

Answer on Question#39493 – Economics - Other

Assignment

How to find total costs that have to recovered if the firm is to make profit...

Solution

Technically, you don't make profits out of cost recovery. Cost recovery barrels are the "bad barrels", as opposed to profit barrels which are the "good barrels". Bad in the sense that it always gives you a negative impact on bottom line value. This is true of course if the nature of the cost itself is non-value generating. Everytime you spend \$1.00 of non-value generating cost recovery, then the PSC contractor will have to absorb a negative financial impact of \$0.15 after cost recovery and tax in a typical oil PSC where the pre-tax profit split is 71% : 29% with a 48% total tax rate. Value-wise it's always bad as you tend to spend the money first before you recover it through production, hence time-value wise it's always a negative as well, even if you're allowed to cost recover all costs immediately. The value of these bad barrels is even worse if cost recovery is charged over several years of PSC depreciation (for capital expenditures), widening the time gap between cash outflow from the pay-out and inflow from cost recovery barrels and tax deductibility. This alone is a strong enough reason why a PSC operator should always strive to be as efficient as possible.

Strangely enough, there are accusations and speculations raised by so many parties that the PSC contractors are not efficient, tend to spend as much as they want uncontrollably, and even make profits out of cost recovery. Those accusations are probably mostly caused by a common misunderstanding that all the expenditures in the PSC are cost recoverable and that cost recovery is a cost reimbursement mechanism for the contractor paid by the government by giving away the cost recovery barrels. I've written another article in this site proving that the misunderstanding is of course wrong. True reimbursement would keep the contractors value-neutral, something which the cost recovery and tax mechanism in the PSC does not achieve as the contractors' financials are still adversely impacted by cost recovery.