroleum Operations, the Contractor shall give preference to the purchase and use of goods manufactured, produced or supplied in India provided that such goods are available on terms equal to or better than imported goods with respect to timing of delivery, quality and quantity required, price and other terms,<sup>360</sup> employ Indian Subcontractors having the required skills or expertise, to the maximum extent possible, insofar as their services are available on comparable standards with those obtained elsewhere and at competitive prices and on competitive terms; provided that where no such Subcontractors are available, preference shall be given to non-Indian Subcontractors who utilize Indian goods to the maximum extent possible, subject, however, to the proviso (a) to Article 23.1<sup>361</sup>. In furtherance to this, the PSC lays down that subject to Article 8.3(f), the Contractor shall establish appropriate procedures, including tender procedures, for the acquisition of goods and services, which shall ensure that suppliers and Subcontractors in India are given adequate opportunity to compete for the supply of goods and services.

### **11.21 INSURANCE**

Article 24 of the PSC dealing with Insurance and Indemnification lays down that during the term of the PSC the Contractor shall obtain and maintain insurance coverage for and in relation to Petroleum Operations for such amounts and against such risks as are customarily or prudently insured in the international petroleum industry in accordance with modern oilfield and petroleum industry practices, and shall within two months of the date of policy or renewal furnish to the

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<sup>359</sup> Articles 22.3 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010

<sup>360</sup> Articles 23.1 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010

<sup>361</sup> Articles 23.2 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010

Government the certificates evidencing that such coverage is in effect. Such insurance policies shall include the Government as additional insured and shall waive subrogation against the Government. The said insurance shall, without prejudice to the generality of the foregoing, shall cover any loss or damage to all installations, equipment and other assets for so long as they are used in or in connection with Petroleum Operations; provided, however, that if for any reason the Contractor fails to insure any such installation, equipment or assets, it shall replace any loss thereof or repair any damage caused thereto, any loss, damage or injury caused by pollution in the course of or as a result of Petroleum Operations any loss of property or damage or bodily injury suffered by any third party in the course of or as a result of Petroleum Operations for which the Contractor may be liable any claim for which the Government may be liable relating to the loss of property or damage or bodily injury suffered by any third party in the course of or as a result of Petroleum Operations for which the Contractor is liable to indemnify the Government, or the State Government, any with respect to Petroleum Operations offshore, the cost of removing wrecks and cleaning up operations following any accident in the course of or as a result of Petroleum Operations; and finally the Contractor's and/or the Operator's liability to its employees engaged in Petroleum Operations.<sup>362</sup> With respect to Indemnity, the PSC lays down that, the Contractor shall indemnify, defend and hold the Government, and the State Government harmless against all claims, losses and damages of any nature whatsoever, including, without limitation, claims for loss or damage to property or injury or death to persons caused by or resulting from any Petroleum Operations conducted by or on behalf of the Contractor subject to the provisions of Article 4.6 of the PSC.<sup>363</sup>

## **11.22 AUDIT AND ACCOUNTS**

Article 25 of the PSC deals with Records, Reports, Accounts and Audit and lays down that the Contractor shall prepare and maintain in original at an office in India accurate and current books, records, reports and accounts of its activities for and in connection with Petroleum Operations so as to present a fair, clear and accurate record of all its activities, expenditures, income, cost

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<sup>362</sup> Articles 24.1.1 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010

<sup>363</sup> Articles 24.2 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010

petroleum, profit petroleum and Statutory levies / taxes. The PSC also envisages that the Contractor shall maintain a separate bank account in a reputed bank<sup>364</sup> and the record, books, accounts and accounting procedures in respect of Petroleum Operations shall be maintained at the business office of the Contractor in India, in accordance with the Accounting Procedure to this Contract.<sup>365</sup> The PSC necessitates the annual audit of accounts shall be carried out on behalf of the Contractor by an independent firm of chartered accountants, registered in India in accordance with the generally accepted auditing and accounting practices in India, whose appointment and the scope of audit shall have prior approval of the Management Committee.<sup>366</sup> The PSC further empowers the Government shall have the right to audit the accounting records of the Contractor in respect of Petroleum Operations as provided in the Accounting Procedure.<sup>367</sup>

### **11.23 INFORMATION, DATA, CONFIDENTIALITY**

Article 26 of the PSC deals with Information, Data, Confidentiality, Inspection And Security and lays down that the Contractor shall, promptly after they become available in India, provide the Government, free of cost, with all data obtained as a result of Petroleum Operations under the Contract including, but not limited to, geological, geophysical, geochemical, petrophysical, engineering, Well logs, maps, magnetic tapes, cores, cuttings and production data as well as all interpretative and derivative data, including reports, analyses, interpretations and evaluation prepared in respect of Petroleum Operations. The PSC also lays down that all these Data shall be the property of the Government, provided, however, that the Contractor shall have the right to make use of such Data, free of cost, for the purpose of Petroleum Operations under this Contract as provided herein.<sup>368</sup> The PSC clearly lays down that all Data, information and reports obtained or prepared by, for or on behalf of, the Contractor pursuant to this Contract shall be treated as

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<sup>364</sup> Article 25.1 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010

<sup>365</sup> Article 25.2 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010

<sup>366</sup> Articles 25.4.1 & 25.4.2 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010

<sup>367</sup> Article 25.5 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010

<sup>368</sup> Article 26.1 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010

confidential and, subject to the provisions of the PSC and that the Parties shall not disclose the contents thereof to any third party without the consent in writing of the other Parties.<sup>369</sup>

However, it is pertinent to note that the obligation specified in Article 26.4 shall not operate so as to prevent disclosure to any Affiliates, contractors, or Subcontractors for the purpose of Petroleum Operations or to employees, professional consultants, advisers, data processing centers and laboratories, where required, for the performance of functions in connection with Petroleum Operations for any Party comprising the Contractor or to banks or other financial institutions, in connection with Petroleum Operations or to bonafide intending assignees or transferees of a Participating Interest of a Party comprising the Contractor or in connection with a sale of the stock or shares of a Party comprising the Contractor or to the extent required by any applicable law or in connection with any legal proceedings or by the regulations of any stock exchange upon which the shares of a Party or an Affiliate of a party comprising the Contractor are quoted or to Government departments for, or in connection with, the preparation by or on behalf of the Government of statistical reports with respect to Petroleum Operations, or in connection with the administration of this Contract or any relevant law or for any purpose connected with Petroleum Operations and finally by a Party with respect to any Data or information which, without disclosure by such Party, is generally known to the public.<sup>370</sup>

#### **11.24 TITLE TO PETROLEUM, DATA AND ASSETS**

Article 27 of the PSC deals with the Title to Petroleum, Data and Assets wherein it lays down in a very lucid manner that the Government is the sole owner of Petroleum underlying the Contract Area and shall remain the sole owner of Petroleum produced pursuant to the provisions of this Contract except as regards that part of Crude Oil, Condensate or Gas the title whereof has passed to the Contractor or any other person in accordance with the provisions of this Contract.<sup>371</sup> The

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<sup>369</sup> Article 26.4 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010

<sup>370</sup> See, Articles 25.5 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010

<sup>371</sup> Article 27.1 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010

PSC lays down that the Title to Petroleum to which the Contractor is entitled under this Contract, and title to Petroleum sold by the Companies shall pass to the relevant buyer party at the Delivery Point. The Contractor shall be responsible for all costs and risks prior to and including at the Delivery Point and each buyer party shall be responsible for all costs and risks associated with such buyer party's share after the Delivery Point.<sup>372</sup> Any assets purchased by the Contractor for use in Petroleum Operations shall be owned by the Parties comprising the Contractor in proportion to their Participating Interest provided that the Government shall have the right to require vesting of full title and ownership in it, free of charge and encumbrances, of any or all assets, whether fixed or movable, acquired and owned by the Contractor for use in Petroleum Operations inside or outside the Contract Area, such right to be exercisable at the Government's option upon expiry or earlier termination of the Contract<sup>373</sup> with the responsibility on the Contractor for proper maintenance, insurance and safety of all such assets acquired and for keeping them in good repair, order and working condition at all times, and the costs thereof shall be recoverable as Contract Costs in accordance with Appendix-C of the PSC<sup>374</sup> and further it shall be in the exclusive use of the Contractor for the purpose of carrying out Petroleum Operations. Any Equipment and assets no longer required for Petroleum Operations during the term of the Contract shall be sold, exchanged or otherwise disposed of by the Contractor, provided however that the proceeds of sale shall be credited to Petroleum Operations as provided in Appendix C to the PSC, post obtaining a prior written consent of the Management Committee shall be obtained in case of transaction in excess of US\$ 50,000 (Fifty thousand United States Dollars) or such other value as may be agreed from time to time by the Management Committee.

## **11.25 ASSIGNMENT OF PARTICIPATING INTEREST**

Article 28 of the PSC deals with the Assignment of Participating Interest whereby it lays down that subject to the terms of the PSC, any Party comprising the Contractor may assign, or transfer, a part or all of its Participating Interest, with the prior written consent of the Government, which

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<sup>372</sup> Article 27.2 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010

<sup>373</sup> Article 27.4 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010

<sup>374</sup> Article 27.5 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010

consent shall not be unreasonably withheld, provided that the Government is satisfied that the prospective assignee or transferee is of good standing, has the capacity and ability to meet its obligations hereunder, and is willing to provide an unconditional undertaking to the Government to assume its Participating Interest share of obligations and to provide guarantees in respect thereof as provided in the Contract, the prospective assignee or transferee is not a company incorporated in a country with which the

Government, for policy reasons, has restricted trade or business, the prospective assignor or transferor and assignee or transferee respectively are willing to comply with any reasonable conditions of the Government as may be necessary in the circumstances with a view to ensuring performance under the Contract, the assignment or transfer will not adversely affect the performance or obligations under this Contract or be contrary to the interests of India, the prospective assignor or transferor of small size on land block having Contract Area less than 200 Sq. Km has completed the Minimum Work Programme committed under Initial Exploration Period as specified in Article 5.2 and 5.2.1<sup>375</sup> The PSC categorically lays down that an application for consent to assign or transfer shall be accompanied by all relevant information concerning the proposed assignment or transfer including detailed information on the proposed assignee or transferee and its shareholding and corporate structure, as was earlier required from the Companies constituting the Contractor, the terms of the proposed assignment or transfer and the unconditional undertaking referred to in Article<sup>376</sup> and shall also submit such information relating to the prospective assignee or transferee of the assignment or transfer as the Government may reasonably require to enable proper consideration and disposal of the application.

The PSC introduces a rider with respect to assignments and transfers that stating no assignment or transfer shall be effective until the approval of the Government is received or deemed to have been received and that the approval may be given by the Government on such terms and conditions as it may deem fit with a proviso that such terms and conditions may not increase the

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<sup>375</sup> Article 28.1 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010

<sup>376</sup> Article 28.3 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010

obligations of the Parties comprising the Contractor. Upon assignment or transfer of its interest in this Contract, the assignor or transferor shall be released and discharged from its obligations hereunder only to the extent that such obligations are assumed by the assignee or transferee with the approval of the Government.<sup>377</sup> However, the PSC lays down that in the event that the Government does not give its prior written consent or does not respond to a request for assignment or transfer by a Party comprising the Contractor within one hundred and twenty (120) days of such request and receipt of all information referred to in Article 28.3 above, consent shall be deemed to have been given by the Government.<sup>378</sup>

No assignment or transfer involving cases wherein the Participating Interest to be retained by the proposed assignor or the percentage interest of assignee shall be less than ten per cent (10%) of the total Participating Interest of all the constituents of the Contractor, except where the Government, on the recommendations of the Management Committee may, in special circumstances, so permit.<sup>379</sup> However, the PSC clarifies that nothing contained in this Article 28, shall prevent a Party comprising the Contractor from mortgaging, pledging, charging or otherwise encumbering at its own risk and cost all or part of its Participating Interest for the purposes of security relating to finance to the extent required for performing its obligation under the Contract, provided the party fulfills certain terms and conditions.<sup>380</sup>

## **11.26 GUARANTEES**

Article 29 of the PSC deals with Guarantees wherein it lays down that each of the Companies constituting the Contractor shall procure and deliver to the Government within thirty (30) days from the Effective Date of this Contract an irrevocable, unconditional bank guarantee from a reputed bank of good standing in India, acceptable to the Government, in favour of the Government, for the amount specified in Article 29.3 and valid for four (4) years, in a form provided at Appendix-G to the PSC, financial and performance guarantee in favour of the

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<sup>377</sup> Article 28.5 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010

<sup>378</sup> Article 28.6 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010

<sup>379</sup> Article 28.7 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010

<sup>380</sup> Article 28.8 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010

Government from a Parent Company acceptable to the Government, in the form and substance set out in Appendix-E1 to the PSC, or, where there is no such Parent Company, the financial and performance guarantee from the Company itself in the form and substance set out in Appendix-E2 of the PSC and a legal opinion from its legal advisors, in a form satisfactory to the Government, to the effect that the aforesaid guarantees have been duly signed and delivered on behalf of the guarantors with due authority and is legally valid and enforceable and binding upon them.<sup>381</sup>

The PSC further lays down that if the Contractor elects to retain the Contract Area during the Subsequent Exploration Period by committing to drill Exploration Wells after completing the Minimum Work Programme, under Article 3.4 (a), each of the Companies constituting the Contractor shall procure and deliver to the Government before the expiry of the Initial Exploration Period an irrevocable, unconditional bank guarantee from a reputed bank of good standing in India, acceptable to the Government, in favour of the Government, for the amount specified in Article 29.3 and valid for the Subsequent Exploration Period opted by the Contractor, in accordance with form provided at Appendix-G to the PSC.<sup>382</sup> The PSC categorically envisages that the amount of the guarantee referred to in Articles 29.1 and 29.2 above shall be an amount equal to seven and one half percent (7½%) of the Company's Participating Interest share of the total estimated expenditure in respect of Minimum Work Programme including Mandatory Work Programme or Work Program as the case may be, to be undertaken by the Contractor in the Contract Area during the Initial or Subsequent Exploration Period. The total estimated expenditure for the Exploration Period for the purpose of furnishing bank guarantee by the Contractor shall be higher of the cost estimates by the Contractor or the Budget estimates presented to the Management Committee or the amount of Liquidated damages

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<sup>381</sup> Article 29.1 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010

<sup>382</sup> Article 29.2 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010



specified in Article 5.<sup>383</sup> A failure to provide the Bank Guarantee shall result in the termination of the PSC by the Government upon ninety (90) days written notice of its intention to do so.<sup>384</sup>

## **11.27 TERMINATION OF CONTRACT**

Article 30 of the PSC deals with the Term and Termination of the Contract wherein it envisages that the term of the PSC shall be for the period of the License and any Lease granted thereunder, unless the Contract is terminated earlier in accordance with its terms, and shall be deemed to have been terminated, if for any reason, the Contractor ceases to hold such License or Lease.<sup>385</sup>

The PSC lays down that subject to the provision of Articles 5, 14 and 30.6 of the PSC and without prejudice to the provisions of Article 30.7 or any other provisions of the PSC, the Contractor shall have the right to terminate the PSC with respect to any part of the Contract Area other than a Development Area then producing, or that prior thereto had produced Petroleum, upon giving ninety (90) days written notice of its intention to do so and with respect to any Development Area in which Petroleum is being produced, or that prior thereto had produced Petroleum, upon giving at least one hundred and eighty (180) days written notice of its intention to do so.<sup>386</sup> The PSC further empowers the Government to terminate it upon giving ninety (90) days written notice with reasons to the other Parties of its intention to do so in the following circumstances, namely, that the Contractor or a Party comprising the Contractor has knowingly submitted any false statement to the Government in any manner which was a material consideration in the execution of this Contract or has intentionally and knowingly extracted or authorised the extraction of hydrocarbon not authorized to be extracted by the Contract or without the authority of the Government except such extractions as may be unavoidable as a result of operations conducted hereunder in accordance with generally accepted modern oilfield and petroleum industry practices which, when so extracted, were immediately notified to the Government or is adjudged insolvent by a competent court or enters into or scheme of

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<sup>383</sup> Article 29.3 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010

<sup>384</sup> Article 29.5 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010

<sup>385</sup> Article 30.1 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010

<sup>386</sup> Article 30.2 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010

composition with its creditors or takes advantage of any law for the benefit of debtors or has passed a resolution to apply to a competent court for liquidation of the Company unless the liquidation is for the purpose of amalgamation or reconstruction of which the Government has been given notice and the Government is satisfied that the Company's performance under this

Contract would not be adversely affected thereby and has given its approval thereto or has assigned any interest in the Contract without the prior written consent of the Government as provided in Article 28 or has failed to make any monetary payment required by law or under this Contract by the due date or within such further period after the due date as may thereafter be specified by the Government or has failed to comply with or has contravened the provisions of this Contract in a material particular or has failed to comply with any final determination or award made by a sole expert or arbitrators subject to Article 33 or has failed to carry out or observe any of the terms and conditions of the License or Lease or the provisions of the Acts or Rules in force thereunder, subject however, to Article 31 or finally on the notice of termination as provided in Article 29.5.<sup>387</sup> The said right encompasses a proviso that in cases where the Contractor comprises two or more Parties, the Government shall not exercise its rights of termination pursuant to Article 30.3, on the occurrence, in relation to one or more, but not all, of the Parties comprising the Contractor, of an event entitling the Government to terminate the Contract, if any other Party or Parties constituting the Contractor (the non-Defaulting Party or Parties) satisfies the Government that it, or they, is/are willing and would be able to carry out the obligations of the Contractor and in cases where the non Defaulting Party or Parties with the consent of the Government has/have acquired the Participating Interest of the Defaulting Party pursuant to the provisions of the Operating Agreement and has/have procured and delivered to the Government a guarantee or guarantees as referred to in Article 29.1 in respect of the Participating Interest of the Defaulting Party acquired by the non Defaulting Party or Parties.

The PSC lays down that upon its termination, for any reason whatsoever, the rights and obligations of the Contractor shall cease but such termination shall not affect any rights of any Party which may have accrued or any obligations undertaken or incurred including obligations

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<sup>387</sup> Article 30.3 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010

under Article 5.7, by the Contractor or any Party comprising the Contractor and not discharged prior to the date of termination.<sup>388</sup> With respect to the environmental protection, the PSC envisages that within Ninety (90) days after its termination pursuant to Article 30.2, 30.3, or 30.4, or such longer period as the Government may agree, the Contractor shall comply with Article 14.9 and any reasonably necessary action as directed by the Government to avoid Environmental Damage or hazards to human life or to the property of others.<sup>389</sup>

### **11.28 FORCE MAJEURE**

Article 31 of the PSC deals with Force Majeure wherein it lays down that any non-performance or delay in performance by any Party hereto of any of its obligations under the PSC, or in fulfilling any condition of any License or Lease granted to such Party, or in meeting any requirement of the Act, the Rules or any License or Lease, shall, except for the payment of monies due under the PSC or under the Act and the Rules or any law, be excused if, and to the extent that, such non-performance or delay in performance is caused by Force Majeure as defined under the PSC.<sup>390</sup> The PSC defines the term Force Majeure as a term that means any cause or event, other than the unavailability of funds, whether similar to or different from those enumerated herein, lying beyond the reasonable control of, and unanticipated or unforeseeable by, and not brought about at the instance of, the Party claiming to be affected by such event, or which, if anticipated or foreseeable, could not be avoided or provided for, and which has caused the non-performance or delay in performance. Without limitation to the generality of the foregoing, the term Force Majeure shall include natural phenomena or calamities, earthquakes, typhoons, fires, wars declared or undeclared, hostilities, invasions, blockades, riots, strikes, insurrection and civil disturbances but shall not include the unavailability of funds.<sup>391</sup> The PSC expressly lays down that the Party asserting the claim of Force Majeure shall have the burden of proving that the circumstances constitute valid grounds of Force Majeure under this Article and

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<sup>388</sup> Article 30.6 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010

<sup>389</sup> Article 30.8 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010

<sup>390</sup> Article 31.1 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010

<sup>391</sup> Article 31.2 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010

that such Party has exercised reasonable diligence and efforts to remedy the cause of any alleged Force Majeure.<sup>392</sup>

The PSC categorically lays down that a Party claiming Force Majeure shall exercise reasonable diligence to seek to overcome the Force Majeure event and to mitigate the effects thereof on the performance of its obligations under it and further that the Party affected shall promptly notify the Management Committee as soon as the Force Majeure event has been removed and no longer prevents it from complying with the obligations which have been suspended and shall thereafter resume compliance with such obligations as soon as possible.<sup>393</sup> The PSC lays down that in cases wherein a Party is prevented from exercising any rights or performing any obligations under this Contract due to Force Majeure, the time for the performance of the obligations affected thereby and for performance of any obligation or the exercise of any right dependent thereon, and the term of any Exploration Phase of the Exploration Period of the PSC, may be extended to the extent of Force Majeure period or by such period as may be agreed by the Management Committee.<sup>394</sup>

## **11.29 APPLICABLE LAW AND LANGUAGE**

Article 32 of the PSC deals with the Applicable Law and Language of the Contract whereby it is categorically laid down that the PSC shall be governed and interpreted in accordance with the laws of India and that English language shall be the language of this Contract and shall be used in arbitral proceedings and also in all communications, hearing or visual materials or documents relating to the PSC.<sup>395</sup>

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<sup>392</sup> Article 31.5 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010

<sup>393</sup> Article 31.4 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010

<sup>394</sup> Article 31.6 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010

<sup>395</sup> Articles 33.1 and 32.3 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010

### **11.30 SOLE EXPERT, ARBITRATION & CONCILATION**

Article 33 of the PSC deals with the entire dispute resolution mechanism, namely, Sole Expert, Conciliation and Arbitration and envisages that the Parties shall use their best efforts to settle amicably all disputes, differences or claims arising out of or in connection with any of the terms and conditions of the PSC or performance thereof.<sup>396</sup> The PSC lays down that matters which, by its terms, the Parties have agreed to refer to a sole expert and any other matter which the Parties may agree to so refer, may be referred to a sole expert who shall be an independent and impartial person of international standing with relevant qualifications and experience, appointed by a written agreement between the Parties and who shall not, by virtue of nationality, personal connection or commercial interest, have a conflict between his/her own interest and his/her duty as a sole expert. It further lays down that in the event that the Parties fail or are unable to agree on a sole expert within thirty (30) days or such longer period as may be mutually agreed by Parties, the sole expert shall be appointed by a body or an institution or an agency or a person, mutually agreed by Parties. Furthermore in case, there is no agreement on the body or an institution or an agency or a person for appointing sole expert or such institution or agency or body fails to appoint a sole expert within thirty (30) days or such longer period as may be mutually agreed by Parties, the matter shall be referred to arbitration. The PSC in the most explicit manner clarifies that any sole expert appointed shall be acting as an expert and not as an arbitrator and the decision of the sole expert on matters referred to him/her shall be final and binding on the Parties and shall not be subject to arbitration.<sup>397</sup> The PSC lays down that subject to its provisions, the Parties shall refer any controversy, difference, disagreement or claim for damages, compensation or otherwise arising between the Parties, which cannot be settled amicably within ninety (90) days after the dispute arises, except for those referred to in Article 33.2 of the PSC, which may be referred to a sole expert to conciliation or an arbitral tribunal for final decision<sup>398</sup> and that the arbitral tribunal shall consist of three arbitrators wherein each Party to the dispute shall appoint one arbitrator and the Party or Parties shall so advise the other Parties

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<sup>396</sup> Article 33.1 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010

<sup>397</sup> Article 33.2 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010

<sup>398</sup> Article 33.3 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010

and the two arbitrators appointed by the Parties shall appoint the third arbitrator.<sup>399</sup> The PSC envisages that the decision of the arbitral tribunal shall be pronounced within Four (4) months unless otherwise extended by the Parties, and, in case of difference among the arbitrators the decision of the majority shall be final and binding on the Parties<sup>400</sup> and that the arbitration agreement shall be governed by the Arbitration and Conciliation Act, 1996. The right to arbitrate disputes under the PSC shall survive its expiry or the termination.<sup>401</sup>

The PSC lays down that the venue of the sole expert, conciliation or arbitration proceedings, unless otherwise agreed by the Parties, shall be New Delhi, India and shall be conducted in the English language. Further insofar as practicable, the Parties shall continue to implement the terms of this Contract notwithstanding the initiation of proceedings before a sole expert, conciliator or arbitral tribunal and any pending claim or dispute.<sup>402</sup> Furthermore the fees and expenses of a sole expert or conciliator appointed by the Parties shall be borne equally by the Parties. The cost and expenses of arbitrator appointed by a Party in accordance with the provision of this Article shall be borne by the respective Party and the cost and expenses of third arbitrator and other incidental expenditure in relation to arbitration and liability thereof shall be at the discretion of the arbitrators.<sup>403</sup>

The PSC finally in dealing with disputes with any of the Government company lays down that notwithstanding anything contrary to the PSC, in the event of dispute among Government

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<sup>399</sup> Article 33.4 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010

<sup>400</sup> Article 33.8 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010

<sup>401</sup> Article 33.10 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010

<sup>402</sup> Article 33.12 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010

<sup>403</sup> Article 33.13 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010

Company(ies) and with the Government, such disputes shall be settled in accordance with guidelines issued on the subject by Government from time to time.<sup>404</sup>

### **11.31 CHANGE OF STATUS**

Article 34 of the PSC deals with the Change of Status of Companies and the communication of the same to the Government. Article 35 of the Agreement deals with various provisions dealing with clauses pertaining to Entire Agreement, Amendments, Waiver and Miscellaneous while Article 36 deals with Certificates and finally Article 37 of the PSC deals with Notices.

The PSC in addition to these articles also comprises of Nine (9) Appendices in total dealing with the Description of the Contract Area, Map of the Contract Area, Accounting Procedure to the Contract, Calculation of the Investment Multiple for Production Sharing purposes, Form of Parent company Financial and Performance Guarantee, Form of Company Financial and Performance Guarantee, Procedure for acquisition of goods and services, Form of Bank Guarantee to be provided pursuant to Article 29, An itemized break-up of the cost estimates given by the contractor in the bid documents pursuant to Article 15.13.

<sup>404</sup> Article 33.14 of the Model Production Sharing Contract for the Ninth offer of Blocks (NELP - IX), Ministry of Petroleum and Natural Gas, Government of India, 2010

## **CHAPTER 12**

### **12.LEGAL AND CONTRACTUAL ISSUES IN THE INDIAN MODEL PRODUCTION SHARING CONTRACT**

#### **12.1 ENVIRONMENTAL CONCERNS**

The term “Environment” comprises all entities, natural or manmade, external to oneself, and their interrelationships, which provide value, now or perhaps in the future, to humankind. Environmental concerns relate to their degradation through actions of humans. A diverse developing society such as ours provides numerous challenges in the economic, social, political, cultural, and environmental arenas. All of these coalesce in the dominant imperative of alleviation of mass poverty, reckoned in the multiple dimensions of livelihood security, health care, education, empowerment of the disadvantaged, and elimination of gender disparities.

The present national policies for environmental management are contained in the National Forest Policy, 1988, the National Conservation Strategy and Policy Statement on Environment and Development, 1992; and the Policy Statement on Abatement of Pollution,1992. Some sector policies such as the National Agriculture Policy, 2000; National Population Policy, 2000; and National Water Policy, 2002; have also contributed towards environmental management. All of these policies have recognized the need for sustainable development in their specific contexts and formulated necessary strategies to give effect to such recognition. The National Environment Policy seeks to extend the coverage, and fill in gaps that still exist, in light of present knowledge and accumulated experience. It does not displace, but builds on the earlier policies. Across the political spectrum of the country there has been recognition of the vital role natural resources play in providing livelihoods, and securing life- support ecological services.

Indian Liability Regime – Evolution



In India, the liability regime is for any loss caused to a third party is generally covered under the Tort law. The legal principles of liability especially pertaining to negligence under the tort law has been developed from the various concepts that have been developed by the courts over a period of time.<sup>405</sup> For the purpose of this article few of the rules related to the issue in hand are being discussed herein.

The principle of Strict Liability was a concept, which was developed with respect to the liability regime in cases of negligence by the English Courts in the landmark judgment in *Rylands v. Fletcher*.<sup>406</sup> In the said matter, the Courts have laid down that

*“... A person who, for his own purpose, brings on his land and collects and keeps there, anything likely to do mischief if it escapes, must keep it in at his peril, and if he does not do so, is prima facie answerable for all the damage which is the natural consequence of its escape. ...”*

Thus, in the matter, the Court had held that the duty of a person towards others is not merely the general negative duty to refrain from active injury, but a positive duty to guard and protect others and as in the instant case one's neighbours, and ensure that lest they suffer harm by reason of dangerous things artificially brought on to one's land. The Court further held that the duty is absolute because it is independent of any negligence on the part of the defendant or his servants.

This rule is referred to as the rule of “*strict liability*” or “*absolute liability*”. It is also referred to

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<sup>405</sup> RATANLAL & DHIRAJLAL, THE LAW OF TORTS, (24d. 2004).

<sup>406</sup> (1868) LR 3 HL 330.

as “*no fault liability*”, where a wrong doer will be held liable irrespective of the fact as to whether the proof of fault has been proved by the claimant or not. However, the rule of strict liability recognise some exceptions as well.

Subsequent to the rule of strict liability, the English Courts came up with yet another rule, the concept of producer’s liability, which was formulated in the landmark judgment of *Donogue vs. Stevenson*<sup>407</sup> The House of Lords in the said matter held that

*“... [A] manufacturer of products, which he sells in such a form as to show that he intends them to reach the consumer in the form in which they left him, owes a duty to the consumer to take reasonable care. There is no contractual duty in this situation as there was no contract at all. But a tortious duty is presumed by courts of law, breach of which makes the manufacturer liable.”*

Thus, in the said matter, the producer of a product was made responsible to have a duty to care towards his consumer and any negligence on his part would make him liable for the same. The concepts of “Consumer Rights” and “Product liability” rule arose from this judgment of the House of Lords and this principle has been followed in India in a catena of Judgments.

In India, the Supreme Court while dealing with the concepts of liability in cases of negligence in *M.C. Mehta vs. Union of India*<sup>408</sup> which is popularly known as the *Shriram Gas Leak* case laid down the principle of “*absolute liability*” thus:

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<sup>407</sup> 1932 AC 562 (HL).

<sup>408</sup> (1987) 1 SCC 395.

“... Where an enterprise is engaged in a hazardous or inherently dangerous activity and harm results to any one on account of an accident or in the operation of such hazardous or inherently dangerous activity resulting for example, escape of toxic gas, the enterprise is strictly and absolutely liable to compensate all those who are affected by the accident and such liability is not subject to any of the exceptions which operate vis-à-vis the tortious principle of strict liability under the rule in *Rylands v Fletcher*. ...”

The *Shriram Gas Leak* case judgment was passed post the Bhopal gas tragedy wherein hundreds of people lost their lives and the Supreme Court in the said case had expanded the principle of Strict Liability as laid down in *Rylands v. Fletcher*<sup>409</sup> and had taken away the shield of exceptions granted in the said case and had held that the same cannot be applied in cases where hazardous or dangerous activities are in operation the same results in an accident. The Indian Parliament in furtherance to the judgment in the *Shriram Gas Leak* case has codified the principle of absolute liability in the Public Liability Insurance Act, 1991. § 3 of the said Act<sup>410</sup> states that in any claim the claimant shall not be required to plead and establish that the death, injury or damage in respect of which the claim has been made was due to any wrongful act, neglect or default of any persons. However, despite the fact that the judiciary has been coming up with the quite imaginative and useful rule of absolute liability to help innocent victims of profit-aimed corporations, the executive despite its pseudo effort of adopting it as the case of § 3 of the Public Liability Insurance Act, 1991 also ensures it is doing otherwise and undo the same. The best example for this is the Public Liability Insurance Act 1991 in § 2<sup>411</sup> defined ‘accident’ as an accident involving a fortuitous, sudden or unintentional occurrence while handling any hazardous substance resulting in continuous, intermittent or repeated exposure to death of or

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<sup>409</sup> *Supra* n. 278.

<sup>410</sup> § 3. (1) Where death or injury to any person (other than a workman) or damage to any property has resulted from an accident, the owner shall be liable to give such relief as is specified in Schedule for such death, injury or damage.

(2) In any claim for relief under sub-section (1) (hereinafter referred to in this Act as claim for relief), the claimant shall not be required to plead and establish that the death, injury or damage in respect of which the claim has been made was due to any wrongful act, neglect or default of any person.

<sup>411</sup> § 2. In this Act, unless the context otherwise requires.-

1(a) "accident" means an accident involving a fortuitous, sudden or unintentional occurrence while handling any hazardous substance resulting in continuous, intermittent or repeated exposure to death, of or injury to, any person or damage to any property but does not include an accident by reason only of war or radio-activity;

injury to any person or damage to any property but does not include an accident by reason of war or radio activity. Thus, by the way of this rider the State, whose sole responsibility is welfare of the people, is attempting to wriggle out of its responsibility to give relief to the victims of “war” from accidents of “radio activity” and thereby removing the law of its teeth and also ensuring its own welfare rather than being concerned about the welfare of the people of the country.

Apart from the tortious liability, the Constitution of India, 1950 guarantees right to Life for all persons under Article 21.<sup>412</sup> The right guaranteed under Article 21 is a negative right wherein it guarantees a right for every person over his or her life and personal liberty and prevents anyone else from depriving the same. The scope of Article 21 has been expanded by the courts to a great extent and in landmark judgment of *Maneka Gandhi v. Union of India*<sup>413</sup> the Hon’ble Supreme Court had expanded the scope of the words ‘personal liberty’ by a very great extent and has also laid down that the Fundamental Rights as enshrined under the Constitution must be interpreted widely and had observed that:

*“... The attempt of Court should be to expand the reach and ambit of the Fundamental Rights rather than to attenuate their meaning and content by a process of judicial construction. ... ”*<sup>414</sup>

Thus by the applicability of Article 21, the state has a duty towards the welfare of the all and the responsibility of the state would extend in all times including those at the time of war or any loss due to radio activity.

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<sup>412</sup> Article 21. Protection of life and personal liberty — No person shall be deprived of his life or personal liberty except according to procedure established by law.

<sup>413</sup> AIR 1978 SC 597.

<sup>414</sup> Ruling by Bhagwati, J. (for himself and Untwalia and Murtaza Fazal Ali, JJ) at p. 628.

The Polluter-pays principle is the concept on environmental pollution wherein it states that the person who is causing environmental damage or creating an imminent threat of such damage should, in principle, bear the cost of the necessary preventive or remedial measures taken to prevent the damage. The principle is based on the concept of equity as a matter of fact it is fair that the person who creates the risk and benefits the most is held liable.<sup>415</sup> This principle of polluter pays has also been endorsed by the Principle 16 of the Rio Declaration wherein it has called upon states to “*promote the internalisation of environmental costs and the use of economic instruments, taking into account the approach that the polluter should, in principle, bear the costs of pollution.*”<sup>416</sup> The principle of polluter pays principle has been recognised and incorporated in the local laws of numerous countries. The Hon’ble Supreme Court of India had relied on the principle in the context of the Fundamental Right to Life under Article 21 of the Constitution to justify imposition of absolute liability on the polluter both for injury to private parties and for environmental reinstatement costs, which the government would otherwise have borne in a catena of Judgments including that of the *Indian Council for Enviro-Legal Action v Union of India*,<sup>417</sup> *Vellore Citizens Welfare Forum v. Union of India*,<sup>418</sup> & *S. Jagannath v. Union of India*.<sup>419</sup> The Hon’ble Court in *Vellore Citizens Welfare Forum*<sup>420</sup> observed that in view of the constitutional and statutory provisions, there could be no hesitation in holding polluter- pays principle to be part of the law of the land.

ii. A comparative analysis of the PSC and its conformity with the liability regime

The PSC under Article 14 while dealing with the environmental protection deals with the

Contractor’s obligation as well. The PSC in this regard under Article 14.14 lays down as follows:-

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<sup>415</sup> S. SHANTHAKUMAR, INTRODUCTION TO ENVIRONMENTAL LAW, (2009).

<sup>416</sup> *Supra* n.

<sup>417</sup> AIR 1996 SC 1446.

<sup>418</sup> AIR 1996 SC 2715.

<sup>419</sup> AIR 1997 SC 811.

<sup>420</sup> AIR 1996 SC 2715.

*“Art. 14.14. The obligations and liability of the Contractor for the environment hereunder shall be limited to damage to the environment which:*

*(a) occurs after the Effective Date; and*

*(b) results from an act or omission of the Contractor.”*

Thus, under the Indian PSC regime, the liability of the Contractor is limited only to the instances wherein the damage to the environment is caused directly by the performance an act or omission of the Contractor. However, under the principle of absolute liability as propounded by the Hon’ble Supreme Court of India, in every case wherein an enterprise is engaged in a hazardous or inherently dangerous activity and harm results to any one on account of an accident or in the operation of such hazardous or inherently dangerous activity resulting, the enterprise is strictly and absolutely liable to compensate all those who are affected by the accident and such liability is not subject to any of the exceptions which operate vis-à-vis the tortuous principle of strict liability. The operations of E & P are hazardous in nature, as any damage to the environmental would cause an irreparable impact on the environment and thereby resulting in catastrophic environmental damages. It has been a proved fact that the extraction of hydrocarbons is an inherently hazardous activity with potential grave risks to the general environment. Environmental woes occur during all the stages of oil and gas cycle but more notable during the upstream stage of operations. The upstream stage involves exploration, appraisals and production. This stage is accompanied by a range of environmental issues like accidental spills and blow out during development stage,<sup>421</sup> operational discharge and atmospheric emissions<sup>422</sup> like gas flaring during production stage. Major incidents like Ecuador rain forest pollution, Piper alpha offshore disaster (1988), gas flaring in Nigeria, Montara accident (2009) and macondo

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<sup>421</sup> Gao, Zhiguo, *Environmental Regulation of the Oil and Gas Industries*, available at <http://www.dundee.ac.uk/cepmlp/journal/html/vol2/article2-11.html>, last visited on 5<sup>th</sup> October 2014.

<sup>422</sup> Wawryk, Dr. Alexandra S., *International Environmental standards in the Oil Industry: Transnational Oil Companies in Emerging Economies* (2002), available at <http://www.dundee.ac.uk/cepmlp/gateway/index.phphtml/Vol13/article13-3.pdf>, last visited on 5<sup>th</sup> October 2014.

blowout (2010) are a few examples of extensive irreversible and irreparable environmental damage caused by the E & P activities in the energy sector. However, the act to limiting the liability to certain instances and thereby an attempt being made to take away the applicability of the principle of absolute liability is blatantly illegal and unlawful and thereby runs the risk of rendering the particular provision void for being *ultra vires* to the constitution, as the right to clean environment has been brought under the ambit of Article 21 of the Constitution. Thus, it is imperative that steps need to be put in place to ensure that the Indian PSC is in conformity with the liability regime set in place in the country for the purpose of combating environmental damage in the country.

## **12.2 Gas Pricing**

Gas Pricing has been one of the biggest issues plaguing the Indian Oil and Gas sector and the PSC too offers no respite from the issue. Currently there are multiple pricing regimes existing in the country for Natural gas supplies. This could be broadly divided into three categories:

APM Gas

Non APM Gas

LNG

Further, there is differential pricing existing for different sectors. Subsidized sectors such as power and fertilizer get relatively less prices as compared to other sectors. Also, region specific pricing exists in the country with North Eastern states getting gas at relatively cheaper prices as compared to other parts of the country. Pricing of major share of gas supplies in the Indian market is controlled and is not market driven as government approval is required before changing the price. However, it is imperative to note that this action of the government in having a controlled pricing may result in disincentivizing investments in the sector in terms of limited

participation from foreign players, who have access to technology, much required in deep-water E&P activities.

Further the controlled pricing also hampers the competitiveness of consuming sectors (power/ fertilizer/ domestic) to compete with global energy markets as it leads to low investments in energy efficiency on the demand side. Policy makers have been considering various aspects to look at the pricing of natural gas. Some of the deliberations done by the government of India on pricing include:

**Pooled Pricing of Gas:** As multiple pricing regimes exist in the country, pooling of gas from different sources has been deliberated by the policy makers. A sectoral pool was being considered with separate pools of power and fertilizer customers. Separate pools were considered in view of avoiding cross subsidies between the customer groups and related administrative issues arising.

**Rangarajan Committee recommendations on Pricing:** The committee has suggested a uniform gas-pricing, at 'unbiased arms-length'.<sup>423</sup> The formula of domestic gas pricing should be 12-month trailing average of volume-weighted average at well-head (on net- back basis) for gas imports and volume-weighted average of US Henry Hub, UK NBP and Japanese Crude Cocktail prices.<sup>424</sup>

The Gas prices in India are expected to increase in case the government initiates actions based on the suggested framework by Rangarajan committee. However, until then it is imperative to note that the issues in the gas pricing mechanism is hampering the prospects of attracting any huge business in the oil and gas E & P sector.

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<sup>423</sup> See, *Report of the Committee on the Production Sharing Contract Mechanism in Petroleum Industry*, Government of India, 2012, on file with author.

<sup>424</sup> *Id.*



### 12.3 DISPUTE RESOLUTION

It is well known rule of English law that “*an agreement purporting to oust the jurisdiction of the courts is illegal and void on the grounds of public policy.*”<sup>425</sup> Thus, any clause in an agreement providing that neither party shall have right to enforce the agreement by legal proceedings is void.<sup>426</sup> However the only exception to this n agreement may however stipulate that there is no intention to contract, or it is only a gentleman’s agreement. In such cases, no action is possible under the agreement.<sup>427</sup> In consonance with this well established principle. The Indian Contracts Act, 1872 has incorporated similar provisions under Section 28 of the Act.

#### **28. Agreements in restrain of legal proceedings, void -**

*Every agreement,—*

- a) *by which any party thereto is restricted absolutely from enforcing his rights under or in respect of any contract, by the usual legal proceedings in the ordinary tribunals, or which limits the time within which he may thus enforce his rights,*
- b) *which extinguishes the right of any party thereto, or discharges any party thereto from any liability, under or in respect of any contract on the expiry of a specified period so*

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<sup>425</sup>HALSBURY’S LAW OF ENGLAND, Vol. 9, 352.

<sup>426</sup>*Baker v. Jones* (1954) 1 WLR 1005

<sup>427</sup>*Rose & Franklin v. Crompton* (1925) AC 445

*is void to the extent.*

***Exception 1 :*** *Saving of contract to refer to arbitration dispute that may arise. This section shall not render illegal contract, by which two or more persons agree that any dispute which may arise between them in respect of any subject or class of subject shall be referred to arbitration, and that only and amount awarded in such arbitration shall be recoverable in respect of the dispute so referred.*

***Exception 2:*** *Saving of contract to refer question that have already arisen – Nor shall this section render illegal any contract in writing, by which two or more persons agree to refer to arbitration any question between them which has already arisen, or affect any provision of any law in force for the time being as to reference to arbitration.*

Thus, the Contracts Act specifically bars the agreements of two kinds as void under this provision, viz.,

- An agreement, by which any party thereto is restricted absolutely from enforcing his rights under or in respect of any contract, by the usual legal proceedings in the ordinary tribunals.
- An agreement, which limits the time within which he may thus enforce his rights, is void to the extent.

The Hon'ble Calcutta High Court in the case of *Coringa Oil Co. v. Keogler*<sup>428</sup> has laid down the following observation in an attempt to explain this section of the Contracts Act:

*“ ... This section applies to agreements, which wholly or partially prohibit the parties from having recourse to a court of law. If for instance, a contract were to contain a stipulation that no action should be brought upon it, that stipulation would be void, because it would restrict both the parties from enforcing their rights under the contract in the ordinary legal tribunals. ... ”*

The only exception to the said provision is reference of existing questions and future disputes to arbitration. This section shall not render illegal contract, by which two or more persons agree that any dispute which may arise between them in respect of any subject or class of subject shall be referred to arbitration, and that only and amount awarded in such arbitration shall be recoverable. Thus, the agreement between parties to refer disputes to arbitration is perfectly valid one.<sup>429</sup> In fact in *Coringa Oil Co*<sup>430</sup> Case wherein, a clause in an agreement that all disputes would be referred to arbitration of two competent London brokers and their decision would be final was held valid and the court had categorically laid down that

*“ ... If a contract were to contain a double stipulation that any disputes between the parties should be settled by arbitration, and neither party should enforce his rights under it in a court of law, that would be a valid stipulation so far as regards to its first branch, viz. that all disputes between the parties should be referred to arbitration, because that of itself would not have the effect of ousting the jurisdiction of the courts, but the latter branch of*

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<sup>428</sup> (1876) 1 Cal. 466

<sup>429</sup> *Gaindalal v. Rameshwar* 171 IC 584

<sup>430</sup> *supra* n.



*stipulation would be void because by that the jurisdiction of the court would be naturally excluded. ...”*

However, it is pertinent to note that the right to proceed against the arbitrator’s award, for example, to have it set aside cannot be excluded by a contract.<sup>431</sup>

*Art. 33.2 Matters which, by the terms of this Contract, the Parties have agreed to refer to a sole expert and any other matter which the Parties may agree to so refer, may be referred to a sole expert who shall be an independent and impartial person of international standing with relevant qualifications and experience, appointed by a written agreement between the Parties and who shall not, by virtue of nationality, personal connection or commercial interest, have a conflict between his/her own interest and his/her duty as a sole expert. In the event that the Parties fail or are unable to agree on a sole expert within thirty (30) days or such longer period as may be mutually agreed by Parties, the sole expert shall be appointed by a body or an institution or an agency or a person, mutually agreed by Parties. In case, there is no agreement on the body or an institution or an agency or a person for appointing sole expert or such institution or agency or body fails to appoint a sole expert within thirty (30) days or such longer period as may be mutually agreed by Parties, the matter shall be referred to arbitration. Any sole expert appointed shall be acting as an expert and not as an arbitrator and the decision of the sole expert on matters referred to him/her shall be final and binding on the Parties and shall not be subject to arbitration.*

*Art. 33.3 Subject to the provisions of this Contract, the Parties hereby agree*

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<sup>431</sup> *see, Ganges Manufacturing Co. v. Indra Chand* (1906) 33 Cal. 1169; *Burla Ranga Reddi v. Kallapalli* (1885) 6 Mad. 368; *Aghore Nath Banerjee v. The Calcutta Tramway Co. Ltd.*, (1885) 11 Cal. 322.

*that any controversy, difference, disagreement or claim for damages, compensation or otherwise (hereinafter in this Clause referred to as a*

*“dispute”) arising between the Parties, which cannot be settled amicably within ninety (90) days after the dispute arises, may (except for those referred to in Article 33.2, which may be referred to a sole expert) be submitted to conciliation or an arbitral tribunal for final decision as hereinafter provided.*

Thus, the PSC lays down that, the Parties may agree to refer matters by the of the PSC to a to a sole expert and further lays down that the Sole Expert so appointed shall be acting only as an expert and not as an arbitrator and adjudicate upon the matter. It further lays down that the decision of the sole expert on matters referred to him/her shall be final and binding on the Parties and shall not be subject to arbitration. Thus the provision pertaining to sole expert in effect closes all channels available to proceed for arbitration in order to resolve and adjudicate upon an issue referred to sole expert and thereby opening up scope for backdoor litigations. Further, by taking away the scope of proceeding to the Arbitrator from the findings of the sole expert in fact has taken away the entire benefit that the party enjoys by opting to choose arbitration over conventional litigation. Similarly it is also a matter of concern that in reality the findings of the sole expert can be construed as an agreement in itself, as both the parties agree to the findings and sign on the same. Hence, the issues pertaining to the enforceability of such findings come into play and it is necessary to ensure that the parties do not take up the pleas available to it to negate its part of performing the agreement viz. the findings of the sole expert.

Incorporation of a company by registration was introduced in 1844 and the doctrine of limited liability of a company followed in 1855. Subsequently in 1897 in *Salomon v. Salomon & Company*,<sup>432</sup> the House of Lords effected these enactments and cemented into English law the twin concepts of corporate entity and limited liability. In that case the apex Court laid down the principle that a company is a distinct legal person entirely different from the members of that

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<sup>432</sup> (1897) A.C 22

company. This principle is referred to as the 'veil of incorporation'. The human ingenuity however started using the veil of corporate personality blatantly as a cloak for fraud or improper conduct. Thus it became necessary for the Courts to break through or lift the corporate veil and look at the persons behind the company who are the real beneficiaries of the corporate fiction. Lifting of the corporate veil means disregarding the corporate personality and looking behind the real person who are in the control of the company. In other words, where a fraudulent and dishonest use is made of the legal entity, the individuals concerned will not be allowed to take shelter behind the corporate personality. In this regards the court will break through the corporate shell and apply the principle of what is known as 'lifting or piercing through the corporate veil'.

The Indian System too follows the same principle as under English law and the lifting of the corporate veil are allowed only in certain cases. In the PSC, the it has been categorically laid down with respect to the disputes pertaining to government companies as follows:-

*Art. 33.14 Notwithstanding anything contrary contained herein above, in the event of dispute among Government Company (ies) and with the Government, such disputes shall be settled in accordance with guidelines issued on the subject by Government from time to time.*

Thus, the government through the PSC in cases of Public Sector Undertakings wherein a majority stake is held by it, forces such undertaking from not resorting to arbitration but to settle the matter in accordance to the guidelines issued by it. The government's act of lifting the corporate veil in the cases of government companies/ PSU's opens up the Pandora's box and thereby leading to the question of the legality on the government's part in doing so.

## **12.4 SHALE GAS**

Shales are fine-grained sedimentary rocks formed from deposits of mud, silt, clay and other

organic materials and can be a rich source of natural gas and petroleum. Natural gas, mainly consisting of methane, which is found, trapped within shale formations. The shales in which the natural gas are trapped are generally both the source as well as reservoir for such gas. Shale gas exploration currently is considered as one of the most rapid growing forms of natural gas exploration. The exploration of shale gas requires a specialized technique as the gas do not directly flow into the well without additional stimulation and is achieved by involving two processes, '*horizontal drilling*' and '*hydraulic fracturing*'. Hydraulic fracturing is a method where high-pressure pumps are used to inject '*fracturing fluids*' viz. water, sand and other chemicals under high pressure into the well. The pumping of the fracturing fluid thus creates stress in the shale far exceeding to its strength and thereby opening up the fractures and thus letting the gas to flow through the well.<sup>433</sup>

The enormous success of shale gas exploration in the west, especially in the United States of America has generated immense amount of interest in India as well. Several Indian companies including GAIL, Oil India Ltd., Reliance Industries have already purchased shale assets overseas and the same shows the immense interest in shale exploration, especially given the face that the gaining of expertise in shale exploration would be of immense help in exploring shale deposits in India. The sharp increase in demand for energy in India over the recent years has fueled the search for alternative methods so as to match up the supply of energy with demand and the massive success of shale gas exploration and exploitation in the United States of America and also several European countries has created interests for such exploration in India. The Ministry of Petroleum and Natural Gases, Government of India has identified six basins viz. Assam-Arakan (north-east), Cambay (Gujarat), Cauvery, Gondwana (Central India), Indo-Gangetic Plain, & Krishna-Godavari as potential basins for shale gas exploration.<sup>434</sup>

The Ministry of Petroleum and Natural Gases, Government of India had also formulated a policy

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<sup>433</sup> *Shale gas extraction in the UK: a review of hydraulic fracturing*, The Royal Society, London and The Royal Academy of Engineering, London, (2012) available at: <http://www.raeng.org>, last visited on 14<sup>th</sup> October 2014.

<sup>434</sup> Batra, R.K., *Shale Gas in India: Look Before you Leap*, The Energy Research Institute (TERI), New Delhi, (2103), Available at: [http://www.teriin.org/policybrief/docs/Shale\\_gas.pdf](http://www.teriin.org/policybrief/docs/Shale_gas.pdf), last visited on 14<sup>th</sup> October 2014.



in this regard and the Draft Policy for the Exploration and Exploitation of Shale Oil and Gas in India was released in the year 2012. The Cabinet Committee on Economic Affairs has approved the said policy in the month of September 2013. The final policy approved by the Cabinet Committee has come in stark contrast to the initial 2012 draft. Initially the 2012 draft policy was made on the lines of permitting all existing operators to explore shale resources in addition to the exploration of conventional oil and gas. But subsequently moving away from the draft policy, the Cabinet Committee during the approval the policy, decided not to include blocks for offer to private firms and further decided to have a separate policy at a later point of time to deal with exploration of shale resources in blocks awarded to private firms for conventional oil and gas and coal bed methane. The current policy for shale gas exploration and exploitation has an extremely restricted scope and has even kept out all the blocks that have been awarded to both public and private sector energy firms under the New Exploration Licensing Policy (NELP) regime and thereby negating the entire step made forward in a positive direction under the NELP regime and have brought in a regressive policy. Thus, the current policy covers a very limited number blocks and thereby leaving all the shale gas/ oil exploration and exploitation for the time being in the hands of Oil and Natural Gas Corporation and Oil India Limited.<sup>435</sup>

The PSC in its current form and style does not cover the aspects of E & P sector in the oil and gas industry such as shale gas, coal bed methane (CBM), etc., and has an extremely restricted scope of application and is applicable only to blocks directly involving oil and associated natural gases and non associated natural gases and thereby failing to consider all other hydrocarbons. It is a matter of fact that the need of the hour for us is that we have a single comprehensive and detailed agreement for the purpose of E & P in the oil and gas sector in India. However, the current PSC regime is not a very healthy one to foster the growth of various other non-conventional hydrocarbons and further, the governmental policy in this regard too is regressive, turning back from the basic purpose behind and the essence of the NELP regime in the country.

Thus, it is imperative that both the government's policy as well as the PSC is adequately

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<sup>435</sup> *Cabinet's new policy: only ONGC and OIL are eligible for shale gas exploration*, The Economic Times (news report). This article can be viewed online at: [http://articles.economictimes.indiatimes.com/2013-09-25/news/42362315\\_1\\_shale-recourses-conventional-oil-and-gas-gas-exploration](http://articles.economictimes.indiatimes.com/2013-09-25/news/42362315_1_shale-recourses-conventional-oil-and-gas-gas-exploration), last visited on 14<sup>th</sup> October 2014.

amended so as to ensure the E & P of all kinds of hydrocarbons are promoted and supported by the government.

## CHAPTER 13

### CONCLUSION AND FINDINGS

The New interest, in the 1900s, in the Production sharing model was partially heightened by the sovereignty concerns and the political environment on one hand without having to hand over the filed and production ownership rights to Oil companies. It must be recalled that in those days, Sovereigns granted concessions with sometimes little authority, often under foreign political dominance. Also, the countries concerned were backward, some- times nomadic, and in no case possessed a legal framework liable to govern such things as petroleum operations There is no model contractual regime for all the governments and all circumstances. Hence, with an underlying objective is creation of wealth or self-sufficiency at the least, the policy makers of a country aimed to establish the optimal design for the definition of economic, social and political objectives through allocation of petroleum E&P rights. However it was soon realized that some of these objectives may be more effectively achieved by combining allocation systems with other policy tools to ensure coordination and coherence among different policy tools. However, not all factors affecting the design of efficient allocation systems can be controlled or influenced by governments. A country's geological potential is such independent factor: geology is a gift of nature. The geological potential determines the country's relative ability to attract investors and to extract rent. The intention of the policy makers is to reduce information asymmetries among market participants through strategic use of geophysical, geological and petro physical data. These entails-

1. The definition of appropriate policies for acquisition and management of geotechnical data (such as MWP, Seismic surveys, petroleum data Banks); and
2. The definition of the country's promotional strategy (such as block's delineation, choice of areas to be licensed, relinquishment policies etc. )

The Contractual regime is just the facilitator for ensuring such procedure could be established for the grant of E&P rights ensuring a Level Playing Field for all the oil companies – domestic or

international. On the other hand, the countered with limited prospectivity have limited options, and generally limited negotiating power.

While PSCs give the impression of giving the state ownership and control over oil resources, in practice, its hands are tied by the restrictions in the contract. Today, the transition, which India might adopt, a paradigm shift from Production Sharing to Revenue Sharing model as experience by the developed world, is reminiscent of a similar transition towards production sharing contracts away from concessions systems starting in Indonesia in 1966. Today, as various countries have shown interest in adopting variations of revenue sharing model rather than Production Sharing, the success of such transition is again shadowed by various discrepancies.

**BIDDING PROCEDURES-** The form, biddable parameters, and the bidding procedure of the allocation system all have a large part in ensuring efficiency, which would be reflected upon as the parties enter into a contract. The success of bidding procedures heavily depends upon attractiveness to potential investors, its robustness against collusion, and its resilience in the face of political and lobbying pressures. A government's technical and administrative capacity should be taken into consideration, as should other policy instruments that may be used to achieve specific objectives. One of such examples includes '**Stabilization Clause**' in the PSC.

The researcher Susan Leubuscher comments,

*"That system assigns the State the role of just another commercial partner ensures that non-commercial issues will not be aired, and excludes representation and redress for populations affected by the wide-ranging powers granted [multinationals] under international contracts<sup>200</sup>".*

Furthermore, Leubuscher points out that investment contracts are largely self-standing and self-referential: they are judged by the goals and conditions that each individual contract sets for itself, rather than by external standards within the broader body of law. Even worse, many of these contracts contain 'stabilization clauses', which can prevent future laws or tax policies applying to the project concerned. For example, a future government may not be able to introduce stricter laws, or to change tax rates. This is generally achieved by one of two mechanisms in the contract:

1. Giving the production sharing agreement a higher legal status than other laws (except the

Constitution) – thus, if there is a conflict with a future law, the PSA takes precedence; or

2. Including clauses that allocate certain risks such as tax or legislative change to the state oil company – in other words, if tax is increased, the state oil company pays, not the foreign company.

As a result, **laws and regulations relating to labor standards, workplace safety, community relations or environment** would be unable to be strengthened in relation to a project during the life of the contract and may even be weakened, depending on the contract. A stabilization clause is extremely disadvantageous for the government that “agrees” to it because it freezes the legal and regulatory situation of the country for an extended period of time and requires the government to pay compensation if changes affect an investor. The stabilization clause must be closely analyzed from a time perspective: what does it mean today and what will it mean tomorrow?

**PARTIES-** The choice of parties to any agreement should be examined carefully, especially when the parties are from different nations and when one of the parties is a government or a public institution. To the extent that a host government is a direct party to an agreement, it accepts direct responsibility and unlimited liability. But it may limit its liability by engaging one of its own enterprises as a contractual party.

### **TAXATION OR COMPENSATION**

The question of how to tax production is an extremely important issue as income earned from the production and sale of a natural resource often accounts for the biggest portion of the government budget. But if the government taxes too much, it runs the danger of pushing companies out of the country to areas that offer better terms.

### **WORK PROGRAMS**

A work program detailing a company’s exploration or development plan can be murky, often hiding behind technical and financial considerations, including how to drill in deep water or earthquake areas. In that regard, questions concerning how to best protect the natural environment also become an issue, partially because of the cost of installing the necessary protective equipment. The host government should insist on a work plan that specifies clearly the circumstances under which a project could be delayed or even discontinued and the circumstances under which it may not.

**ENVIRONMENT PROTECTION** - Each government has an obligation to protect its

environment. However, where environmental standards are covered by PSAs and license-concession agreements, environmental rules and regulations can be ambiguous, giving oil companies the right to interpret, negotiate, or even veto, albeit indirectly, environmental standards. For example, the PSA for Azerbaijan's major oil development project allows the contracting companies to discharge air emissions "*in accordance with generally accepted international petroleum industry standards and practices.*"

**CONTRACTUAL FOUNDATION** - A host government has granted oil companies, through the PSA, a say in the enforcement of standards, when these standards have been incorporated as contractual provisions. A contractual provision can be more easily contested, and even violated, than a statute or regulation.

**BREACH OF CONTRACT**- Breaching the provisions of the PSA, even an environmental provision, is only a contractual violation. The violating party will normally be required only to rectify the breach, perhaps even pay damages. Only if a serious or material breach has occurred is termination of the agreement a possibility. Moreover, a breaching party could argue that its breach came as a direct result of the action or inaction of the other party. A breach of a contractual provision is an extension of the contract negotiation process, a renegotiation, albeit more acrimonious.

**DISPUTE RESOLUTION** - Most production sharing any disputes would be courts of the country international arbitration ICSID in Geneva or the International Chamber of Commerce in Paris. These arbitration hearings are often held in secret, and presided over by tribunals consisting generally of corporate lawyers and trade negotiators – as such, they tend to narrowly favour the investment interest, rather than broader issues of national interest or sovereignty

The Indian Model Production Sharing Contract, though is a well-drafted and comprehensive document, it has its own inherent issues and lacuna. As discussed herein some of the key issues contractually in the PSC are numerous and some of the key issues as addressed herein are the environmental issues wherein for instance the PSC recommends for the following of the international standards, however, it is pertinent and in fact saddening to note that there are no such standards in place in the oil and gas sector. Similarly, in the study it is seen that the environmental regulations as per the PSC is in complete contravention with the liability regime set in place in the country and hence requiring immediate attention and review so as to bring it in

consonance with the law of the land.

The PSC while dealing with the dispute resolution mechanism, has created the maximum possible confusion by creating a status unknown to law for the sole expert and the reference to the matters to the sole expert in fact appears to only complicate the issues and create a backdoor entry to the courts. One of the primary purpose and reason behind the alternative disputes resolution mechanism is to ensure that the relationship between the parties are maintained and are not spoilt, but by the mechanism of excluding arbitration in certain cases and creating a backdoor channel to go to the courts is only negating the said objective and is a very regressive move.

Similarly it is a matter of fact that the current format of the PSC applies only to a few hydrocarbons and in fact a plain reading of the PSC would reveal that the PSC categorically excludes other types of hydrocarbon. India in the recent years has seen the emergence of various hydrocarbons, which were in fact unknown a few years ago, such as shale gas. Thus, it is imperative that the current PSC regime is adequately amended so as to ensure that the PSC is a comprehensive agreement that would cover all hydrocarbons and thereby reduce the multiplicity of numerous agreements for the same industry.

The biggest trouble in the current PSC regime pertains to the financial aspects. There are numerous facades to this issue ranging from cost recovery to gas pricing. The oil and gas policy

regime in order to overcome its issues especially the issues pertaining to cost recovery needs a complete overhaul and so on as suggested by the Rangarajan Committee may be moved from profit sharing to revenue sharing (or production-linked) contracts. In fact, if a close study is made on the existing system, the cost recovery model has been at the root of the problems so far in oil and gas exploration regime that is the New Exploration Licensing Policy. The same can be proved by a mere study of the Reliance issue pertaining to the KG-D6 basin wherein the root cause of the entire issue with the government is the issue pertaining to cost recovery. Under the existing PSC, the contractor first recovers his expenditure before sharing profit. What is under consideration is production-linked payment, which is said to be more transparent and will have less intervention in routine exploration and development activities. Under the proposal, which is a shift in regime that has been proposed by the Rangarajan Committee, oil companies would

have to pay the Government an agreed amount, depending on the level of output, and not on the investment in the exploration block. Though this shift in regime may not directly result in more revenues for the Government, it ensures that as the contractor earns more, the Government gets progressively higher revenue. Besides, it will also safeguard the Government's interest in case of a windfall arising from a price surge or a surprise geological find. The proposed method, according to Ministry officials, will create greater transparency and foster a hassle-free operational environment.

Owing to all these issues, the Indian government is finally considering changes to the current format of the Production Sharing Contract and thereby to include a new mechanism for determining the price of natural gas. These possible changes appear to be the direct result of the report by the committee led by C. Rangarajan, chairman of the Economic Advisory Council to Prime Minister.<sup>436</sup> The report has envisaged that these changes are necessary so that the allure of the fiscal terms for oil and gas investments on several fronts is projected to the international market and thereby attract investments to the sector.<sup>437</sup>

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<sup>436</sup> *Supra*, n. 295

<sup>437</sup> India Considering Changes to Production Sharing Contracts, *Oil & Gas Journal*, available at <http://www.ogj.com/articles/2013/04/india-considering-changes-to-production-sharing-contract.html>, last visited on 14<sup>th</sup> October 2014.



Some of the Key recommendations of the Committee under consideration for revising the current model of PSC are as follows:-<sup>438</sup>

- *Replacement of cost recovery with total revenue sharing determined by bids.* The committee cited past disputes over contractor costs as a reason to change. Under the recommendation a bidder would offer different revenue shares for different levels of production and price.
  
- *Extension of a tax holiday for drilling in offshore blocks with water depths exceeding 1,500 m to 10 years from 7 years.*
  
- *Extending the exploration term for frontier licenses in more than 400 m of water and licenses in ultradeep water (more than 1,500 m) to 10 years from 8 years.*
  
- *Establishing government committees to address policy disputes and delays in exploration.*
  
- *Making lists of blocks available to the Comptroller and Auditor General from which to select targets of audits.* The focus would be on blocks in exploration and development phases, when costs are higher. CAG audits have triggered disputes over costs for recovery under current PSCs.
  
- *Determining natural gas prices under PSCs on the basis of international proxies.*

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<sup>438</sup> See generally, *Supra*, n, 295.

The Indian PSC calls for “arm’s-length” pricing, but lack of development of the domestic gas market makes that difficult. The recommendation is for pricing based on an average of producer netbacks for gas imported by India and netback values derived from prices at hubs in the US, UK, and Japan.

It is of utmost importance that the government immediately acts on the current oil and gas policy and bring about the necessary changes so as to make India an attractive destination to invest in the Oil and Gas industry especially in the upstream sector. This dream can however be achieved only with adequate and timely changes to the current PSC regime with due regard to the issues and lacuna that exists in the present system. Thus, with the hopes of implementation of some of the major changes as recommended by the Rangarajan Committee in the forthcoming round of bidding, viz. NELP X, only the times to come will stand testament for achieving the expected growth and development the E & P sector in the Indian Oil and Gas industry and thereby easing out the norms of doing business in India and making the nation an attractive destination for investments in the sector.

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5. <http://www.dundee.ac.uk/cepmlp/gateway/index.phphtml/Vol13/article13-3.pdf>
6. <http://www.dundee.ac.uk/cepmlp/journal/html/vol2/article2-11.html>
7. <http://www.eia.gov/tools/faqs/faq.cfm?id=40&t=6>.
8. <http://www.epa.gov/>

**APPENDIX A - PRESS RELEASE**

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

## **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](http://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**

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. 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. 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. 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. 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-deepwater (offshore, at more than 1,500 m depth) blocks from eight years currently, to ten years.

### **Contract Management**

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**

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.

## **BIODATA OF AUTHOR**

## **RAJ KUMAR**

Cell: +91963460685: Email: [lexraj कुमार@gmail.com](mailto:lexraj कुमार@gmail.com)

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### **Education**

**UNIVERSITY OF MADRAS, Chennai**, Tamilnadu India  
BA LL.B (Bachelor of laws), August 2000.

**ROBERT GORDON UNIVERSITY**, Aberdeen, United Kingdom  
LL.M. International commercial law, December 2005

**ROBERT GORDON UNIVERSITY**, Aberdeen United Kingdom Postgraduate  
certificate in Oil & Gas Law, August 2007

**UNIVERSITY OF PETROLEUM & ENERGY STUDIES**, Dehradun, India Pursuing  
PhD (Part time) in the area of Production Sharing Contract expected October 2015

### **Employment**

#### **Academic Appointment**

COLLEGE OF LEGAL STUDIES, UNIVERSITY OF PETROLEUM & ENERGY STUDIES  
May 2009-May 2015

#### **Researcher**

Centre for Energy Law Research, University of Petroleum & Energy Studies, Dehradun,  
India.

#### **Instructor/Consultant**

Navitas Resources (NR) Pte. Ltd. Singapore  
Resonance Energy Private Ltd. New Delhi

Instructor for “**Interactive Workshop on Legal Issues in Oil & Gas Industry**”, 4 & 5  
September, 2014, Holiday Inn, New Delhi

### **Selected Publication/Conference/Paper Presentation**

*Sources of International Law under Article 38(1): A Hierarchy of Law or Procedure?* AALCO J. Int'l L. Volume 4 Issue no 1, August 2015 (Forthcoming)

*Governance of Shale Gas in India: Issues and Challenges*, International Energy Law Review (IELR), 2014 Issue no 6, page 208-211

*Shale Gas: A Dream or Reality?* Energy Law Reports, Vol.1, Part 4. p. 113

*Production Sharing Contract for Exploitation of Hydrocarbon Resources*, Energy Law Reports, Vol.2, Part 2. p. 165

*India and Energy Policy*, UPES Law Review, Vol.1 Issue 2 (August)

Key note speaker at “**Conference on Energy Sector for Legal Fraternity**”, 4 May 2013, PHD house, New Delhi.

Attended “International Workshop on Empirical Research” National Law University in collaboration with Cornell University Law School (New York USA) 2-7 February, New Delhi

Attended as special delegate on behalf of University of Petroleum & Energy Studies in “**World Energy Policy Summit 2012**”, 26-27 November 2012, Hotel ITC Maurya, New Delhi

Presented paper titled “**Legal and contractual framework for exploration & production of oil and natural gas in India**” as key note speaker in 18<sup>th</sup> Annual India oil & gas review summit (IORS) and International exhibition 2011, 7-9 September Taj Lands End Mumbai organized by Oil Asia

Presented paper titled “**Exploration & Production business and Regulatory policy in India**” as key note speaker at The 2nd South Asian Geosciences Conference and Exhibition, GEOIndia 2011, 12-14 January New Delhi

Attended as special delegate on behalf of University of Petroleum & Energy Studies in ‘**Legal & Tax Summit 2009-in Power, Oil & Gas**’, 29-30 May 2009, Hotel Le Meridian, New Delhi

## **PERSONAL INFORMATION**

Family name: NARAYANAN

First name: RAJKUMAR

DOB: 15/02/1976

Gender: Male

Marital Status: Married

Nationality: Indian

