FINANCIAL ACCOUNTING FOR PRODUCTION SHARING AGREEMENTS

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Overview

A Production Sharing Agreement (PSA), sometimes referred to as a Production Sharing Contract (PSC), is an arrangement used in the upstream sector for the exploration and production of petroleum resources. It is a contract between one or more investors and a government in which rights regarding exploration and extraction of mineral resources are determined. The purpose of the PSA, compared to other types of concession agreements, is to allow for the development of resources by utilizing an oil and gas entity's expertise and financial capability while retaining the sovereign rights over the resources. Accordingly, they are a common method used to facilitate the exploitation of a country's hydrocarbon resources and have been widely adopted by many developing countries. While there is no standard form of PSA, most demonstrate similarities in regard to structure and substance.

A typical PSA mandates that an oil and gas entity will be required to supply all the capital necessary to undertake their responsibilities under the agreement. These responsibilities may include such things as performing exploration activities (usually within a set timeframe), the development and production of found resources and the construction of all necessary infrastructure. The PSA will also define the quantum and metric by which the government will receive their portion of production output of the PSA. For example, the government may take their share of oil in kind or it may be paid in cash under an agreed pricing formula.

In exchange, the oil and gas entity will have the right to extract the resources over a specified period of time which is usually the full production life of the field. The oil and gas entity will be entitled to a share of the oil produced which will allow for the recovery of specified costs ("Cost Oil") plus an agreed profit margin ("Profit Oil"). Notwithstanding that the oil and gas entity has funded all activities under the PSA, the government will retain title to all of the hydrocarbon resources and, oftentimes, the legal title to all fixed assets constructed to exploit the resources.

While PSAs are not standard and may even differ within the same jurisdiction, these differences should not impact the principles underpinning the recognition of exploration and evaluation (E&E) assets or production assets. Costs that meet the criteria of IFRS 6, IAS 16 and IAS 38 should be recognized in accordance with the usual accounting policies where the entity is exposed to substantial economic risks and will accrue the probable future economic benefits of the assets.

Cost Capitalization

When the oil and gas entity bears the exploration risk of a PSA, the rules for cost capitalization are similar in approach to non-PSA projects. Specifically, expenditures incurred in the exploration and development phase of the project will be capitalized in accordance with the requirements of IFRS 6, IAS 16 and IAS 38. In this case, the reserves used for depreciating the constructed assets will be those attributed to the reporting entity for the duration of the PSA. The probable hydrocarbon reserves and current prices should support that the exploration and extraction, development and fixed asset investment will be recovered during the life of the PSA.

Where an entity is exposed to performance risk rather than exploration risk, the cost capitalization rules are somewhat different. While the entity can continue to capitalize the exploration, evaluaton and development costs, they are not classified as Property, Plant and Equipment (PP&E) under IAS 16. In this case, the entity would report a receivable from the government where equal to the allowable cost recoveries plus the profit margin in accordance with IAS39/ IFRS 9.

Revenue Recognition

For PSAs where the entity bears the exploration risk, its share of revenues (both the Cost Oil and the Profit Oil) shall be recorded when the oil is produced and sole. The entity should record revenue only when the hydrocarbon production commences and only to the extent to which it is entitled. Oil and gas extracted and/or sold on behalf of the government should not be recorded as revenue or a cost of production as the entity, in this capacity, is acting as the government's agent only.

If the entity bears the risk of performing the contract rather than the actual exploration activity, the expenditure incurred in respect of the exploration and development of the asset is capitalized as a receivable from the government rather than as a fixed asset. When the outcome of the PSA can be reliably estimated, the percentage of completion method will be used to determine the amount of revenue to be recognized and which will include the expected profit margin.

Decommissioning

The decommissioning of oil and gas production assets may be required by law, the terms of the operating licences or for other reasons. Decommissioning creates an obligation and, hence, a liability under IFRS.

Some PSAs require that a decommissioning or abandonment fund be established with the objective of offsetting future decommissioning costs. The PSA may require that contributions to these funds be made on an annual basis until the date of decommissioning or allow them to be made on a voluntary basis prior to the decommissioning date. There are several ways that decommissioning is addressed in PSAs however there are three methodologies most commonly used.

The most commonly used decommissioning arrangement requires that the operating entity perform the decommissioning activity using the fund established for that purpose. Another, less common method, requires that the entity pay for the decommissioning and then claim for reimbursement from the fund. Lastly, the government may opt to take control of the asset at the end of the PSA term, take over the decommissioning obligation and also the entitlement to the established decommissioning fund.

In all cases, the oil and gas entity should recognize their obligations to pay decommissioning costs as a liability and recognize their interest in the decommissioning fund separately. Accounting for their share of the fund should be performed in accordance with relevant accounting standard recognizing their level of control the fund - full, joint or significant - as the case may be.

About the Author:

Katrina LaRocque is the president of Petrotech Consulting Services Ltd., an international company which provides accounting, audit and advisory services to the oil and gas industry. Ms. LaRocque has written numerous articles, papers and essays related to oil and gas accounting and has lectured on various industry matters.