
THE GLOBAL REGULATORY DEVELOPMENTS JOURNAL

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Production Sharing Agreements Accounting Procedures: Getting Both Sides to Do It Right

David Hesse and Philip Mace*

In this article, the authors explain why, for host states, the accounting procedure in a production sharing agreement should be treated as a key fiscal instrument, not an administrative attachment.

Over the past 60 years, production sharing agreements (PSAs)¹ have become the predominant vehicle for foreign investment into new petroleum ventures following the 1962 UN General Assembly resolution 1803 on Permanent Sovereignty over Natural Resources (1962 UN Resolution), and the cost recovery system pioneered by Indonesia in 1966.²

Simply put, under the PSA model, the host state retains sovereignty over its natural resources until petroleum is produced and the international oil companies (IOCs) become entitled to their share of production. IOCs are thus incentivized to explore diligently and successfully. If they do not discover, develop, and produce oil or gas they lose millions, if not hundreds of millions, of dollars. If they get to production, they recover their costs and share in production with the host state or national oil company (NOC)—a carrot and stick (coupled with a win-win) approach.

PSAs have been used many hundreds of times throughout Asia, Africa, and Latin America. There have been numerous PSA success stories (for example, Indonesia and Malaysia in Asia, Libya and Algeria in North Africa, Angola and Nigeria in Sub-Saharan Africa, and Brazil and Guyana in the Americas). However, notwithstanding the great number of successful PSA projects witnessed since the 1960s, implementation of the PSA has not gone without some significant challenges, particularly with respect to the cost recovery aspect of the model.

The PSA

PSAs vary from country to country in a variety of ways, such as the host state's profit share, the IOC's cost recovery cap, the IOC's minimum work and expenditures, the host state's tax incentives, or the level of stabilization protection against future legislative or regulatory changes. However, the fundamental driving force behind the PSA regime is a constant:

The host state grants the IOC exclusive rights on sovereign territory to explore a defined area for subsurface petroleum deposits for a period of 3 to 7 years. In exchange, the IOC agrees to spend a substantial amount (often hundreds of millions of dollars) over that period to explore for petroleum and, if successful, to spend substantially more (often billions of dollars) to develop producing oil and gas fields. The IOC is likely to be entitled to retain its interest for the next 20 to 25 years, recover its costs and share in the production with the host state or NOC.³

Accounting Procedures and Cost Recovery: Records, Reports, Statements, and Audits

The IOC is expected to keep detailed and accurate records of its costs over the exploration/appraisal period and, if successful, the development period. Once production begins, it is entitled to recover eligible costs that it has incurred through the cost recovery mechanism. Cost recovery is, therefore, a key economic component of the PSA regime. In reality, the IOC's costs are only relevant under the PSA if petroleum is produced. This factor alone may explain why in many cases, IOC cost recovery statements for exploration and appraisal expenditure are often incomplete, incorrect, or not submitted on time. To complicate matters, in some countries, where the petroleum sector has yet to fully develop, governments and regulatory agencies may not have the technical capacity or compliance support to adequately monitor or audit the cost recovery statements submitted by the IOC. Such failure on both sides to adequately record, monitor, and agree upon cost recovery amounts for exploration and appraisal may have a serious impact on moving

the project forward to development once a commercial discovery is made.

The IOC will generally be required to submit quarterly and annual cost recovery statements to the host state or NOC. If the IOC is successful and begins commercial production, these statements will be used to calculate its share of production for cost oil or cost gas. The PSA will typically contain provisions setting forth the IOC's obligations to prepare and maintain records of petroleum operations and activities in accordance with accepted international petroleum industry practices and standards. The PSA will also contain an accounting procedure annexed to the back of the PSA.

The accounting procedure is one of the most important protections for the host state's economic interest. Although often treated as a technical annex, it directly affects how much production the contractor can take to recover its costs (as cost oil or cost gas), how quickly those costs can be recovered, and therefore how much profit oil or profit gas remains for the state. Weak accounting rules can significantly erode government revenue even where the headline fiscal terms appear strong.

In general, the accounting procedures set forth:

- which costs are recoverable and which are not,
- when costs may be recovered,
- whether costs are treated as capital or operating expenditures,
- how shared costs are allocated,
- how affiliate transactions are valued,
- the statements the IOC is required to submit and the periods covered by such statements, and
- how the state may audit the IOC's records and accounts and the procedure for disputing costs.

Keeping Track of the Nitty Gritty

Over the past 20 to 30 years, parties have relied heavily on various PSA models circulated through the world, and many PSAs have been signed without sufficient attention being paid to the cost recovery regime. In fact, it is not uncommon to find the same typos in the accounting procedure for PSAs entered into by different countries.

Common Drafting Issues

Several recurring weaknesses create revenue risk for host states:

- overly broad definitions of recoverable costs;
- no clear rules on what non-recoverable costs are;
- weak controls on IOC head office overhead;
- limited rules for affiliate transactions;
- unclear cost allocation methodologies;
- ambiguous depreciation or amortization rules;
- inadequate treatment of salvage, refunds, rebates, or insurance proceeds;
- poor alignment between the PSA body and the accounting procedure;
- short audit periods and limited rights of access; and
- heavy reliance on external accounting standards without giving priority to the PSA text.

These drafting gaps often become the source of later disputes and may shift substantial economic value away from the host state.

Audit Rights

Even well-drafted accounting procedures are ineffective if the state cannot verify compliance. Audit rights are therefore essential. The host state should have access to books, invoices, contracts, affiliate records, procurement files, and supporting calculations, and should have enough time to conduct meaningful reviews. Short audit limitation periods are risky, especially when government capacity is weak or records are difficult to obtain. The procedure should also clarify the consequences of unsupported or disallowed costs.

Documentation standards are equally important. The accounting procedure should specify the form of accounts, the applicable accounting standard, the bookkeeping currency, exchange rate methodology, retention periods, digital access requirements, and the obligation to maintain records in a usable and reviewable format. Without strong recordkeeping obligations, the state may struggle to challenge costs years after they are incurred.

Host state capacity is a practical issue running through all of these topics. Petroleum accounting involves technical, legal, tax,

commercial, and engineering judgments. Ministries and regulators often require specialist auditors, cost accountants, transfer pricing expertise, and coordination with revenue authorities and national oil companies. Where state institutions are fragmented or under-resourced, even a strong accounting annex may not be effectively enforced.

Conclusion

For host states, the accounting procedure in a PSA should be treated as a key fiscal instrument, not an administrative attachment. It is a vital tool to protect the integrity of cost recovery and preserve the intended production sharing balance between the contractor and the state. In practical terms, host states should seek accounting procedures that are precise, enforceable, and aligned with the core PSA fiscal terms. This can be achieved with careful drafting and the involvement of all relevant stakeholders. In addition, it is essential that the host state has the capacity and training to monitor and enforce its rights under the PSA (including the accounting procedure) on an effective basis throughout its term.

Notes

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1. Reference to PSA also includes production sharing contracts (PSCs) and exploration production sharing agreements (EPSAs).

2. The Indonesian PSC: the end of an era, Brad Roach, Alistair Dunstan, *Journal of World Energy Law & Business*, Volume 11, Issue 2, Pages 116-135, 2 April 2018.

3. In most cases, the host state or NOC will ask the IOC to confirm that it has the economic, financial, and technical ability to explore, develop, and produce any commercially viable petroleum discovered. After all, the host state is putting all its eggs in one basket for three to seven years for the exploration area in question, so it is important for the host state to know the IOC has what it takes.