Production Sharing Contract (PSC) Audits

WHAT ARE PRODUCTION SHARING CONTRACTS?

Under a PSC the Contractor Group bears the mineral and financial risk of exploration, and the State is permitted an ownership (participation interest), when and if, it has been agreed, that any hydrocarbon discoveries within the PSC acreage are to be developed and produced.

The State retains title to or ownership of the hydrocarbons; however, the PSC(s) govern the classification and designation of all hydrocarbon production as eitherCost Recovery Hydrocarbons (Oil & Gas) or Profit Hydrocarbons (Oil & Gas).

Cost Recovery Hydrocarbon (Oil & Gas) Production – Cost Recovery proceeds are distributed to the participants, who incurred or participated in each category of PSC expenditures, until each category of PSC expenditures have been fully recovered. The order of Cost Recovery distributions, generally, goes for the recovery of:

- Exploration costs; then,
- Operating costs; and then
- Development costs.

All participants, who incurred each category of expenditures, receive a portion of the Cost Recovery proceeds in the order in which they were incurred until each category of expenditures have been fully recovered.

Profit Hydrocarbon (Oil & Gas) Production - Proceeds for the sale of Profit hydrocarbon production are distributed between the State run National Oil Company and the Contractor Group. The State generally receives the highest percentage of the proceeds for Profit Hydrocarbon Production.

Once all Cost Recovery expenditures have been reimbursed, all hydrocarbon production is then considered as Profit Hydrocarbon Production.

The terms and conditions of the State's PSC are, almost exclusively, the same; however, the State's ability to negotiate and amend the percentage split of hydrocarbon production between Cost Recovery and Profit production provides the State with the flexibility to encourage the exploration and/or production of highly productive or highly prospective areas, as well as, encourage the development and production of hydrocarbon discoveries, which are marginally economical.

WHAT ARE THE OBJECTIVES OF A PRODUCTION SHARING CONTRACT AUDIT?

The principal objective ofaPSC Audit is to provide assurance to the State's representatives that the Contractor Group has conducted all PSC Operations in compliance with the terms and conditions of the Production Sharing Contract. Specifically, this includes ensuring that:

- The Contractor Group has satisfied it's operational, commercial, financial, tax, and reporting obligations, to all regulatory authorities, including the State's representative, as stipulated by the PSC.
- All Cost Recovery Expenditures, as reported, have met all the PSC's governing terms and conditions to qualify as "allowable cost recovery expenditures, and the claimed values are supported by adequate, auditable, empirical evidence.
- The Contractor Group has maintained adequate accounting records in accordance with the terms and conditions of the PSC, which generally require the accounting records to be in compliance with the

generally accepted accounting practices utilised by experienced operators in the international petroleum industry.

- All export and internal sales of petroleum products have been conducted in accordance with the terms and conditions of the PSC, any sales and lifting agreements, and/or have been conducted at the stipulated sales prices and/or at sales prices, which have been determined through actual arms' length transactions.
- All hydrocarbon production statistics and sales proceeds have been accurately calculated, have been properly recorded in the Cost Recovery records, have been properly apportioned between the State and the Contractor Group, and have been properly reflected in all Cost Recovery Statements and Reports.

Examples of Cost Recovery Audit Findings are:

- The overstatement of Cost Recovery expenditures
- Value added taxes, being included in Cost Recovery amounts
- Duplicate payments
- The inclusion of sub-contractor withholding taxes in Cost Recovery values
- The understatement of the State's share of profit hydrocarbon production
- The inclusion of JVOA determined overheads, rather than the overhead provisions, as stipulated in the PSC

Please do not hesitate to contact us if you want to discuss Production Sharing Contract Audits.