Profitability Based Revenue-over-Cost (R/C) PSC

PETRONAS

Presented at:
Petroleum Policy and Management (PPM) Project
The 4th Workshop of the Philippine Sulu Sea-East Palawan Basin Case Study
14th – 19th March 2005, Manila, Philippines

PETRONAS

Presentation Outline

- Objective
- Profitability Based Revenue-over-Cost (R/C) PSC
- Conclusion

PETRONAS

Objective

- To share the concepts of Profitability Based Revenue-Over-Cost (R/C) PSC in improving the new exploration PSC.

PETRONAS

Evolution of Malaysian PSC

- As 2nd March 2005, a total of 54 PSCs were signed and in operations.

Concession Agreement

Concession agreements between oil companies and state governments.

1976 PSC

Primarily to convert the then existing concession between oil companies and state governments into PSCs.

1985 PSC

Terms were developed based on the prospect of fields, oil price and cost structures of mid. '80's

Deepwater PSC

Terms were catered for very high costs and high risks deep water environment.

Target for big players with experience in deepwater exploration, development and production.

R/C PSC

Terms were developed based on E&P environment of mid '90's

Promote cost efficiency which is critical for small field development.

1976 1985 1993 1997

PETRONAS

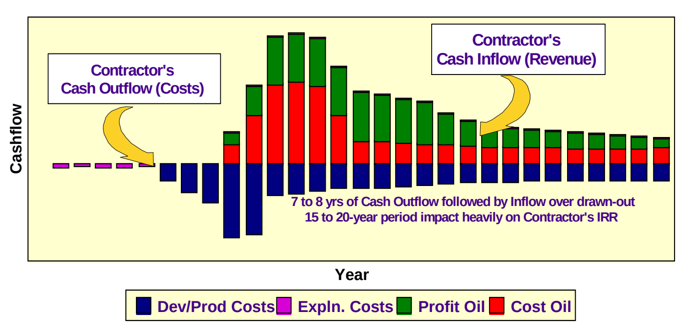
Profitability Based Revenue-over-Cost (R/C) - Salient Features

- The Profitability Based Revenue-over-Cost (R/C) PSC incorporates the following incentives :-
  - Progressive
  - Self Adjusting
  - Promoting Cost Effectiveness
  - Promoting Re-investment
  - Provision of equitable rewards to compensate for increase risks, rising costs and diminishing field sizes

PETRONAS

Profitability Based Revenue-over-Cost (R/C) - The Concept

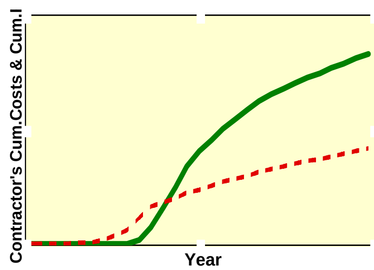
- Contractor bears 100% of risk investment, incurs all petroleum **COSTS**
  - Costs, reserves & future oil price are estimates when a Contract is agreed.
- Contractor gets **REVENUE**, i.e. Cost Oil plus a share of Profit Oil (PO)
  - PO share shall yield a reasonable return (IRR) on risk investment.

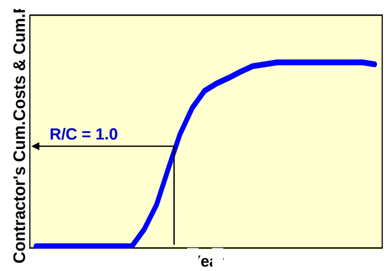


Profitability Based Revenue-over-Cost (R/C) - The Concept

- One of the "yardsticks" to gauge Contractors' profitability at any time is the RATIO of Contractors' **Cumulative REVENUE** over **Cumulative COSTS**.
- We define the above yardstick as **Contractors' R/C Index**

R/C Index = $\dfrac{\text{Contractors' Cumulative Cost Oil +Profit Oil From The Effective Date}}{\text{Contractors' Cumulative Petroleum Costs From The Effective Date}}$

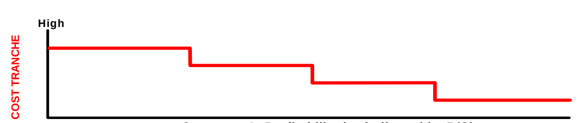




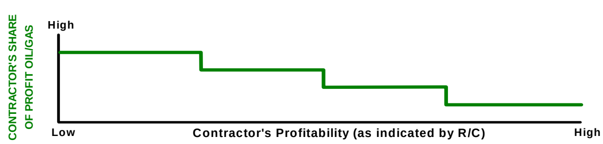
R/C = 1; Represents PAYOUT (undiscounted), but true Payout (considering time value of money, tax payment, etc.) occurs when R/C is around 1.4

Profitability Based Revenue-over-Cost (R/C) - A Progressive Fiscal System

- The basic principle of a progressive fiscal system is to allow Contractor to take more when its profitability is low and PETRONAS' take progressively increases when Contractor's profitability improves.
- Higher Cost Tranche is given when Contractors' Profitability is low and decreases as Contractor's Profitability increases.



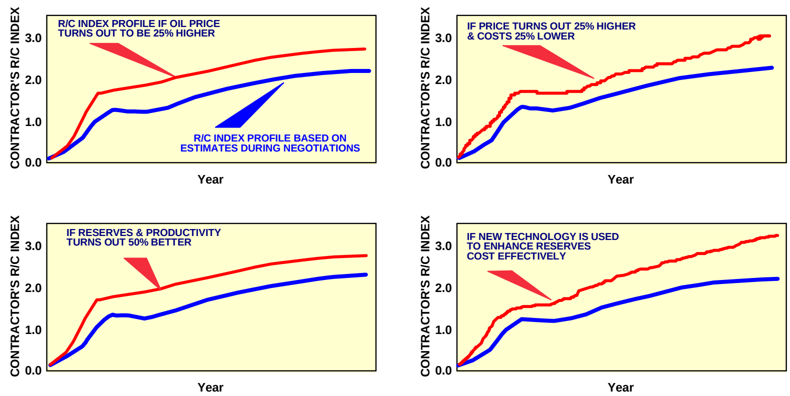
- Higher Contractor's share of Profit Oil/Gas is given when Contractor's Profitability is low and decreases as Contractor's Profitability increases.



PETRONAS

Profitability Based Revenue-over-Cost (R/C) - A Self-adjusting Mechanism

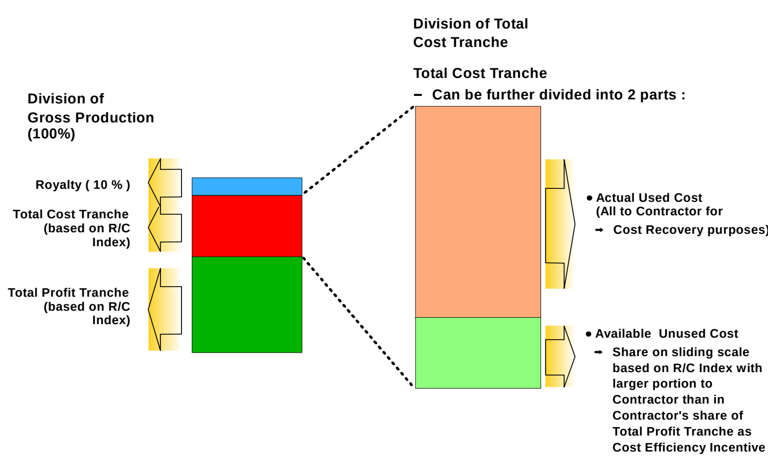
- Costs, Reserves & Oil Price are estimated based on current conditions and current Technology when a Contract is negotiated and agreed.
- Estimates likely to change, New technologies may evolve over time.



PETRONAS

Profitability Based Revenue-over-Cost (R/C) - Promoting Cost Effectiveness

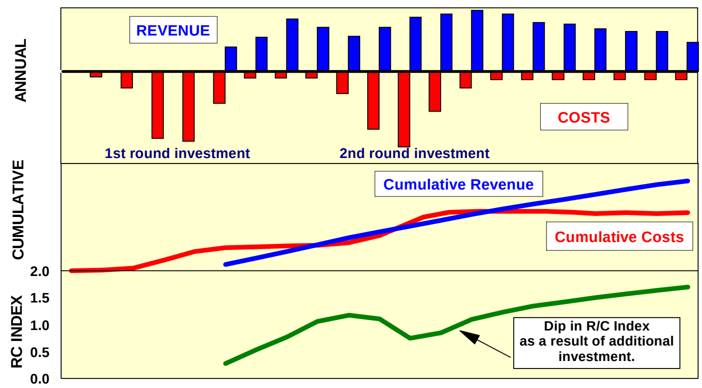
- Larger portion of the Unutilised Cost Tranche to Contractor than in Contractor's share of Total Profit Tranche will provide incentive for Contractors to lower their costs, i.e. the more they save, the more they gain.



PETRONAS

Profitability Based Revenue-over-Cost (R/C) - Promoting Re-investment

- The Re-Investment incentive encourages oil companies to continue investing in their Contract Area to generate more revenue.

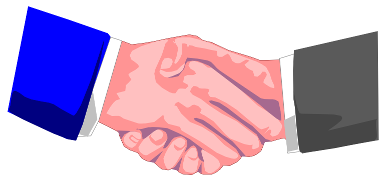


PETRONAS

Conclusion

- The Profitability Based Revenue-over-Cost (R/C) is a progressive, self-adjusting system which could help to generate fresh interest for exploration investment in Malaysia.
- The R/C system allows Contractors to have a higher take during the early life of a project when the economic health is poor and PETRONAS progressively increases its take later when the economic health improves.
- The Cost Reduction incentive will entice oil companies to focus on cost saving. This will lead to larger PSC "cake" and all parties having a bigger share.
- The Re-Investment incentive will encourage oil companies to continue investing in their Contract Area. This will in turn generate more revenue to be shared by all parties
- Contractors' economic return under our proposed R/C fiscal terms is comparable to those of the surrounding countries (e.g. Brunei, Philippines).
- Despite the incentives, the proposed formula does not mitigate the risk of unsuccessful exploration efforts as it is considered an integral part of the exploration and production environment.

Thank You for your Attention



PETRONAS

Comparison of the Production Rate/Volume and Profitability Based

Confidential- Limited Circulation

Production Rate/Volume Based	Profitability Based
• Progressive system with respect to volume. • Host Organisation take increases with increasing production rate/volume. • May not fully reflect profitability of a project (e.g. bigger field in a remote or deeper water area).	• Progressive system with respect to profitability. • Host Organisation Take increases as economic health of project improves (indicated by a R/C Index).
• Insensitive with respect to changes in economic climate or investment level.	• Flexible and self adjusting with respect to changing economic climate, geologic prospect and investment level.
• Gives rise to distorted incremental economics. • First field / project enjoys higher profit splits / benefits. • Hardly any incentives for investment in subsequent fields / projects.	• Provide realistic incremental economics. • dynamic balance in profit sharing between Host Organisation and Contractor. • Provide incentive for re-investment.