

Treatment of Royalty Paid in Dispute, Pending the Final Decision of the Court

The following is the opinion given by the Expert Advisory Committee of the Institute in response to a query sent by a member. This is being published for the information of readers.

A. Facts of the Case

1. Royalty on production of crude oil, casing head condensate and natural gas is paid to Central Government (for production from offshore fields) and to State Governments (for production from onshore fields) in terms of the statutory provisions of Oilfields (Regulation and Development) Act, 1948 (ORDA), Petroleum & Natural Gas (PNG) Rules, 1959 and Notifications issued thereunder from time to time.
 2. Upto March'98, petroleum sector was under Administered Pricing Mechanism (APM) wherein, the price of indigenous crude oil produced by oil producers (the company and other similar companies) was determined on the basis of operating cost and 15% post tax return on capital employed. Till March'98, under APM regime, royalty on crude oil in the Schedule to ORDA was fixed by the Government of India at specific rate in Rupees per metric tonne.
 3. In the year 1997, the Government of India vide Resolution dated 21st November, 1997 decided phased programme of dismantling of APM from petroleum sector starting from 01st April, 1998 and to be completed by 31st March, 2002. It was decided that cost-plus formula is withdrawn for indigenous crude oil producers and the price receivable by oil producers will be linked to increasing percentage of international crude prices in a phased manner i.e., domestic price would be equivalent to pre-announced percentage of weighted average free on board (FOB) price of actual imports of crude oil during the transition period (April'98 till March'02). However, royalty rates continued to be specific upto March'02.
 4. In terms of Government of India Resolution dated 21st November, 1997 and Resolution dated 28th March, 2002, petroleum products were decontrolled in the following manner:
 - (i) Consumer prices of all products except MS (petrol), HSD (diesel), Aviation Turbine Fuel (ATF), SKO (kerosene) for PDS and LPG for domestic crude were decontrolled w.e.f. 01.04.1998.
 - (ii) Pricing of ATF decontrolled w.e.f. 01st April, 2001.
 - (iii) Consumer prices of HSD (diesel) and MS (petrol) to be market determined w.e.f. 01st April, 2002.
 - (iv) The subsidies on a specified flat rate basis on PDS Kerosene and domestic LPG to be borne by Consolidated Fund of India from 01st April, 2002. These subsidies to be phased out in the next 3 to 5 years.
- Vide Resolution dated 28th March, 02, following was also decided:
- (i) The Oil Coordination Committee (OCC) will be wound up w.e.f. 01st April, 2002.
 - (ii) A Cell, by the name of 'Petroleum Planning and Analysis Cell (PPAC)' will be created under the MoP&NG effective 01st April'02 to assist the Ministry.
5. Meanwhile, keeping in view the proposed reform process in the hydrocarbon sector, i.e., Proposed dismantling of Administered Pricing Mechanism (APM), a Committee headed by Shri J.M. Mauskar, Joint Secretary (Exploration) in the Ministry of Petroleum & Natural Gas (MoP&NG) was constituted in the year 2000 for evolution of a new scheme of royalty w.e.f. 1.4.1998.
 6. Based on the recommendations of the Mauskar Committee, the new Scheme effective from 01.04.1998 was circulated vide Resolution dated 17th March, 2003. Salient features of the Resolution dated 17th March, 2003 are as under:
 - (i) Royalty will be fixed on Ad valorem basis.
 - (ii) Royalty will be calculated on cum-royalty basis.
 - (iii) A deduction of 7.5% and 10% of the crude oil price considered for onland and offshore production respectively will be made in order to determine the wellhead price.
 - (iv) For the period 01.04.98 to 31.03.02, royalty @ 20% will be paid on the wellhead price derived and calculated on the basis of notified percentages of weighted average FOB price of actual import of crude oil

- stipulated in Government Resolution on dismantling of the APM.
- (v) With effect from 01.04.02, the wellhead price of crude oil as derived from the market driven price obtained/obtainable by the producers based on 'arm's length transactions' will be considered for royalty calculations.
 - (vi) For onland areas, royalty will be paid @ 20% of the wellhead price till the year 2006-07. The convergence process would commence w.e.f. the year 2007-08 with tapering rates of royalty @ 1.5% each year so as to facilitate convergence with New Exploration Licensing Policy (NELP) rates of 12.5% by the year 2011-12. For offshore areas, royalty will be paid @ 10% of the wellhead price.
 - (vii) *The requisite notifications, orders etc. to implement the above decision will be issued separately.* (Emphasis supplied by the querist)

Mechanism of sharing of under-recoveries- Extension of discounts by the company:

7. Meanwhile, international oil prices began to rise steeply from the year 2003-04 (during the year 2002-03, average price of Indian Basket of crude oil was around US\$ 27/bbl, which rose upto US\$ 39/bbl in the year 2004-05). In order to protect the interests of common man from the uncertainties of rising international oil prices, it was decided that the Public Sector Oil Marketing Companies (OMCs) will not increase the selling prices of PDS kerosene and domestic LPG (Petrol (MS) and Diesel (HSD) was also added in the year 2004-05) in commensurate to increase in international prices. As a result, OMCs began to incur under-recoveries on sale of these products. Accordingly, based on the decision taken at the level of Union Cabinet, a mechanism for sharing the under-recoveries of OMCs was evolved by the Government of India during the year 2003-04 wherein it was decided that such under-recoveries of OMCs would be shared among upstream and downstream companies. The same was communicated by the Government of India vide its letter dated 30 October, 2003. *As per the mechanism, it was decided that the contribution from upstream companies would come in terms of discounts on the prices of crude oil, LPG and Kerosene supplied by them to OMCs.*

The salient features of the mechanism are given below:

- (a) OMCs would strive to make up for about 1/3rd of the projected under-recoveries by cross-subsidisation through other retail products.
- (b) The balance under-recoveries of OMCs, after accounting for over-recoveries from other retail products, would be equally shared amongst the OMCs and upstream sector companies (including the company).
- (c) The amount of under-recovery of each OMC to be made good by the upstream sector would be equal to half of the balance under-recoveries.
- (d) *The contribution from the upstream sector companies would come in terms of appropriate discounts on the prices of crude oil, Domestic LPG and PDS kerosene supplied by them to OMCs.*
- (e) Contribution of upstream sector companies would be broadly in the ratio of each company's PAT (profit after tax).

However, Government while communicating the mechanism directed that revenue of State Governments in terms of royalty on crude oil should not be affected by the discount.

(Emphasis supplied by the querist.)

8. In view of above directives, effective from April'03, the company started extending discount on sale price of crude oil and realised only sale price net of discount. *Accordingly, the company started paying royalty on production of offshore crude oil to the Central Government at post-discount sale price (i.e., actual sale price realised by the company).* However, in view of specific directive from Government of India, *the company paid royalty to State Governments including Government of Gujarat on production of onshore crude at pre-discount (notional) sale price.* (Emphasis supplied by the querist.)
9. As brought out at paragraph 5 above, aforesaid Resolution dated 17.03.2003 was issued keeping in view complete dismantling of APM and realisation of international prices to domestic crude producers, viz., the company and other such producers. However, as explained above, though, complete dismantling of APM from hydrocarbon sector was envisaged, it could not happen, as the Government of India effective from the year 2003-04, started regulating prices

of petroleum products of vital importance of common man viz., LPG domestic and PDS kerosene (HSD and MS from the year 2004-05). Consequently, the Government of India started directing the company and other oil companies to extend discounts from the sale price in respect of crude oil supplied to refineries, i.e., started regulating net realised prices of domestic crude oil also.

10. As provided in Resolution dated 17th March'03, Government of India issued Notification dated 16th December'04, which substituted Schedule under section 6A of ORDA for regulation of payment of royalty. Relevant portion of Notifications dated 16th December, 2004 pertaining to rates of royalty in respect of nomination blocks awarded to National Oil Companies (NOCs) viz., the company and other oil companies is reproduced below:

"1 (1) B(ii) With effect from 1.4.2002:

(a) Onland areas: @ 20% of Well Head Price

...

Note1: Well Head Price of Crude Oil and Casing Head Condensate for areas covered under 1. (1) B. and 2. (1).B. above will be determined by deducting 7.5% and 10% of the Crude Oil and Casing Head Condensate price considered for onland and offshore production respectively.

Royalty will be calculated on cum – royalty basis as under:

Royalty Amount = (Well Head Price X Royalty Rate)/(100+Royalty Rate)"

It is pertinent to mention that in view of the fact that complete dismantling could not happen, as envisaged at the time of submission of Mausker Committee Report, following vital recommendations of Mausker Committee (which was incorporated in the Resolution dated 17th March'03) were not incorporated for implementation in the Notification of 16th December' 04:

"(a) consideration of the wellhead price of crude oil as derived from the market driven price obtained/obtainable by the producers based on 'arm's length transactions' for royalty calculations and

(b) the process of tapering of royalty rate so as to facilitate convergence with NELP rates of 12.5% by 2011-12"

(Emphasis supplied by the querist.)

11. Subsequently, Government substituted earlier Note in respect of methodology for

determination of wellhead price from sale price vide Notification dated 20th August'07, wherein it was decided that the wellhead price of crude oil for nomination blocks of the company and other oil companies shall be determined by deducting ₹1,251/MT and ₹947/MT for onshore and offshore respectively *from the sale price of crude oil.* (Emphasis supplied by the querist.)

12. *To sum up, presently, royalty on crude oil produced from onland fields is payable @ 20% of well-head price, wherein well-head price is determined by deducting ₹1,251/MT and post well-head levies from the sale price of crude oil.* (Emphasis supplied by the querist.)

13. Meanwhile, since the company was realising only post-discount sale prices on sale of crude oil but paying royalty to State Governments on pre-discount sale prices, as per the specific directive from Government of India, it resulted into *an uncharacteristic situation wherein the statutory ceiling of 20% royalty fixed under section 6A of ORDA was breached. The company in fact paid royalty in excess of 20% and sometimes as high as 50% of sale price at well-head.* Consequently, the company made various representations to the Government of India to review their directives of payment of royalty to State Governments including the Government of Gujarat at pre-discount prices so as to ensure compliance of statutory provisions. (Emphasis supplied by the querist.)

14. *Subsequently, keeping in view the statutory provisions of the Oilfields (Regulation and Development) Act 1948, Petroleum & Natural Gas Rules, 1959, notifications issued there-under and the company's representation, and after consulting the Ministry of Law, the MoP&NG vide its letter dated 23rd May, 2008 withdrew its earlier directives issued vide letter dated 30th October, 2003 regarding payment of royalty to State Governments at pre-discount prices. Consequently, the company started making payment of royalty at post-discount price from 01st April, 2008 (due on 31st May, 2008) to state governments (including the Government of Gujarat) as per the provisions of ORD Act and also in line with royalty payment to the Central Government.* (Emphasis supplied by the querist.)

Demand of royalty on pre-discount price by Government of Gujarat:

15. Initially, the Government of Gujarat issued

- demand notices to the company with a request to pay differential royalty (royalty on pre-discount less royalty on post-discount) from April'08 onwards, which were suitably replied by the company.
16. Subsequently, the Government of Gujarat also represented to the Central Government. In reply, Central Government had clarified to the Government of Gujarat that the decision taken by the Central Government for payment of royalty on post-discount prices is the result of a thorough examination of the matter considering various statutory provisions in consultation with the Ministry of Law.
17. The Government of India, MoP&NG vide letter dated 05 November, 2009 had clarified that:
- The mechanism under which upstream oil companies issue price discounts to OMCs is not their internal arrangement but decisions taken at the level of the Union Cabinet from time-to-time.
 - The burden sharing mechanism effective from 2003-04 is still in vogue and offering of discounts is not a post-sale event. As explained, discounts are calculated and communicated by Government on a quarterly basis.
 - During the years 2003-04 to 2007-08, royalty on onshore crude was paid by the company on pre-discount prices on the specific directive from Government, which was subsequently, reviewed and modified, keeping in view the provisions of ORD Act and P&NG Rules.
18. *In September'11, Government of Gujarat filed Special Civil Application (SCA) No.13943/2011 before the Gujarat High Court against MoP&NG and the company, seeking the following reliefs:*
- To set aside the letter dated 23.5.2008 of MoP&NG*
 - To direct the company to pay the royalty on pre-discounted price of crude oil w.e.f. April, 2008.*
- (Emphasis supplied by the querist)
19. *Vide judgment dated 30.11.2013, the Gujarat High Court accepted the stand of Government of Gujarat. High Court relied on resolution dated 17.3.2003 which notified the recommendations of the Mauskar Committee, and held that after the said resolution, the basis of royalty would be the market-driven price arrived at from arms' length transaction. It was held that the directions of MoP&NG asking the company to give discounts to OMC were an internal matter and it could not be at the cost of the Government of Gujarat. High Court directed the company to make payment of royalty on pre-discounted price and make the payment of shortfall within two months.*
- (Emphasis supplied by the querist)
20. Aggrieved by the order of Gujarat High Court, the company challenged the said order dated 30.11.2013 by filing SLP before the Supreme Court of India wherein the Government of Gujarat and MoP&NG have been made respondents. Hon'ble Supreme Court vide order dated

13.02.14 (copy of the order has been supplied by the querist for the perusal of the Committee), admitted SLP of the company, issued notice to respondents and directed them to file counter affidavits within 2 months and granted stay against the order dated 30.11.2013 of Gujarat High Court on the condition that the company pays royalty to the Government of Gujarat on pre-discounted price of crude oil w.e.f. 1.2.2014.

21. In terms of said order, the company has started paying royalty to the Gujarat Government on pre-discount price w.e.f. February'14 in respect of crude production from Gujarat. Differential royalty (royalty on pre-discount notional sale price less royalty on post-discount actual sale price) paid to the Gujarat Government as per Supreme Court interim order dated 13.02.2014 is accounted and shown as deposit with the

Government of Gujarat. During the year 2014-15, there is no fresh development in the matter and the matter is still pending with Hon'ble Supreme Court. It is also understood that till date, respondent(s) have not filed any counter affidavit(s) (as desired by the apex court). Meanwhile, the company continued paying royalty on pre-discount price to the Government of Gujarat in terms of interim order dated 13.02.14 of Supreme Court. Total amount paid to the Government of Gujarat in terms of Supreme Court order dated 13.02.14 towards differential royalty (royalty on pre-discount notional sale price less royalty on post-discount actual sale price) w.e.f. February'14 to March'15 works out to ₹2,107 crore which has been shown as deposit.

22. Accounting treatment:

Sl. No.	Period	Description	Accounting Treatment
1.	2008-09 till 2013-14	Royalty on actual post-discounted sale price paid to Gujarat Government	Charged to statement of profit and loss
2.		Differential royalty (royalty on pre-discount notional sale price less royalty on post-discount actual sale price) demanded by Government of Gujarat (estimated to ₹11,633 crore)	Shown as contingent liability
3.	February'14 to March'15	Royalty on actual post-discounted sale price paid to Gujarat Government	Charged to statement of profit and loss
4.		Differential royalty (royalty on pre-discount notional sale price less royalty on post-discount actual sale price) paid to Gujarat Government as per Supreme Court interim order dated 13.02.2014 (amounting ₹2,107 Crore)	accounted and shown as deposit with Government of Gujarat

Recent judgment of Supreme Court dated 03.08.15 in the matter of demand of sales tax on pre-discount price by the Government of Gujarat:

23. As explained above, effective from April'03, the company started extending discount on sale price of crude oil and realised only sale price net of discount. Accordingly, the company paid sales tax/ VAT to the respective State Governments including the Government of Gujarat on sale of crude oil at post-discount sale price, i.e., actual sale price realised by the company. However, during the process of sales tax assessments for the years 2004-05 and onwards, Gujarat Sales Tax Authorities disallowed the discounts given by the company to oil marketing companies (OMCs) on sale of crude oil, LPG (Domestic) and SKO (PDS) in terms of directives from MoP&NG for sharing of under-

recoveries of OMCs. As a result, assessment orders were issued raising demand of significant amount of sales tax, interest and penalty thereon. The estimated liability was to the tune of ₹2,482 crore approx. for the period from 2004-05 to September, 2014. (Emphasis supplied by the querist.)

24. The company filed appeals with the concerned first Appellate authority but the matter was decided against the company. Subsequently, appeals were filed with the Gujarat VAT Tribunal. The Gujarat VAT Tribunal vide its order dated 19.09.2013 also upheld the view of Gujarat VAT Department. However, the Hon'ble High Court of Gujarat vide its order dated 18.12.2014 reversed the judgment of Gujarat VAT Tribunal and allowed the appeal in favour of the company.

25. Against the aforesaid Order of Hon'ble Gujarat High Court, the Gujarat VAT Department filed an SLP before the Hon'ble Supreme Court. *SLP was mentioned in the Apex Court on 03.08.15. The Hon'ble Supreme Court vide its order dated 03.08.2015, dismissed the SLP filed by Department.* Accordingly, the issue of payment of sales tax has now been settled at the level of Apex court. As a result, it has been established that the actual post-discount price realised by the company is the sale price for the purpose of payment of sales tax. (Emphasis supplied by the querist)

B. Query

26. During the pendency of the judgment of Hon'ble Supreme Court and keeping in view its interim order dated 13.02.2014, the querist has sought the opinion of the Expert Advisory Committee as to whether the company is correct in showing as deposit, the amount of ₹2,107 crore paid to the Government of Gujarat towards differential royalty (royalty on pre-discount notional sale price less royalty on post-discount actual sale price) for the period from February'14 to March'15 in terms of Supreme Court order dated 13.02.2014 or whether the company should adopt any other accounting treatment.

C. Points considered by the Committee

27. The Committee notes that the basic issue raised by the querist relates to whether the company is correct in showing as deposit, the amount of ₹2,107 crore paid to the Government of Gujarat towards differential royalty (royalty on pre-discount sale price less royalty on post-discount actual sale price). The Committee has, therefore, considered only this issue and has not considered any other issue that may arise from the Facts of the Case, such as, treatment of actual royalty paid by the company, accounting for differential royalty during the year 2008-09 till 2013-14 demanded by the State Govt. as contingent liability, treatment of disputed sales tax, interest and penalty, etc. Further, the Committee wishes to point out that its opinion is expressed purely from accounting perspective and not from the perspective of interpretation of legal enactments, such as, the Oilfields (Regulation and Development) Act 1948, Petroleum & Natural Gas Rules, 1959, court orders, various Resolutions of the Government of India and notifications, scheme of royalty, etc.
28. The Committee notes from the Facts of the Case that the company is disclosing the differential amount of royalty during the period 2008-09 till 2013-14 demanded by the State Government as 'contingent liability'. It is also noted that for the financial year ending 31st March, 2015, the differential royalty paid vide order of the Supreme Court has been accounted for and shown as 'deposit'. Further, it is noted from the financial statements contained in the Annual Report (2014-15) of the company

as supplied by the querist that for the financial year ended 31st March, 2015, the company continues to disclose the disputed obligation as its contingent liability along with the disclosure of the differential royalty paid as 'deposit'.

29. With regard to the accounting for the amount paid towards differential royalty, the Committee notes the interim order of the Supreme Court, directing the company to pay the differential royalty amount to the State Government from February 2014 as follows:

"Pending further orders from this Court, operation of the impugned judgement shall remain stayed subject to the condition that the Appellant—the company pays royalty to respondent no. 1—State of Gujarat on pre-discounted price of crude oil w.e.f. 1st February, 2014 onwards."

From the above, the Committee is of the view that direction of the Court to pay the differential royalty to the State Government w.e.f. 1st February, 2014 and not with effect from 2008-09 indicates that the order is only an interim order pending the final judgement. In case the decision of the Supreme Court is in favour of the company, the amount deposited shall be refundable to the company, whereas, if the decision goes against the company, the amount paid would be adjusted against the liability of the company. Thus, the amount paid is akin to a deposit with the Government. Accordingly, the Committee is of the view that as on 31st March, 2015, apart from the compliance with the requirements of AS 29, the company should recognise the payment made against the disputed liability as 'deposit' which should be classified under an appropriate accounting head, considering the requirements of Schedule III to the Companies Act, 2013. However, the company should appropriately explain the fact of the dispute either through appropriate nomenclature, for example, 'Deposit of royalty paid in dispute' or through an appropriate disclosure in the Notes to Account so as to disclose the nature of the item and to give a true and fair view to the users of the financial statements. In this regard, the Committee noted from the financial statements contained in the Annual Report (2014-15) of the company that the company has explained the item 'Deposits' by way of a note under notes to financial statements that the differential

royalty has been paid as per the interim order of the Supreme Court, which is further explained by way of note to the contingent liabilities. The Committee is of the view that the aforesaid disclosures appear to be appropriate.

D. Opinion

30. On the basis of the above, the Committee is of the opinion that as on 31st March, 2015, apart from the disclosure as contingent liability, as discussed in paragraph 28 above, the company should recognise the payment made against the disputed liability as 'deposit' which should be classified under an appropriate accounting head, considering the requirements of Schedule III to the Companies Act, 2013, as discussed in paragraph 29 above. However, the company should appropriately explain the fact of the dispute either through appropriate nomenclature, for example, 'Deposit of royalty paid in dispute' or through an appropriate disclosure in the Notes to Account so as to disclose the nature of the item and to give a true and fair view to the users of the financial statements. Since the company has made such disclosures, as discussed in paragraph 29 above, the accounting treatment followed by the company appears to be correct.

1	The Opinion is only that of the Expert Advisory Committee and does not necessarily represent the Opinion of the Council of the Institute.
2	The Opinion is based on the facts supplied and in the specific circumstances of the querist. The Committee finalised the Opinion on February 1, 2016. The Opinion must, therefore, be read in the light of any amendments and/or other developments subsequent to the issuance of Opinion by the Committee.
3	The Compendium of Opinions containing the Opinions of Expert Advisory Committee has been published in thirty four volumes. A CD of Compendium of Opinions containing thirty four volume has also been released by the Committee. These are available for sale at the Institute's office at New Delhi and its regional council offices at Mumbai, Chennai, Kolkata and Kanpur.
4	Recent opinions of the Committee are available on the website of the Institute under the head 'Resources'.
5	Opinions can be obtained from EAC as per its Advisory Service Rules which are available on the website of the ICAI, under the head 'Resources'. For further information, write to eac@icai.in .