Chapter 13

Sharing of Profit Petroleum

13.1 The issue of sharing of profit petroleum was added to the terms of reference of the Commission *vide* Presidential notification dated 31st October, 2003. This notification requires the Commission to make recommendations on the following :

(i) "Whether non-tax income of profit petroleum to the Union, arising out of contractual provisions, should be shared with the states from where the mineral oils are produced; and,

(ii) If so, to what extent".

Profit Petroleum

13.2 Profit petroleum is in the nature of non-tax revenue receivable by the central government out of the profit generated on account of production of crude oil and natural gas from the fields awarded by the government under a production sharing contract (PSC). Central government becomes entitled to a share in profit if, in the event of commercial production, a project generates profit. The formula for sharing of the profit is specified in the relevant PSC.

Background

13.3 The "regulation and development of oil fields and mineral oil resources; petroleum and petroleum products; other liquids and substances declared by Parliament by law to be dangerously inflammable" is included as entry 53 in the Union List of the Seventh Schedule to the Constitution of India. Accordingly, the Oil-fields (Regulation and Development) Act, 1948 (ORDA) was enacted by the Parliament. The Petroleum and Natural Gas Rules, 1959 (P&NGR), framed under this Act, lay down the terms and conditions for grant of exploration licenses and mining leases in respect of petroleum and natural gas. But, the central government is at liberty under the Act to authorize granting of mining lease on terms and conditions different from those laid down in the rules.

13.4 In terms of articles 294-296 of the Constitution, the ownership rights on all land and mineral resources located within the territory of the state, rest with the state. It is in recognition of this constitutional right that the P&NGR provide that a license or lease in respect of any land vested in a state government shall be granted by the state government, albeit with the previous approval of the central government. In addition, section 6A of the ORDA specifically creates a liability on the holder of a mining lease for payment of royalty in respect of any mineral oil mined, quarried,

excavated or collected by the holder from the leased area at the rate specified in the Schedule in respect of that mineral oil. As regards the authority to whom royalty is to be paid, rule 14 (1) of P&NGR states that:

"(1) (a) Notwithstanding anything in any agreement, a lessee shall

(i) where the lease has been granted by the central government, pay to that Government

(ii) where the lease has been granted by the state government, pay to that Government

a royalty …………..".

It is, therefore, clear that the royalty is payable to the state for on-shore areas and to the centre, for off-shore areas. But, under the ORDA, the central government has the authority to enhance or reduce the rates of royalty.

13.5 Keeping in view the ownership rights of the states over the land within their territory, the exploration blocks in the on-land areas are offered to national oil companies or to others by the central government after obtaining the concurrence of the respective state governments.

Mining Lease/Licence for Oil and Gas Exploration

13.6 The Ministry of Petroleum and Natural Gas (MOP&NG) has informed us that at present there are five different regimes in the matter of mining lease/ licenses for exploration of oil and gas, namely :

a) Petroleum Exploration License (PEL) and Petroleum Mining Lease (PML) granted to national oil companies [Oil and Natural Gas Commission (ONGC) and Oil India Ltd. (OIL)],

b) Mining Licences granted under small size discovered field PSCs,

c) Mining Licences granted under medium size discovered field PSCs,

d) Petroleum Exploration License and Petroleum Mining Lease granted under pre-NELP PSCs, and

e) Exploration Licences granted under the New Exploration Licensing Policy (NELP).

13.7 Under the first regime, exploration blocks were offered to national oil companies on nomination basis. These companies are required to pay full statutory levies viz. royalty to the state government/ central government for on-land/off-shore areas and cess to the central government. The combined burden of royalty and cess on the national oil companies at present works out to more than Rs 3000 per metric tonne. National oil companies pay customs duties in the nomination fields, in case of petroleum mining licenses granted prior to 1.4.1999. ONGC and OIL have also incurred substantial exploration costs in discovering oil and gas in on-land and off-shore areas.

13.8 Some of the small and marginal fields discovered by ONGC and OIL were offered to other parties for rapid development under two rounds of bidding in the year 1992 and 1993. In the PSCs relating to those fields, the rates of royalty and cess were frozen with a view to providing fiscal stability i.e. a stable tax regime to the contractors. In order to ensure that the states get royalty from on-land blocks at full rates i.e. 20 per cent, the

difference is paid to the states through Oil Industry Development Board. The central government has exempted the imports from customs duties and has frozen the cess for the life of the contract at the rate of Rs 900 per metric tonne as against the normal rate of Rs 1800 per metric tonne effective from 1st March, 2002.

13.9 Prior to 1997, in the pre-NELP exploration blocks, the two national oil companies as licensees, were required to bear all the liability of statutory levies, namely royalty and cess, but the exploration blocks were offered to various companies in order to attract private investments in exploration and production of oil. The private companies were selected through a bidding process. As per the PSCs under this regime, the share of the national oil companies could be up to a maximum of 40 per cent and the parties to the contract are to share profit oil and profit gas separately from each field on the basis of post-tax returns. Royalty is paid to the state for on-land areas at the same rate as applicable in the nomination blocks/fields i.e. at the rate of 20 per cent. Further, central government forgoes its revenues by granting customs duty exemption on imports required for exploration, development and production. At present, two fields are on production under this regime, and ONGC has so far incurred an expenditure of about Rs 250 crore towards statutory levies. This way, ONGC and OIL are carrying an additional burden, for which there are no provisions in the PSCs.

13.10 The system of offering exploration blocks to various parties was modified in 1997 with the introduction of the NELP, under which the national oil companies and private players are treated at par and are required to compete with each other for acquiring exploration acreages under uniform contractual and fiscal framework. As regards PSCs entered into under NELP, the policy was announced by the government in 1997 and it became effective in 1999, after completion of relevant requirements, including concurrence from state governments. Under NELP, ONGC and OIL compete for obtaining the petroleum exploration license instead of being nominated. The net revenue remaining after deduction of royalty and costs (i.e. pre-tax profit) is to be shared between the contractor and the government of India on the basis of an investment multiple system. The contractor is allowed full cost recovery on all costs incurred in an exploration block. All companies are required to pay royalty at the rate of 12.5 per cent on crude oil to the state governments for on-land areas and at 10 per cent to central government for shallow water areas. Royalty is payable at half the rate i.e., at 5 per cent, to the central government for deep water areas for the initial seven years of commercial production. Half the royalty from off-shore areas is credited to a hydrocarbon development fund to promote and fund exploration related activities. Under NELP, government has exempted companies from payment of cess on crude oil. Further, imports have been exempted from custom duties and a seven year tax holiday is available from the date of commencement of commercial production. In forgoing the revenues, the objective of the central government is to encourage exploration of oil and gas and find more reserves to meet economic growth and strategic requirements of the country.

13.11 Apart from Gujarat and Assam, which are the two major oil and gas producing states, blocks have, at present, been offered under NELP in nine other states, namely Andhra Pradesh, Bihar, Himachal Pradesh, Madhya Pradesh, Mizoram, Nagaland, Rajasthan, Tripura and West Bengal.

The Issue

13.12 The MOP&NG has informed us that, after approval of NELP by the cabinet, the matter was taken up with the state governments for obtaining their concurrence. While concurring with the New Exploration Licensing Policy, which reduces the rate of royalty from 20 per cent to 12.5 per cent, government of Gujarat maintained that the central government should share at least 50 per cent of the profit petroleum under the PSCs with the state government. Similar requests were also made by the governments of Assam and Madhya Pradesh. The claims of the state governments were referred to the Ministry of Law, which opined that the legal issues raised were not quite sustainable, as the regulation and development of oil fields and mineral oil resources is a subject of the central government under entry 53 of the Union List and is clearly outside the purview of states. However, since the state governments have been given the benefit of certain arrangements/practices under P&NGR for the areas falling in the states, such as the authority to grant license, lease etc. and receive rents, fees and royalties, there would not be any constitutional or legal objection if, in the same spirit, the central government decided to share profit petroleum under the PSCs with the state concerned in the interest of cordial centre-state relationship.

Views of States

13.13 The Commission sought the views of the states on the basic issue of sharing of profit petroleum as well as the criteria for distribution of the profit. States have sent varied responses on the issue of sharing of profit petroleum. Andhra Pradesh, Assam, Jharkhand, Manipur, Nagaland and Rajasthan support the sharing of profit petroleum with the producing states. While Assam, Nagaland, Rajasthan have favoured a sharing between the centre and the states in the ratio of 50:50, Manipur has suggested sharing with mineral oil producing states in the same proportion as other taxes/duties. Assam has referred to the proprietary rights of states over the petroleum reserves and has added that when the state consented to the NELP, it clearly stated that the state should get a share of the profit, especially in view of the lower rates of royalty fixed under the NELP. Rajasthan has also made a similar submission in the context of the rights of the state by virtue of its ownership of the land and minerals, the power given to the state to grant leases and the inadequacy of rates of royalty. Assam, Nagaland and Rajasthan have also referred to the expenditure incurred by them on development of infrastructure, provision of essential public services and to environmental costs in order to facilitate oil exploration and development. Jharkhand has suggested a share of 15 per cent of profit for the petroleum producing states. Andhra Pradesh has suggested sharing of profit petroleum to the extent of 50 per cent according to the present procedure of collection and 25 per cent if states are permitted to collect royalty from off-shore and provided a share in the oil development cess. Maharashtra has suggested that the

states' share of 'profit petroleum' in respect of petroleum produced in the state or in contiguous high seas be fixed at 50 per cent. The same logic must be extended in respect of other minerals being mined by central public sector undertakings in the state.

13.14 Haryana, Himachal Pradesh, Orissa, Punjab, Uttaranchal and Uttar Pradesh have suggested that profit petroleum should be shared not only with the producing states but with all the states. While Haryana has recommended determination of the share of each state on the basis of per capita consumption, Punjab would like this income to be part of the divisible pool with at least 40-50 per cent of profit petroleum devolved to all the states. The *inter se* distribution may be made as per the same formula as for the share of Union taxes/duties. Orissa has also suggested that the profit from petroleum should be brought into the divisible pool to be shared with all states, but in proportion to the consumption of petroleum products. Chhattisgarh is of the view that the central government cannot raise revenues for itself from on-shore mineral oil, which vest in the state concerned. The revenues from petroleum, whether accruing from on-shore or off-shore oilfields, should be in the nature of receipts under Union excise duty and form part of the shareable pool of taxes and apportioned on the same basis as other receipts in the shareable pool of taxes. Himachal Pradesh has suggested that any profit income, that has accrued to the Union government, should be made part of the total shareable pool, because the profits arise from sales across the country and not in the state of origin alone. Profit income is not and should not be made specific to the state of origin.

13.15 Chhattisgarh, Madhya Pradesh, Orissa and Tamil Nadu have represented that if it is accepted that mineral oil producing states have a right on profit petroleum arising out of contractual provisions entered into by the Union government, the same principle should be recognized in the case of other minerals.

13.16 Goa, Jammu and Kashmir, Karnataka, Meghalaya and Sikkim have no comments on the matter, as mineral oils are not produced in these states.

13.17 Kerala has suggested that if non-tax revenue is to be shared, sharing should not be confined to any particular item and instead, the entire non-tax revenue of the Union government should be shared with the states as per formula arrived at by the Finance Commission. However, if only profit petroleum is to be shared, it should be given to the concerned states only after factoring in the receipts from the Union government as projected to the Finance Commission.

13.18 The stand of Gujarat is somewhat different from other states. The contention of Gujarat is that as per article 296 of the Constitution, the states have ownership rights on all lands and minerals located within the territory of the state. Under article 297, all lands, minerals and other things of value underlying the ocean within the territorial water or the continental shelf or exclusive economic zone of India vest in the Union and are held for the purpose of Union. These provisions clearly establish ownership rights of the state government as well as government of India. All petroleum resources located within the territory of the state are, therefore, the property of the state. Under the constitutional provisions,

government of India has only legislative competence for regulation and development of oil fields and mineral oil resources, petroleum and petroleum products etc. Under the P&NGR, petroleum exploration license or mining lease is to be issued by the state government in on-shore areas after prior approval of government of India. Further, the royalty on production from on-shore areas is to be paid to the respective state governments. Special conditions, if any, on exploration license or mining lease by government of India, can be imposed only in consultation with the respective state government for on-shore areas. A reference has also been made to the rates of royalty, stating that these are lower than the maximum rate of 20 per cent indicated in the rules and that in the non-NELP oil fields also the royalty rate would decrease to 12.5 per cent. The state has also referred to environmental costs and to the costs incurred by it for development of infrastructure and public services.

13.19 In the opinion of the government of Gujarat, the constitutional provisions do not confer on the central government, ownership rights of the petroleum resources located in on-shore areas. The issue regarding ownership of petroleum resources for on-shore areas is further clarified by the fact that royalties are payable to the state government and the royalty payments, by their nature, are required to be made to the owners. Government of Gujarat has stressed that sharing of profit in any commercial activity is a right, which only the owner can exercise. Since the government of India is not the owner of on-shore hydrocarbon resources, it cannot exercise such rights.

13.20 Government of Gujarat has, therefore, suggested that the central government's claims to future profit petroleum should be devolved to respective state governments. Tripura has also expressed a similar view and stated that the entire profits derived under PSCs should go to the state concerned. Government of Gujarat has, however, further submitted that past receipts of the central government from on-shore production should also be reimbursed to respective state governments. The profit petroleum arising from ONGC's operations (not covered under NELP) should also be made available to the state government by applying the profit petroleum formula and by making retrospective payments to the state.

Views of the Ministry of Petroleum and Natural Gas

13.21 MOP&NG is of the view that for the acceleration of exploration efforts in the on-land areas, the support and cooperation of the state governments is critical. State governments grant PELs and PMLs for the on-land areas located in the states. Without the grant of these licenses, no legal right can flow for exploration and production of crude oil and natural gas. State governments also give approvals for land acquisition, laying of pipeline etc. In the absence of full cooperation of state governments, exploration and production would suffer. As these are high risk activities, no estimation of recoverable costs and profits can be made with certainty. Actual accruals of profit petroleum from the NELP blocks may start only after 8 to 10 years of operations during which period costs are expected to be recovered by the contractors. There are, however, uncertainties not only regarding

the time by which revenue flow would commence but even the quantum of receipts.

13.22 MOP&NG has further expressed the view that from a harmonious construction of the provisions of the Constitution, ORDA and P&NGR, it would appear that the central government is not prohibited from considering the claim of state governments regarding sharing of profit petroleum on "equity considerations". Hence, in order to promote centre-state relations and to seek maximum cooperation from state governments, sharing of profit petroleum between the centre and the respective states could be agreed to. MOP&NG would, however, like this arrangement to apply only in respect of the PSCs signed under the NELP and not under those signed prior to that.

13.23 Regarding the claims made by the government of Gujarat, MOP&NG has stated that the memorandum submitted by the government of Gujarat needs to be seen from the point of view of the requirement to attract investment for exploration and production of oil and gas, balancing the interest of the state government with national/public interest. It is also necessary that the states and the centre get reasonable shares from the development and production of hydrocarbon resources. As for profit petroleum from ONGC in particular, it has been stated that the concept of profit petroleum under the PSC is a different concept, where the contractors are first given the right to recover the entire cost incurred in exploration, appraisal, development and production after payment of all statutory levies. ONGC, on the other hand, has taken a risk and invested huge resources in the exploration of oil and gas all over the country, as well as in off-shore areas, which includes Gujarat. Irrespective of profit or losses, it is required to pay all statutory levies and taxes as may be specified from time to time. The state government gets royalty as per the P&NGR. In addition, ONGC pays local taxes and its operations add to the benefit of the local economy. ONGC has been working in Gujarat for over forty years and is governed by the arrangement applicable to the nomination regime. The demand of the state government for profit petroleum from ONGC on notional basis is not justified, as ONGC operates under a different regime. ONGC, being a national oil company, is also required to incur certain liabilities in public interest from time to time. Recently, this liability involved bearing a portion of subsidy on kerosene and LPG, the fuels for mass consumption, the benefit of which has flowed to all people including those in Gujarat. In view of these factors, the ministry is of the view that the question of ONGC giving profit petroleum to the state should not arise inasmuch as the central government also does not receive any profit petroleum from ONGC or OIL from nomination areas/fields.

13.24 With respect to the demand of the government of Gujarat for sharing of profit petroleum for the oil and gas fields located in Gujarat under the PSCs for small size fields (all PSCs for discovered fields in Gujarat relate to small size fields), it has been stated that the government of India has provided fiscal stability to the contractor in the respective PSCs, whereby they are required to pay statutory levies at the rates specified in the respective PSCs, which have been frozen for the entire contract period.

Further, in order to promote development of marginal/small fields, the central government has also provided certain fiscal incentives, such as nil customs duty on imports for petroleum operations. The central government has also undertaken the liability to compensate the states including Gujarat for additional royalty as may be decided from time to time under the P&NGR and which is over and above the rate provided in the PSCs. The interests of the state governments are thus fully protected, as far as royalty is concerned. As such, in this case also, there is little justification for sharing profit petroleum.

13.25 As regards the PSCs under the pre-NELP regime, it has been stated that ONGC as a nominee has undertaken to pay royalty to the state as is applicable for its own nomination blocks/fields. In these exploration blocks, considerable liability has been passed on to national oil companies and the profit petroleum, which may accrue under the PSCs in case of commercial production, gets eroded by the liability of the national oil companies in respect of these PSCs. There is also a proposal to compensate national oil companies for the statutory levies borne by them on behalf of private companies. The issue of profit petroleum should not, therefore, be raised in isolation by Gujarat government. As for profit petroleum under NELP, it has been stated that the state has concurred with the terms of NELP. It had, however, separately demanded that the centre shares at least 50 per cent of the profit petroleum accruing to it under the PSCs. Under NELP, the royalty rate for on-land area for crude oil is 12.5 per cent as compared to the rate of 20 per cent applicable for nomination blocks to ONGC. In view of the lower rate of royalty under NELP and the over all scenario, the profit petroleum under NELP PSCs could be shared with the state in the ratio of 50:50. MOP&NG has concluded by stating that the demand for a share in profit petroleum by the state should be seen in the context of the overall fiscal regime, the impact on the revenues of the central government, overall public interest/national interest as well as the need for a reasonable share to the state government from its national resources.

Views of the Ministry of Finance

13.26 The Ministry of Finance has stated that the profit petroleum is a new source of non-tax revenue for the government and is likely to become important after a few years. Keeping in view the long term implications, in case the Commission feels it necessary to provide a certain share of this non-tax revenue to states, it should be within the overall ceiling to be prescribed for the transfers to states from the gross revenue receipts of the centre. The Ministry has also requested the Commission to keep in view the implication of sharing one particular stream of non-tax revenue with states as this may lead to requests for sharing of other sources of non-tax revenue of the centre, as well.

Our Approach

13.27 We have examined the suggestions made by the states, the Ministry of Petroleum and Natural Gas and the Ministry of Finance, keeping in view the specific constitutional provisions in this regard as well as the overall context of centre-state fiscal relations.

13.28 As far as regulation and

development of oilfields are concerned, we are inclined to agree with the view expressed by the Ministry of Law that it is a subject given to the Union under the Constitution. Parliament has given the powers of licensing and earning of royalties to the states through the ORDA. Even in the matter of additional conditions to be put on a license, the central government is required to consult the state government concerned but not necessarily take its consent. The central government is also entitled to fix the rate of the royalty, keeping in view the overall interests of development of the industry. Further, while the Act and rules provide for payment of royalty, there is no mention of profit petroleum, which flows from the arrangements between the central government and the contractor. The payment of royalty to the state recognizes adequately the ownership of the state over its land and mineral resources. The contention that the profit petroleum should accrue exclusively to the states of origin is, therefore, not tenable.

13.29 The next issue is whether the profit petroleum accruing to the central government as per contractual arrangements could be shared with the mineral oil producing states. In our view, the ownership of the land and mineral clearly confers a right on the state to revenues arising out of the exploitation of the minerals. It is in view of this that the state is entitled to a royalty. When the rates of royalty are reduced from existing levels for speedier development of the sector, it is natural that the states would expect to be compensated at a later date, once the uncertainties are over and profits start accruing.

13.30 We have been informed that the NELP provides for a reduction in the rate of royalty from the existing 20 per cent to 12.5 per cent with a view to encouraging petroleum exploration and mining. To this extent, there is a sacrifice involved on the part of the state concerned in respect of revenues that would otherwise be due to it. The states, where mineral oil is produced, have obviously consented to the NELP in the expectation that profit petroleum would be shared. It would, therefore, be appropriate for the central government to agree for a certain share in profit petroleum for the states in which the exploration blocks are offered under the NELP. The share of the state concerned should, however, be commensurate with the sacrifice made in terms of loss of revenue from royalty. We are also conscious of the fact that profit petroleum from the blocks offered after introduction of the NELP will only accrue after our award period. In the meantime, states may suffer a revenue loss on account of lower royalty rates.

13.31 MOP&NG has drawn our attention to substantial revenues forgone by the central government by exempting companies from payment of customs duty on imports for exploration, development and production activities as well as granting seven year tax holiday for discoveries made after 1998. These fiscal incentives have been granted by the central government in order to attract risk capital in the country to explore areas for oil and gas. Even in the case of NELP blocks, although the state governments have been persuaded to agree to a lower royalty rate for on-land areas for crude at 12.5 per cent compared to 20 per cent applicable for the earlier regime, the central government is forgoing its revenues

by exempting companies from payment of cess on crude oil as well as customs duty on imports. Keeping these factors in view, the MOP&NG has suggested sharing to the extent of 50 per cent of the profits earned by the central government. Most of the states that produce mineral oil and gas have agreed to this suggestion. In the circumstances, we recommend that the non-tax income of profit petroleum to the Union, arising out of contractual provisions in the case of NELP blocks, may be shared in the ratio of 50:50 with the states from where the mineral oils are produced.

13.32 The additional term of reference given to us does not distinguish between the profit petroleum from NELP blocks and those under PSCs signed prior to the adoption of the NELP. However, the MOP&NG has suggested sharing of profits in respect of the PSCs under the NELP only. Profit sharing has not been recommended in respect of nomination fields held by the national oil companies on the ground that the burden of royalties as well as other taxes and duties, including local taxes is discharged by the national oil companies under the prevalent fiscal regime. In the case of PSCs signed for discovered fields, the Ministry, while not supporting sharing, has pointed out that although these contracts provided for freezing of royalty rates for the duration of the contract in the interest of fiscal stability for the contractor, states are entitled to a compensation by the centre, if the royalty rate fixed under the P&NGR is higher than the rate agreed to in the PSC. We, therefore, agree with the MOP&NG that the question of sharing of profits in respect of nomination fields and non-NELP blocks does not arise.

13.33 While submitting its views to the Commission, the MOP&NG had informed us that the claims of states in respect of non-tax revenue relating to 'Production Level Payments' and 'Commercial Discovery Bonus' on contracts signed under the coal bed methane policy would also be referred to this Commission. But this has not been done. It is, however, felt that the approach to sharing of the revenues with the states concerned would have to be uniform for petroleum and coal bed methane. We, therefore, recommend that revenues earned by the central government on contracts signed under the coal bed methane policy may also be shared with the producing states in the same manner as profit petroleum.

13.34 Some states have contended that if profit petroleum is to be shared with the producing states, profits on other minerals should also be shared with the producing states. We have recommended sharing of profit petroleum only in the case of NELP contracts, where the states are likely to lose revenues from royalty due to lower royalty regime. Our intention is not to recommend sharing of non-tax revenues with the states as a general principle. But, recognizing the need for equitable treatment in respect of all minerals, we recommend that wherever loss of revenue is anticipated for a state in the process of implementation of a policy, which involves production sharing, a similar compensation scheme must be put in place by the central government.

Recommendations

13.35 To sum up, our recommendations are as follows :

(i) The Union should share the profit petroleum from NELP areas with the

states from where the mineral oil and natural gas are produced;

(ii) The share should be in the ratio of 50:50;

(iii) There need not be sharing of profits in respect of nomination fields and non-NELP blocks;

(iv) The revenues earned by the central government on contracts signed under the coal bed methane policy may also be shared with the producing states in the same manner as profit petroleum; and

(v) In respect of any mineral, if a loss of revenue is anticipated for a state in the process of implementation of a policy, which involves production sharing, a similar compensation mechanism should be adopted by the central government.

❑❑