MANAGING THE ACTIVITIES OF THE NIGERIAN OIL AND GAS INDUSTRY

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1.0. NTRODUCTION

Oil and gas operations commenced in Nigeria effectively in 1956, with the first co mmercial find in that year by the then Shell D'Arcy. Before this time, that is, from November 1938, almost the entire country was covered by a concession granted to the company to explore for petroleum resources. This dominant role of Shell in the Nigerian oil industry continued for many years, until Nigeria's membership of the Organization of Petroleum Exporting Countries (OPEC) in 1971, after which the c ountry began to take a firmer control of its oil and gas resources, in line with the pr actice of the other members of OPEC. This period witnessed the emergence of Nati onal Oil Companies (NOCs) across OPEC member countries, with the sole objecti ve of monitoring the stake of the oil-producing countries in the exploitation of the resource. Whereas in some OPEC m ember countries the NOCs took direct control of production operations, in Nigeria, the Multinational Oil Companies (MNOCs) were allowed to continue with such o perations under Joint Operating Agreements (JOA) which clearly specified the res pective stakes of the companies and the Government of Nigeria in the ventures.

This period also witnessed the arrival on the scene of other MNOCs such as Gulf Oil and Texaco (now ChevronTexaco), Elf Petroleum (now Total), Mobil (now Ex xonMobil), and Agip, in addition to Shell, which was already playing a dominant r ole in the industry. These other companies were also operating under JOAs with N NPC, with varying percentages of stakes in their respective acreages. To date, the above companies constitute the major players in Nigeria's oil industry, with Shell accounting for a just little less than 50% of Nigeria's total daily production, which currently stands at about 2.4 million barrels of oil per day. JOAs are also still do minant in the oil industry in Nigeria, accounting for over 90% of total oil and gas production in Nigeria today. The emergence of offshore oil and gas operations a nd the granting of deep water acreages to the oil producing companies has howeve r witnessed a shift from JOA regimes to Production Sharing Contracts (PSCs), wit h implications for the operation and regulation of the oil industry in Nigeria. This shift is attributable to a number of factors ranging from the complexity of operations in the offshore terrain, (which makes regulation under a JOA more difficult), to dwindling resources of the country, (which makes funding under the JOAs precarious for the government). At a time when the Nigerian government is intent on increasing oil and gas reserves and the country's production capacity without the necessary funds to back it up, a funding arrangement which achieves those objectives without having a negative impact on the scarce resources available for investment in other sectors of the economy is imperative. A number of oil and gas projects using the PSC model are due to come on stream soon and the successes recorded so far in this area have encouraged the government to consider extending PSC arrangements to other areas of the industry which had hitherto operated under JOAs. This paper examines these contractual models in the Nigerian oil and gas industry, their respective strengths and drawbacks, and the current shift in emphasis from JOAs to PSCs, adducing reasons for this shift, and what this portends for investment in the sector in Nigeria. The aim is to show the long term effects of this shift on the investment climate and the overall development of the Nigerian economy, in which oil and gas plays a central role. THE JOA AND HOW IT OPERATES Modelled after partnership agreements, the JOA operates as a form of partnership between the joint venture partners, which spells out the participatory interest of each of the partners and also designates one of the partners as the operator of the venture. In Nigeria, the NNPC represents the interest of the government in the joint ventures, whereas the respective MNOCs operate the different ventures with varying participatory interests. The JOA governs the relationship between the parties, including budget approval and supervision, crude oil lifting and sale in proportion to equity, and funding by the partners. In addition to the JOA, a Memorandum of Understanding (MOU) governs the manner in which revenues from the venture are allocated between the partners, including payment of taxes, royalties and industry margin. The income derived from the operation is also shared in proportion to the equity interests of the parties to the venture, with each party bearing the cost of its royalty and tax obligations in the same proportion. Allocations are also made from the revenue to take care of operating and technical costs. Challenges of the JOA

ome of the constraints associated with the JOA include poor funding, due mainly to the imbalance in the financial capacity of the different joint venture partners, esp ecially the government which has other pressures on its resources, leading often to reduction in operations and consequential loss in revenue. JOA is also constrained by allegations of gold plating of operating costs by the non-operators of the venture, which often leads to mutual suspicion between the parties, and the rather unfair distribution of revenues, especially in the situation of upsides from high oil prices. Additionally, the Operator also faces peculiar challenges in Nigeria such as the need to meet the incessant demands by oil producing communities for development programmes in their areas demands which could lead to disruptions in operations from time to time.

With the expansion of the Nigerian oil and gas industry, acreages started being allocated in the shallow and deep offshore areas, and this introduced the need for a different regime, as it brought its own unique challenges in terms of funding and technical complexity. This led to the introduction of PSCs in the new offshore and inland basin acreages, which is gradually assuming prominence in the entire industry.

THE PSC AND HOW IT OPERATES

As the name implies, PSCs focus on the sharing of the output of oil and gas operations in agreed proportions between the Oil Company, as a contractor to the government, and the NOC, as the representative of government interests in the venture. This form of contracts originated in Indonesia in 1966 and was modelled along the lines of share cropping in agriculture, where the owner of the land grants a farmer the rights to grow crops on his land and shares the proceeds with the farmer in agreed proportions after the harvest. Under a PSC, the contractor, usually a foreign oil company bears the entire cost and risk of exploration activities, and only reaps the rewards after a commercial find. In the event of a commercial discovery, the contractor recovers its costs fully from allocation of oil, referred to as ‘Cost Oil’. Allowance is also made from production for royalties, after which the remainder of the production, called ‘Profit Oil’, is shared in agreed proportions between the company and the government as represented by the NOC. The Oil Company thereafter pays income tax on its profits from the venture. The oil and all the installations remain the property of the host government throughout the duration of the contract. In Nigeria, this form of contractual arrangement is relatively new, and covers mostly acreages in the shallow and deep offshore areas and the inland basins. The major o perators in Nigeria are still largely the holders of the PSCs but there have also been new entrants, made up of independent foreign oil companies, which enter into partnerships with indigenous companies to bid for oil blocks, and thereafter operate it in line with predetermined contractual arrangements. In addition to the specific contracts signed with the individual companies, the main law which regulates the operation of PSCs in Nigeria is the Deep Offshore and Inland Basin Production Sharing Contracts Act No. 9, Laws of the Federation of Nigeria, 1999. This law sets out the general framework for the operation of PSCs, including the applicable royalties, tax regimes, and the manner in which costs and profits are allocated between the parties. It provides for payment of a flat rate of 50% tax on petroleum profits by PSC operators, and sets different royalty regimes, depending on the water depth in which the operation is carried out, ranging from 12% for water depths of 200-500m, to 0% for water depths in excess of 1,000m. PSCs in inland basins attract a flat royalty of 10%. In addition to royalties, taxes and its share of profit oil, the government also earns revenue from signature bonuses paid by the oil companies upon successful bids. Most forms of payments under PSCs operating in Nigeria are made in oil, as the law provides for cost oil, tax oil, royalty oil and profit oil. Investment Tax Credits and Allowances are also available to the investors at the rate of 50% of the value of such investments. Some of the advantages associated with PSCs include the relative flexibility in the management of the operations, and the fact that there is no financial burden on the host government, and even after a commercial find, the payment to the contractor is in oil, which does not attract any direct financial cost. Leveraging on the technical know-how and experience of the companies in such operations, the government can focus its energies in other areas of the economy while trusting that the oil and gas industry will develop at an acceptable pace without the usual trappings of cash call constraints. However, PSCs have some drawbacks such as the risky nature of the operation. For instance, in the event of an unsuccessful operation, millions of dollars could be completely lost - unless the local laws allow for costs from one acreage to be transferred to another, which is not always the case, and would depend on the provisions of the PSC entered into by the parties. Also, the fact that the contractor is usually allowed a relatively unfettered hand to draw up and execute its programme could lead to allegations of gold plaiting of costs. The long term nature of transactions in the oil industry however usually mitigates some of these difficulties. The tendency is usually for both parties to strive to make room for flexibility in dr awing up the terms, and also make provisions for renegotiation in the event that particular provisions are later found to be causing undue hardship. In recent times, there has been a conscious shift in the contractual structure in the oil and gas industry in Nigeria from JOAs to PSCs.