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Government of India
Ministry of Petroleum & Natural Gas
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20th September, 2013

To

Director General,
Directorate of Hydrocarbons
OIDB Bhawan
Sector-73, Noida
Pin-201301 (U.P.)

Subject: Uniform Licensing Policy for Award of Hydrocarbon Acreages with New Contractual System and Fiscal Model

Sir,

I am directed to enclose the draft note on uniform licensing policy for award of hydrocarbon acreages with new contractual system and fiscal model.

2. In this regard, you are requested to get the comments on the attached draft Note from all private/JV Companies. The stakeholders may also send their views/comments on the draft note directly at email id: uniformpolicy@gmail.com.

3. The comments received from the stakeholders on or before 15th October, 2013 will be considered for policy formulation.

(K.K. Sharma)
Under Secretary to the Government of India
Tel. No. 23073859

Copy: Secretary General, AOGO
CMD, ONGC
CMD, OIL

Encl: As above.

EXPOSURE DRAFT ON UNIFORM LICENSING POLICY FOR AWARD OF HYDROCARBON ACREAGES WITH NEW CONTRACTUAL SYSTEM AND FISCAL MODEL

1.0 PREAMBLE

1.1 Government of India has been reviewing policies from time to time for intensifying exploration activity and investment there in. In past, there had been a gradual shift in the E&P policy, from nomination acreage to competitive bidding. With increasing demand for oil and gas, foreign exchange constraints, and the massive requirement of resources for expeditiously exploring and developing vast on-land and offshore territories, the Government of India designed the New Exploration and Licensing Policy (NELP) and Coal Bed Methane (CBM) Policy in late 90s, thereby opening the sector toall global E&P players, including foreign companies, with the aim of attracting private investment and infusing technology from all around the world. These policies were formulated in a framework of progressive de-regulationin the hydrocarbon sector.

1.2 NELP was made in the year 1997, which has been implemented under nine rounds so far between 1998-2012.254 blocks have been awarded for exploration, of which 178 are active, while 78 have been relinquished. Although 126 discoveries have been made in41 of these active blocks, commercial production has commenced in only 3 out of these blocks.

1.3 The policy designed 16 years back does not seem to have kept pace with the global dynamics in E &P, and it is essential to review the suitability of this policy in the present circumstances, with due consideration of impediments experienced in implementation. In order to bring uniformity in operations and remove impediments caused due to more than one operator, it is essential that a uniform licensing policy be applied for future contracts in award of exploration and production acreages.

2.0 REGIMES FOR AWARD OF EXPLORATION BLOCKS

2.1 The present two contractual regimes in force for allocation of acreages for E&P operations of hydrocarbons have different fiscal terms and conditions. While PSCs under the New Exploration and Licensing Policy (NELP) for E&P of Oil and Gas, is based on production sharing contract (PSC) where Government take depends on sharing of profit petroleum, based on the Pre-Tax Investment Multiple (PTIM) with cost recovery,contracts under Coal Bed Methane (CBM) Policy provides for revenue sharing based on production linkedpayment (PLP) without cost recovery. Both PTIM and PLP are biddable parameters.

2.2 During the course of implementation of CBM and NELP, it has been seen that though these two are mutually exclusive contracts, there are overlapping of resources in certain blocks, which cannot be explored due to separate contractual conditions. Further, unconventional hydrocarbon resources such as shale oil and gas, which were not known and considered at the time NELP contracts were awarded , are often present in the same area which is already under exploration albeit in a different horizon and rock structure. It is very difficult to distinguishamong shale gas, tight gas and conventional gasonce the production takes place, however technology and cost involved in the operation of unconventional hydrocarbon is very different from the conventional hydrocarbon. As such, for the current blocks under operation, exploration of these new resources interferes with the original bid evaluation criteria of government take, technical competence and minimum work programme committed. As such, the option available is to wait for the block to be relinquished or ML period to get over for exploration of these new resources.

2.3 As PSCs have progressed from the exploration stage to the development and production stage through successive NELP rounds, certain constraints have been observed in working of the existing contractual and fiscal model of NELP by both the Government and Contractors. Fiscal Model in the existing PSC comprises two main elements, both of which are biddable: (i) 100% cost recovery of exploration, pre-development, development, production cost and Royalty paid to the Government (ii) sharing of profit petroleum, based on the Pre-Tax Investment

Multiple (PTIM). The shares of the Operator and the Government in profit petroleum in a particular year are calculated on the basis of PTIM actually achieved by the Contractor at the end of the preceding year.This model has the following constraints:

- With primary focus on recovery of upstream costs, requiring close monitoring, expeditious exploratory work is adversely affected;
- It lacks the incentive to keep costs down for the operator;
- Requires constant and micro monitoring by the Government to protect the take of Government, leading to procedural delays and arbitrations.

2.4 Theseconstraintsare now increasingly overshadowing the basic Government objectives of energy security through expeditious development of hydrocarbon resources available in the country while simultaneously conserving and promoting their efficient use. The Government, while remaining committed to guard the natural wealth available within our frontiers, needs to promote judicious development of oilfields.

2.5 The Ashok Chawla Committee on Allocation of Natural Resources has made critical observations regarding IM based profit sharing formula. The Committee stated that the system "gives incentive (to an operator) to increase his investment, or front-end his work plan in order to see that the threshold where Government's profit take rises rapidly is not reached". The report clearly points out the risks associated with the IM based formula for sharing of profit petroleum, especially with a steep jump in profit sharing from one slab to another.

2.6 Similar conclusions on PSC and Fiscal Model have also been made by Comptroller and Auditor General (C&AG) in its audit report on PSC in Hydrocarbon exploration.

2.7 Given the similar conclusions that two independent agencies have reached as regards the adverse impact of the profit sharing mechanism in protecting GOI's share (linked to IM), designed in the late 1990s, it was felt that there is need to revisit the Contractual and Fiscal Model and address this issue in respect of the

future PSCs.Accordingly, The Government of India constituted a committee under the chairpersonship of Dr C. Rangarajan, Chairman, Economic Advisory Council to the Prime Minister, to look into the PSC mechanism in petroleum industry, so as to enhance production of oil and gas and the Government's share, while minimising procedures for monitoring the expenditure of producers.Committee has submitted its report which is in public domain.

3 NEW REGIME BASED ON RANGARAJAN COMMITTEE RECOMMENDATION

3.1 The award of acreages for hydrocarbon exploration and production in future will be brought under a uniform licensing policy covering all categories of hydrocarbons, with new fiscal terms for administration and monitoring of such contracts. A uniform licensing policy to enable E&P operators to explore and extract all hydrocarbon resources covered under the Oilfield regulation and development (ORD) Act, 1948, and Petroleum and Natural Gas (PNG) Rules, 1959 under one PEL/PML, and one contractual regime will replace the NELP and CBM regime for the Contracts to be awarded in future. This will ensure focus on exploration and accountability of operators being solely responsible for the activities in the awarded acreage. The uniform licence will enable the contractor to explore conventional and unconventional oil and gas resources such as shale gas/oil, tight gas, gas hydrates and any other resource to be identified in future which is fit for commercial exploitation, simultaneously under the overall contractual regime applicable from time to time.

FISCAL TERMS:

3.2 The present basis for production sharing, i.e. PTIM and Cost recovery willbe replaced with an incremental production-based sliding scale combined with a fixed, price-sensitive scale.Following fiscal componentsmay be in the model:

3.3 *Royalty:* Royalty will be paid to the Government from Gross Revenue. Fixed ad valorem rate of royalty is suggested for the proposed model. The present royalty

structure forOnlandincluding CBM blocks would be continued. However, in order to incentivize shallow and deepwater offshoreexploration which is highly cost intensive, it is proposed to introduce zero rate of royalty.As revenue sharing proposed here would be net of royalty, part of it can be captured in revenue share.

3.4 *Revenue Sharing:* Revenue, net of royalty, in case of on land including CBM blocks and total revenue in case of shallow and deepwater offshore blocks will be shared between the Contractor and the Government, based on the average daily production in a month for oil, and Gas in a quarter, using a sliding scale calculation methodology. The Contractor will be required to bid the share in percentage terms payable to the Government as per the price-band and incremental production matrix. For the purpose of calculating Government's share of production, the average of oil prices for the month and gas prices for the quarter will be considered for determining the price.

3.5 The revenue share from production for each cell of the matrix will be biddable, each cell having equal weightage and the winning bid will be determined on the basis of bid evaluation criteria**.** The bid has to be progressive and in the increments of at least 0.5% for each successive cell with respect to the Government take, *i.e.*, the Government take will be in an ascending order for increases in production and price. The NPV of Government's share in revenue, using the benchmarked production profile for the block, will be one of the deciding criteria for assessing a bid. The numbers specified in each cell of the matrix of the winning bid will be agreed to in the revenue sharing contract (RSC) that will be signed between the Government and the Contractor.

3.6 The production tranches will be different for various sectors (onland, shallow water, deep water, and CBM), and price bands will be based on historical and prevailing price trends. Production and price bands will be suitably designed after due deliberation and considering available historical data for Indian geological basins.

3.7 Any abnormally low bid, especially in case of a single bid for a block, would require close scrutiny to safeguard the Government take.

3.8 This model will be applicable for all future contracts, only the production tranches will be changed, depending on historical data available at the time of award of blocks. In order to maintain the sanctity of the contracts already signed and in place, PSCs/ CBM contracts signed by the Government up to the ninth round of NELP and round IV of CBM will be continued with the existing fiscal model.

3.9 In the proposed new model, no deductions will be allowed after the incidence of royalty (wherever applicable) and before the petroleum split between the Government and the Contractor. Thus, a major impact of the proposed model would be to provide the Contractor with the incentives for keeping costs down. Pegging the costs down will enhance the Contractor's profitability of operating the project.

3.10 **Income Tax*:*** As per existing income tax laws, the Contractor will be required to pay income tax on his profit. Seven years' tax holiday from the start of production will be available for both oil and gas fields, except for ultra-deep water blocks (i.e., those blocks for which a significant part of the block is having a depth of more than 1500 metres), where the period of tax holiday would be for 10 years.

HIGHLIGHTS OF THE PROPOSED CONTRACT:

3.11 The overall bidding parameters of the Minimum Work Programme (MWP) commitment, Technical capability and the fiscal package will remain the same as in present PSC/CBM contract. Only the bid evaluation criteria for the fiscal package will change with the proposed changes in the fiscal model, although its weight in the overall bid will remain the same.The blocks to be bid as a oil/gas block or as a CBM block or for both will be specified at the time of bidding in NIO. Blocks having potential for oil and gasas well as CBM will have adequate weightage for bothin BEC depending upon their relative predominance. This will

be required in view of the fact that production tranches are different and substantially lower and quantity of MWP is distinctly different for CBM production.

3.12 In the interest of hydrocarbon exploration, Contractors will be allowed to carry out further exploration throughout the Mining Lease (ML) period in the ML area.

3.13 Other contractual bottlenecks for exploration and exploitation of hydrocarbons will be addressed with suitable amendments in the provisions for the exploration period, flexibility in carrying out the appraisal programme, development of discoveries in deep-water and frontier areas, *force majeure*, etc.

CONTRACT MANAGEMENT

3.14 For effective Contract Management, at present representatives of Regulator/Government nominee constitute Management/ screening committee for PSCs/CBM contracts respectively. In order to strengthen contract management, following may be considered:

3.15 An Inter-Ministerial Committeeto be chaired by JS(E)will be constituted to deal with coordinationrelated Issues**.** This Committee may have representatives from the Ministries of Petroleum & Natural Gas, Environment & Forests (MoEF), Defence, Finance, and Law & Justice. For issues pertaining to Coal-Bed Methane (CBM), a representative from the Ministry of Coal may be co-opted. Committee will address the issues relating to inter ministerial coordination and take decisions.As there will be no element of cost-recovery in the proposed system, the role of the Management Committee (MC) or of the Government nominees on the MC will be largely related to monitoring and control of technical aspects. The functions pertaining to approval of annual budgets, audited accounts and appointment of auditors will not be required.The new regime is expected to help overcome uncertainty with regard to the time involved in securing various categories of approvals from the MC.Reservoir integrity, efficiency of production,

suitability of technology will be scrutinized by MC andMC and the DGH will be responsible to ensure the health, safety and Environmental aspects besides monitoring the timelines for various activities.

3.16 In the proposed model, unlike the present regime, there will be no need for the Declaration of Commerciality (DOC), or the field development plan (FDP) for a discovery to be approved by the MC. The contractor will only have to share the details with the DGH and the MC for the purpose of monitoring of timelines.However, estimate of recoverable reserves, which has capital market resonance, hence will be subject to approval by MC. Similarly, production profile will have to be approved by the MC.

3.17 An Empowered Committee of Secretaries (ECS)comprising of Secretary(P&NG), Secretary(Finance) and Secretary (Law) was constituted under NELP vide CCEA Resolution.The ECS has the mandate to consider the Bid Evaluation Criteria, conduct negotiations with the bidders wherever necessary and makes recommendations to CCEA on award of blocks. It is proposed to vest additional powers to this ECS on all contractual issues raised during the entire period of implementation offuture contracts based on the proposed model and to reconcile and resolve minor technical disputes by including experts on the subject as special invitees, and any other issue relating to contract evaluation which remains unresolved by the Management Committee. Selection of experts will be done from the Government, regulatory organisations, and national scientific and technological organisations, while ensuring that no conflict of interest exists for such persons.

3.18 All cases where unanimity with the Government nominee is not reached in a management committee meeting may be referred for consideration by the ECS.

3.19 As the element of cost recovery will not be applicable in the new fiscal regime, CAG audit for such blocks may not be required, and production monitoring through field surveillance may be considered adequate,along with revenue audit.

3.20 Minor deviations from the contract will invite financial penalty which will be graded item wise, where as major deviations will result in termination of contract. For

example if production in a year falls short by 10% of committed production, a penalty of 25% of the shortfall will be imposed on the contractor.

4.0 BENEFITS OF NEW REGIME

4.1 Following are the projected benefits of the proposal:

4.2 Introduction of uniform Licensing policy will ensure that thereis uniformity in contractual provisions for exploration and production of all kinds of hydrocarbon, and in individual awarded acreage, operators will be able to explore all types of hydrocarbon resources. This will remove impediments on account of multiple operators, thus, expedite exploration

4.3 As PTIM and cost recovery mechanism is proposed to be dispensed with, issues related to cost, if any, by the Operators and need for the Government to monitor the costs so as to safeguard own share of profit petroleum will not arise.

4.4 Unlike in the existing fiscal model in PSC, where profit petroleum to the Government commences only when all contract costs have been recovered (in case of a 100% cost-recovery bid by the Contractor), share of revenue to the Government will commence from the first day of production in the new system. The proposed changes will lead to a simple and transparent system with easy-to-monitor parameters of production and price.

4.5 With no direct cost recovery, the proposed system would not be directly sensitive to fluctuations in costs, in determining the Government's profit share unlike the existing system. It enhances the incentive for the contractor to keep costs down. It is in line with the Government's broad objectives of efficiency in oil field operations and conserving scarce hydrocarbon resources.

4.6 The new model reduces efforts and time in examining and monitoring by the Management Committee (MC). It will enable greater concentration on monitoring of technical aspects for effective exploration and optimal exploitation of reservoirs. The proposed fiscal model also addresses the issue of windfall profits to the Contractor in case of a price surge.

4.7 Allowing companies the option of bidding the production share at various production levels and oil price tranches, there should be little complaint about the toughness of the terms, as these will get determined by the marketplace and should allow bidders to factor in the fiscal terms of contract. Moreover, to mitigate the risk of E&P companies, there is no minimum government share prescribed and the bidder is free to bid any non-zero share. The Contractor's cost recovery will be embodied in his share of production, which the Contractor will be free to bid. Further, provision of bidding for rate of royalty starting for zero will provide big incentive for deepwater exploration, which is highly cost intensive and risk prone.

4.8 The proposed system is much more flexible and investor-friendly in comparison with the systems adopted in neighbouring countries in Southeast Asia, like Myanmar and Indonesia. These countries, which have a cost-recovery mechanism, follow a more rigid and harsh fiscal regime. Myanmar, for example, has cost-recovery, but also has signature, discovery and production bonuses, State participation, domestic market obligation, and various types of fees. Similarly, Indonesia has cost-recovery, and also signature bonus, three production bonuses, State participation, a very high percentage of royalty (20%), domestic market obligation, and a fixed percentage as government share. In contrast, the proposed system does not have any signature or production bonuses, State participation, or domestic market obligation (for oil), and has reduced royalty rates for certain areas and biddable share of production to the government, without any prescribed minimum government share. There should be no scope of collusion among bidders in a situation of scarcity turning the market into a supplier's one.

4.9 The proposed model is basically a royalty – tax regime, with production level payment. Government share arrived at through competitive bidding has to observe non-linearity with respect to marginal rate of appropriation, increasing with the output and shifting upwards for a price rise, for the government take to capture windfall gains on account of price rise.This model is being followed by a number of countries, with modifications. Columbia, for example, follows a royalty – tax regime, with a biddable "X" factor, *i.e.*, additional biddable government participation in production, after royalty. It also levies an additional profit tax (windfall tax) linked to

a base price, based on a formula. Many other countries follow a production linked or a production and price linked system with variations (like cost recovery, bonuses, State participation, windfall tax, and other levies). Few examples are Trinidad & Tobago, Tanzania, Ecuador, and Equatorial Guinea.Royalty Tax regime is also followed in the United States of America (USA).

4.10 It is perceived that prospectivity in offshore blocks along the Eastern and Western coastline is very high and there is enthusiastic response in this regard. These blocks are in ultra-deep waters, which can be anywhere beyond 1,500 metres in depth. The only change in tax benefits proposed in the policy is that such Ultra deep water blocks, which cover deeper geological horizon and carry higher risk and entail heavy investment will avail of a ten year tax holiday, while for other categories such as onland (including CBM), shallow water and deep water blocks of less than 1500 meter depth, present seven years tax holiday will continue.The change proposes will incentivize exploration of this part of Indian sedimentary basins.

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