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A Legal Analysis of Production Sharing Contract Arrangements in the Nigerian Petroleum Industry

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Abstract
Production sharing contract (PSC) is an arrangement used in the upstream sector for the exploration and development of petroleum resources. Several oil producing countries, particularly the developing ones have adopted it as a contract for the exploration and development of their oil and gas resources. Nigeria has adopted it for the exploration and development of the offshore and inland basin. This paper examined the concept and general basic features of PSC. It went further to look at the PSC arrangements in Nigeria and observed that there are various models of PSC executed in Nigeria and identified the significant differences in each one. In addition, it reviewed the Deep Offshore and Inland Basin Production Sharing Contracts Act, 1999 which gave legislative backing to the fiscal terms granted by the Government to certain PSC models. It evaluated the various models of PSC executed in Nigeria and ascertained the shortcomings in them.
Keywords: production sharing contract, different models of production sharing contract in Nigeria

1. Introduction

Production Sharing Contract (PSC) is a distinct petroleum arrangement that has been adopted by many developing countries in the exploration and production of their petroleum resources as it guarantees the sovereign right of the state over these resources and meets their economic desires by providing capital and technology for their production. In this arrangement, the Government assumes minimal or no risk at all in the production of its petroleum resources.

In the early 1990s, when Nigeria sought to increase its petroleum production through the exploration and development of the offshore and inland basin, the Government adopted PSC as the appropriate upstream petroleum contract that would be suitable for the award of the acreages. PSC was considered fitting as it would not bring about any financial burden on the government like the joint venture (JV) arrangement where there were challenges of meeting cash call obligation. It is pertinent to note that prior to the 1990s, Nigeria used the PSC arrangement in 1973 for the development of two oil prospecting licences. However there were some challenges with the implementation the PSC which necessitated a renegotiation of some of its terms. This experience discouraged further use of PSC and made Government to adopt the Risk Service Contract in 1979 for the award of eleven oil blocks. Nonetheless, in all the licencing rounds conducted since the early 1990s, PSC has been adopted for the award of the acreages.

This paper examines the various models of PSC arrangement in Nigeria with a view to highlighting their dissimilarities.

2. Concept, Historical Background and Features of PSC

A PSC is a contractual arrangement made between an oil company(contractor), which in most cases is a foreign one and a designated state enterprise (state party) authorizing the contractor to conduct petroleum exploration and exploitation within a certain area (contract area) in accordance with the rules of the agreement (Taverne, B. 1996). It is considered as the oldest form of risk contract with a dual character; the first is that it represents a petroleum right since it authorises the contractor to undertake petroleum exploration and exploitation within the contract area (Taverne, B. 1996). Secondly, it embodies a contractual form of co-operation between the contractor and the state party (Taverne, B. 1996). PSC has been described as a form of taxation designed to satisfy the political objectives for state participation (Daniel, P. 1995). PSC often contains some terms that offer special advantages to the host country like production bonuses, scholarships, training, grants to government authorities or educational institutions, domestic market obligations and public participation options (Pongsiri, N. 2004).

Indonesia was the first petroleum producing country to adopt PSC as the legal instrument for permitting foreign oil enterprises to carry out petroleum operations in its territory (Taverne, B. 1999). The origin of its adoption can be traced back to the Netherlands-Indies Mining Law of 1899, as amended in 1919 (Taverne, B. 1999).

It is instructive to note that although the first PSC was executed in Indonesia, nonetheless the concepts date back to French Napoleonic traditions, under which mineral wealth was not owned by individuals, but rather by the state for the benefit of all citizens (Lawson, F.H. et al. 1967 cited in Duong 2004:1219). The initial use of the production sharing system took place in agriculture and under the system, farmers, as tenant-sharecroppers, cultivated field which title was held by the government or landlords (Duong, W.N. 2004). They were then compensated by a share of the production (Brissaud, Jean 1912 cited in Duong 2004:1220). The foremost PSC in Indonesia was signed on April 7, 1960 between Permian and Kobayashi Group, a Japanese consortium and was for a liquefied petroleum gas project (Gao, Z. 1994).

It is worthy of note that there is no universal model or standard PSC, each country has developed its variant of the contract over the years (Taverne, B. 1996). Nevertheless, Duval et al (2009:69-79) observed that PSC has retained the following basic features:

The International Oil Company (IOC) is appointed by the Host Country (HC), directly or through its national oil company (NOC), as the exclusive “contractor” (and not as a concessionaire) to undertake petroleum operations in certain area during specified time periods; The IOC operates at its sole risk, its own expense, and under the control of the HC; If petroleum is produced, it belongs to the HC, with the exception of a share of production that can be taken in kind by the IOC for cost recovery and for profit sharing; The IOC is entitled to recover its eligible cost under the PSC from a portion of the production from the area subject to the contract; After cost recovery, the balance of the production is shared, based on a predetermined percentage split between the HC and the IOC; The net income of the IOC is taxable, unless the PSC provides otherwise; The title to the equipment and installations purchased by the contractor pass to the HC either immediately or overtime, in accordance with the cost recovery schedules.

PSC is now being used in the exploration and development of petroleum resources by the following countries: Malta, Guatemala, Libya, Syria, Jordan, Angola, China, Qatar, Gabon, Philippines, Argentina, Bangladesh, Bolivia, Cameroon, Chile, Egypt, Ethiopia, Malaysia, Vietnam, Yemen, Trinidad and Tobago, Equatorial Guinea, Georgia, India, Indonesia, Iraq, Kazakhstan, Madagascar, Uganda, Peru, Russia and Thailand, to mention a few.

3.0 Overview of the Production Sharing Contract Arrangements in the Nigerian Petroleum Industry

The use of PSC as a contractual framework in the Nigerian petroleum industry can be classified into two eras. The first is the 1973 PSC, while the second is the 1993 and post 93 PSCs, which can be further categorised into three broad models based on the differences in their terms. Accordingly, this section would examine PSC in Nigeria under two subheads namely the 1973 PSC and the 1993 and post 93 PSCs.

3.1 The 1973 PSC

The first PSC in Nigeria was executed on 12th of June 1973 between the Nigerian National Oil Corporation (NNOC), the predecessor of the Nigerian National Petroleum Corporation (NNPC) and Ashland Oil (Nigeria) Company. It was executed as part of the effort of the government to exercise control on petroleum activities in Nigeria. Besides, Government in 1972 issued a Notice vesting all areas not covered by existing oil mining leases, oil prospecting licences and oil exploration licences in the NNOC and that no concessions will be granted to any companies, organisations or individuals foreign or indigenous (GN(1972) No.311:284). NNOC was required to select suitable oil companies to cooperate with it as contractor in working its concessions.

The 1973 PSC covered two oil prospecting licences (OPLs) and contained the following provisions:

a. The initial term was 20 years with a provision for a renewal for an additional term of five years.
b. The contractor provides all the funds for the petroleum exploration, development and production as well as operating expenses and bears the risk involved.
c. The contract was to terminate if oil was not discovered in commercial quantities within five years from the effective date.
d. Title to petroleum passes to each party at wellhead.
e. It did not establish a Management Committee to control and manage of the petroleum operations, the contractor was simply required to prepare a work programme and budget and submit it to the NNOC for approval within one month after the effective date of the contract and thereafter at least two months prior to the beginning of each year. The approval must not be unreasonably withheld by the NNOC. Any proposal for revision of the Work programme and budget by the NNOC must be communicated within thirty (30) days after it has been received. If NNOC does not notify the contractor of the revision to the work programme and budget, it shall be deem to be approved.
f. The contractor was required to pay production premiums at a graduated rate based on daily production per barrel. The production premiums were however recoverable as operating cost.
g. The contractor was required to recruit and train Nigerians in the conduct of all the petroleum operations.
h. All operating costs, including rents and royalty paid, as well as interest costs on funds borrowed to conduct operations were completely recoverable, out of the proceeds of sale of a maximum of the first 40% of available crude oil.
i. The contractor was allowed to include two percent (2%) of the actual operating costs as overhead charges in the calculation of the total operating costs.

j. The contractor was required to pay for all the equipment necessary for the petroleum operations and such equipment upon arrival in Nigeria became the property of NNOC provided they are not on lease.
k. The recovery of operating costs and the allocation of the available crude oil as follows:
   i. Cost Oil: Up to 40% of available crude oil was set aside as "Cost Oil" for reimbursement of the contractor's allowable costs which include rents, royalties and all operating costs including interest costs on fund borrowed to conduct petroleum operations. This allocation was revised to 50% in 1986.
   ii. Tax Oil: 55% of the balance of the available crude oil after deducting cost oil was allotted as "Tax Oil" and allocated to the contractor for the payment of Petroleum Profit Tax but if the proceeds of Tax oil were insufficient to pay such tax, the NNOC and the contractor are required to provide the additional amount in the proportion to their participating interest shares at the time such additional amount of Petroleum Profit Tax is payable.
   iii. Profit Oil: The remaining available crude oil after deducting cost oil and tax oil was "Profit Oil" and it was shared in the proportion of 65% for NNOC and 35% for the contractor but if the daily production of available crude oil exceeds 50,000 barrels per day, participating interests which applied were 70% for NNOC and 30% for the contractor.

A number of shortcomings were associated with this PSC. It was executed when Nigeria had little or no knowledge about the concept of a PSC and the model terms that could benefit the country. The Government assumed that since it was not concession it had control over the petroleum operations which obviously did not reflect in the provisions. For instance, no Management Committee was established by the PSC to superintend over the petroleum operations. Although the PSC mandated the contractor to submit the work programme and budget to the NNPC, the contractor was apparently in control of the operation as there were no defined Work Programme obligations in quantitative terms. Some terms of the PSC were at variance with the basic framework of a contemporary PSC, such as the transfer of title to available oil at wellhead which is a feature of concession. Generally, title to oil in most PSCs passes at the point of export or valuation. Also in the PSC production premiums was recoverable as part of cost oil; this is not common in a present-day PSC.

Furthermore, the PSC was found to be lopsided in favour of Ashland by the Crude Oil Sales Tribunal set up to investigate an alleged loss of ₦2.8 billion from the accounts of the NNPC, with the Midland Bank in London, between 1978 and 1979. The Tribunal recommended that the PSC be reviewed in order to make the terms equitable and Government accepted this recommendation. Consequently, the PSC was amended in 1979 and 1986. The 1979 amendment increased the volume of cost oil as a share of total available production while the 1986 amendment improved Ashland's royalty, Petroleum Profit Tax, Investment Tax Credit and profit sharing terms while it also altered the form of cost recovery.

Nonetheless, the amended 1973 PSC was replaced with another PSC in 1994, which had the basic terms in the model PSC that was used in the award of acreages in the 1991 licencing round in Nigeria (Olisa, M.M. 1997). Besides, NNPC executed another PSC covering OPLs 90 and 225 with Ashland Nigeria Exploration Unlimited, which is a sister company of Ashland on 25 March, 1992. The two PSCs were however terminated by the Federal Government on 13 June, 1997 because Ashland transferred its interest in the PSCs to Perenco Investments S.A. of France without the consent of the Government (Daily Times 18 June, 1997:10). After the termination of the PSCs, an Eight Man Interim Committee was set up by NNPC to take over and manage the operations of the PSCs and report to National Petroleum Investment Management Service (NAPIMS) on a regular basis; while another Committee was also set up to negotiate a new PSC with a prospective "Contractor", which initially was TOTAL Exploration (Nigeria) Limited (Total) but eventually with Addax Petroleum Development (Nigeria) Limited (Addax) as Total did not agree with the terms of the draft PSC and wanted a new fiscal package. The Ashland PSCs were however transferred to Addax and a PSC to that effect was executed on 6 May, 1998, between the NNPC and Addax, covering OPLs 98 and 118 (now OMLs 123 and 124 respectively) and OPLs 90 and 225 (now OMLs 126 and 137 respectively).

3.2 The 1993 and post 93 PSCs

In the early 1990s, when the Federal Government offered the first set of deep offshore and inland basin acreages, it stipulated that all new petroleum exploration contracts would be on a PSC basis (Belo-Osagie, M.1992). The rationale behind the adoption of PSC were the funding constraints being experienced in the JV arrangement, the high geological risk associated with deep water and inland basins exploration, the desire of the Government to retain title to the oil concession and the aspiration to increase the nation's reserve base. Accordingly, oil prospecting licences (OPL) awarded during the 1991 licencing round and subsequent licencing rounds were on PSC terms. The oil company bids for and is awarded the right to explore and produce oil and gas. The OPL is granted in the name of NNPC. The oil company executes a PSC with the NNPC as a contractor for the exploration and production of OPL and the eventual oil mining lease (OML) that would be granted if oil is found in commercial quantity.

Between 1991 and 2007, five licencing rounds (1991, 2000, 2005, 2006 Mini, and 2007) have been conducted by the Government in which three different model of PSCs have emerged from the PSCS executed and they are 1993 PSC, 2000 PSC and 2005 PSC. The PSCs are quite similar in many respects but some provisions in the 2000 PSC and 2005 PSC are improvements made based on the shortcomings observed in the 1993 PSC model. The 2005 PSC was used in the 2006 Mini, and 2007 licensing rounds.

The following are the similar salient features of all the 1993 and post 93 PSCs:

(a) The contract areas are located in the deep offshore and inland basin and different considerations apply to the PSC, depending on the location of the contract area.
(b) The term of the PSC is for a period of between 25-30 years. The OPL is for a minimum period of 5 years and an aggregate period of 10 years and if oil is found in commercial quantity the OML is for 20 years. For instance, the 2005 PSC stipulates five (5) years for the OPL of acreages that are located onshore and shallow waters.
(c) The contractor bears all the cost of exploration, and if oil is found, it also bears the cost of the ensuing development and production operations.
(d) The contractor has no title to the oil in the ground but to the oil produced.
(e) If commercially viable natural gas is discovered in the contract area and the contractor is required to submit proposals to NNPC for the commercial development of the gas field. The development will be under a separate agreement or supplemental agreement.
(f) The contractor is expected to prepare the work programme and budget for the contract area.
(g) The contractor is required to pay production bonus once it attains certain level of production.
(h) The contractor does not pay company income tax but only petroleum profit tax.
(i) It provides for the establishment of a Management Committee for the purpose of providing orderly direction of all matters pertaining to the petroleum operation and work programme. The Committee is composed of ten (10) members. The parties have equal representation on the Committee. NNPC appoints the Chairman, while the Contractor appoints the Secretary who is not a member. The Committee meets regularly and takes decisions by unanimity.
(j) The NNPC has title to equipment purchased for the petroleum operations.
(k) The contract contains an economic benefit clause whereby if new laws are made or existing ones are amended the parties can make adjustments in order to maintain the contractor's economic benefits
(l) The contractor is required to recruit and train Nigerians in all aspects of Petroleum Operations.
(m) Crude oil produced is allocated as follows:

1. Royalty Oil is allocated to the NNPC in such quantum as will generate an amount of proceeds equal to the actual royalty payable during each month and the concession rental payable annually.
2. Cost Oil is allocated to the contractor in such quantum as will generate an amount of proceeds sufficient for recovery of operating costs in the contract area. In the 1993 PSC and 2000 PSC, there is no cost recovery limit. However, the 2005 model PSC stipulate a cost recovery ceiling of between 60%-80% of Available Crude Oil in each Development Area less deduction of Royalty Oil in any accounting period.
3. Tax Oil is allocated to the NNPC in such quantum as will generate an amount of proceeds equal to the actual Petroleum Profit Tax liability payable during each month.
4. Profit Oil is the balance of crude oil after deducting Royalty oil, Tax oil and Cost oil. It is shared between the NNPC and the contractor in the agreed proportion.

Notwithstanding the similarities in the features of the 1993 PSC, 2000 PSC and 2005 PSC, there are some variations in some of the basic terms of the PSCs. The 2005 PSC introduced new terms such as: Commercial Discovery and Declaration of Commerciality; Assignment; Representations and Warranties; Review/Re-negotiation of Contract and Fiscal Terms; Valuation of petroleum production; Conflict of Interests; and Transparency.

The following are highlights of the differences in some key provisions of the various model PSCs in the Nigerian petroleum industry:

a. <u>Signature Bonus</u>: The 1993 PSC provides that the Signature Bonus must be paid on the effective date of the contract. While the 2000 PSC provides that the Signature Bonus should be paid within thirty days after the effective date of the contract. The 2005 PSC however stipulates that the Signature Bonus must be paid before the execution of the contract.

b. Production Bonus: In all the PSCs different modes of payment for the production bonus has been observed, the 1993 requires cash equivalent of an indicated percentage of production but the 2000 PSC specifies one hundred thousand barrels (100,000 bbls) or cash equivalent for the attainment of each of the cumulative level of production. The 2005 PSC stipulates a quantity of crude oil or cash equivalent based on the attainment of a certain cumulative level of production.
c. Minimum Work Programme: The 1993 PSC specifies a three (3) phase minimum work programme and indicated an amount for each phase, which if not fully expended is allowed to be carried forward to the next phase. It did not indicate specific details of the activities to be conducted by the contractor. And there is no remedy if the work programme commitments are not met. The 2000 PSC stipulates a two (2) phase minimum work programme and specified the number of well that should be drilled in each phase without indicating an amount for each phase. Although, it mandated the contractor to submit a performance bond for each phase. It further provides that if at the end of any of the phases, the contractor should perform less than the required minimum work programme; then the outstanding amount under the performance bond shall be forfeited and paid to NNPC. On the other hand, in the 2005 PSC, the minimum work programme is more detailed as it provides for a two (2) phase work programme and specifies the number of wells that should be drilled in each phase coupled with the requisite data to be acquired and processed. It in addition states the minimum financial commitment for the exploration period.
d. Parent Company or Corporate Guarantee: In the 2005 PSC, the contractor is required to submit a Parent Company Guarantee to NNPC and where there is no parent company; the contractor is expected to submit a Corporate Guarantee from an affiliate or a company that is acceptable to NNPC. In the 1993 and 2000 PSCs, the contractor is not obligated to submit such Guarantee.
e. Incremental Investment: The 2005 PSC enables the contractor to make request to the NNPC for additional capital investment which is called "incremental investment" and NNPC is required to either approve or disapprove. The 1993 and 2000 PSCs do not have such provision.
f. Technical and Economic Data: The 2000 and 2005 PSCs mandate the contractor to submit to the NNPC technical and economic data, or other relevant information in respect of the contract area. This however does not include the contractor's internal proprietary or confidential information which are not directly related to the PSC. There is no such provision in the 1993 PSC.
g. Field Development: In the 2000 and 2005 PSCs, the contractor is obligated to determine with the NNPC the technical and cost aspect of any field development prior to the development of such a field. In the 1993 PSC, such provision is lacking.
h. Local Content Vehicle: The 2005 PSC provides for a Local Content Vehicle (LCV) which is required to partner as a contractor and to perform some activities in the work programme. The LCV is expected to meet both operational and financial obligations in the PSC. The 1993 and 2000 PSCs as well as those executed in 2006 and 2007 do not contain any provision on LCV.
i. Profit Oil Split Mechanism: In the 2005 PSC, the profit oil split is based on the sliding R-factor which is a complete departure from the cumulative production profit split mechanism that is provided for in the 1993 and 2000 PSCs.
j. Consolidation of Cost Recovery: The 2000 and 2005 PSCs distinctly circumscribed cost recovery to an OPL and any OML derived therefrom in order to avoid the ambiguity in the 1993 PSC which appears to permit the consolidation of costs from OPLs particularly where the PSC covered several OPLs. Disputes have arisen on whether the provision of 1993 PSC allows for consolidation of cost in PSCs covered by several OPLs. The contractors have argued that clause 8 (1) (b) of the 1993 PSC permits consolidation and recovery of operating expenses from producing OMLs, on the other hand, the NNPC did not agree with this interpretation and is of the view that proceeds from each OPL ought to be ring fenced for purposes of cost recovery and that section 8(1) of the Deep Offshore and Inland Basin Production Sharing Contracts Act provides that "cost oil shall be allocated to the contractor in such quantum as shall generate an amount of proceeds sufficient for the recovery of operating costs in oil prospecting licences as defined in the production sharing contracts and any oil mining leases derived therefrom". NNPC further argued that in clause 1 of the PSC, the term OPL and OML are defined in the singular and therefore costs of operations from a non-producing OPL of one contract area cannot be recovered from a producing OPL or OML of another contract area. The Arbitral Panels have however found in favour of the contractors but the enforcement of the awards have been challenged by the NNPC on the ground that the subject matter of the arbitration is taxation which is within the exclusive jurisdiction of the Federal High Court (FHC).
k. The 2005 PSC stipulate that its provisions will only apply to one OML that is derived from the OPL and should there be a second OML from the OPL, then a new PSC would govern the second OML. The 1993 and 2000 PSCs do not contain such provision.

l. Consolidation of OPLs for Tax Purposes: the 2000 and 2005 PSCs did not include the provision in the 1993 PSC that allows the contract to consolidate for tax purposes all OPLs and OMLs derived therefrom. The provision on consolidation of OPLs for tax purpose is now a subject of dispute between NNPC and some of the Contractors in the 1993 PSCs that have come on stream. The dispute is in relation to how crude oil produced in the respective fields is to be allocated and also involves the determination of Petroleum Profit Tax (PPT). The NNPC and the Contractors do not agree on the proper interpretation of the provisions of Clause 8.1 of the 1993 PSC especially in relation to consolidation of OPLs for PPT purposes. While the Contractors contends that by the provision of Clause 8.1 (e) of 1993 PSC, they are entitled to consolidate OPLs for PPT purposes, NNPC is of the opinion that, under the Deep Offshore and Inland Basin Production Sharing Contracts Act, consolidation of OPLs for PPT purpose is not recognised as section 9 provides that Tax Oil shall be allocated to NNPC or the holder, as the case may be, in such quantum as will generate an amount of proceeds equal to the actual PPT liability payable during each month. In effect the dispute is in relation to the interpretation of section 9 of the Act whether it permits consolidation of OPLs for PPT purposes. The Arbitral Panels have found in favour of the contractors but the enforcement of the awards has been challenged by the Federal Inland Revenue Services
m. Downstream Project: The 2005 PSC mandates the contractor to undertake a downstream project. The 1993 and 2000 PSCs as well as the PSC executed during the 2007 licencing rounds do not contain any downstream project obligation for the contractor.
n. Non-Gratification Clause: In the 2005 PSC, there is a provision that NNPC and the contractor(s) warrant that they have not made and will not make any gift or reward to any officials or employees of the State to induce or reward such persons for any acts taken in accordance with their duties.

4. Deep Offshore and Inland basin Production Sharing Contracts (PSC) Act. 1999

In response to the demands of foreign investors, the Federal Government on the 23rd of March 1999 enacted the Deep Offshore and Inland basin Production Sharing Contracts Act (PSC Act) (Lukman, R.1999). The PSC Act was enacted to demonstrate Government's commitment to the PSC arrangement. Section 19 of the Act backdated the commencement date of the Act to the 1st of January 1993 so as to make it applicable to the 1993 PSCs executed before 1999. It must however be pointed out that this Act does not apply to the 1973 PSCs assigned to Addax as they are not located within the inland and the deep offshore areas as defined in the Act. Hence the PSCs do not enjoy the fiscal incentives granted to the 1993 and post 93 PSCs. The Act only provides for fiscal incentives to oil companies operating the Deep Offshore and Inland Basin areas. It applies to all PSCs executed for the purpose of exploration and production of oil in the deep offshore and inland basins. It fixed the duration of the oil prospecting licence between 5 and 10 years. It amended the Petroleum Profit Tax Act (PPTA) and stipulates 50% flat rate of chargeable profits as the petroleum profits tax payable under a PSC. However, it did not exempt the contractors from the payment of other taxes, duties or levies imposed by the Federal, State, Local Government or Area Council Authority. It granted an investment tax credit of 50% to NNPC or the holder and the contractor who have incurred capital expenditure entirely and exclusively on petroleum operation in the production sharing contracts executed before 1st July 1998. Similarly, it provides that parties to any PSC would be granted Investment Tax Allowance of 50% on their expenditure. It also provides for the payment of royalty at a graduated rate in the deep offshore area while that of the Inland Basin is fixed at 10%. It provides that the computation and payment of the petroleum profit tax must be in US Dollars. The Act provides that royalty oil shall be allocated to the NNPC while Cost oil shall be allocated to the Contractor.

The negative aspect of this Act is that it has removed the flexibility that is usually associated with PSC and has effectively tied the hands of government by specifying rate of taxes and royalty without stipulating a convenient way to review these provisions without having to amend the Act through legislative process. There is no doubt that section 16 of the Act provides for a periodic review of the Act and a review of the provisions if the price of crude oil exceed $20 per barrel. It however did not prescribe how it should be done whether by a regulation or by an order. The absence of a mode of review has created ambiguity and a lacuna in the Act.

5. Evaluation of Production Sharing Contract Arrangement in Nigeria

Despite the attractiveness of PSC arrangement, it is not without some faults. Omorogbe (1986) identified three drawbacks of PSC. The first one is that the contractor may concentrate on producing one lucrative field and slow down exploration on other areas covered by the contract that are potentially risky. Secondly, the contractor can chose to be wasteful or extravagant in the petroleum operation knowing that its expenses would be fully met, which would obviously be to the disadvantage of the host country. A typical example of this drawback is the 1993 PSC, where the Senate Committee on Upstream Petroleum Sector discovered that Shell incurred the sum of N602 billion in the development of the Bonga Oil field and recommended that Shell should pay the amount to the Federal Government(The Guardian 1st May, 2006: 1-4).

The third drawback is that the contractor may earn what is referred to as "windfall profits", which occurs when there is a great increase in the price of crude oil, thereby giving the contractor a greater share of revenue than would ordinarily have been conceded(Omorogbe, Y. 1986). Profitability under PSC arrangement is said to be substantially dependent on oil price (Le Leuch, H. 1988). This drawback is evident in the 1993 and 2000 PSCs, where the profit oil split is based on a cumulative production variable model, which apparently does not respond to fluctuation in oil prices or profitability. It is based on production level, i.e. on physical data not economic data. Generally, as cumulative production increase, profit oil splits are increased giving the government a greater share of profits (Johnson, D. 2006). It controls profit oil split. It was designed when oil prices and cost were relatively stable. One shortcoming of the model is that it has no effect on government's share of the net profits when oil prices increase. Clause 10 of the 2005 PSC however, contains "R" Factor variable model, which responses to fluctuations in oil prices. It is the ratio of revenue to expenses. (Bindemann, K. 1999). This means that the cumulative contract revenue earned by the oil contractor from cost recovery and the profit oil are divided by cumulative expenses incurred during a specified period.

Apart from these general drawbacks, there are some other inherent defects in the PSCs executed in Nigeria, particularly in the 1993 PSC. This was admitted by a senior executive of one of the multinational oil companies when he said thus:

> all the parties now have more information on how a PSC should operate and further negotiation would enhance the revenue base of each party in a win-win situation. In the previous PSC, the government was not well knowledgeable about the agreement. But with more information and exposure, in comparison to what obtains in other parts of the world, they (government) can negotiate a better deal (The Guardian 8th March, 2005).

An inherent shortcoming of the 1993 PSC is that Clause 7.1(o) and Article 11(1) (h) of Annex B expressly enable the contractor to finance the petroleum operations with loans from external sources provided the approval of the NNPC is obtained and any interest on the loan is recoverable as operating cost. This will certainly erode on an early government take or revenue that can be derived from the petroleum operations. In one of the model PSCs used in Indonesia, where the contractor is allowed to recover interest on any money borrowed for the petroleum operations, there was a provision in the PSC called 'First Tranche Petroleum (FTP). The FTP is a portion of production which is split between the government and the contractor before any deduction of cost recovery; and as such it serves as a cap on the cost recovery (Gao, Z. 1994).

It should however be pointed out that such a term does not exist in the 2000 PSC and 2005 PSC. Article II (2) (e) (v) of Annex B of the 2005 PSC expressly excludes the recovery of interest on loan facilities or commissions on overdrafts incurred in the conduct of petroleum operations as part of cost.

Another drawback in the 1993 and 2000 PSCs is the absence of a cost recovery ceiling. Cost recovery mechanism determines whether there would be an early Government take. It establishes how cost incurred by the contractor in the petroleum operations is computed and recovered. It is one of the important features of a PSC which allows the contractor to recover all operating cost from production if there is a commercial discovery (Gao, Z. 1994). The absence of cost recovery ceiling in the 1993 and 2000 PSCs means that government take would be low. Most PSCs have a cost-oil limit of about 50% of available production although contracts with unlimited cost recovery are also in existence (Bindemann, K. 1999).

Omorogbe, Yinka (2005) has argued that the reason for no cost recovery ceiling in the 1993 and 2000 PSCs may be due to the fact that Nigeria has one of the world's highest risk ratings and it not a place that readily attracts investment capital.

It instructive to note that in countries like Angola, Trinidad and Tobago, Indonesia, there is usually a cost recovery ceiling in the PSCs so that there can be an early government take. For instance in Angola, the cost recovery ceiling is usually 50% (Vaz Alexandre Pessoa, 2007). There is a flexible term in the PSC that would enable the cost oil ceiling to be increased if development costs are not recovered within 5 years, however, such increase would not exceed 65%.

It is gratifying to note that in the 2005 PSC a cost recovery ceiling varies between 60%-80%. Similarly, the Guidance Note for the 2007 licencing rounds provide for a cost recovery ceiling 70% for onshore and continental shelf while 80% is for deep offshore, Anambra, Benue and Chad basins.

The absence of a suitable audit provision is a weakness noticed in all the PSCs executed in Nigeria. Audit provision can be employed to determine the actual cost the contractor can recover. Typically, it is in the PSC contractor's interest to keep the costs as high as possible to avoid paying taxes or profits to the government. Quarteman, C.L. (2005) made the following observation about the Nigerian PSC arrangement that were executed before 2005:

> Nigeria's PSC system tempts the contractor to engage in creative accounting to show increased costs and avoid showing a profit. The state is cognizant of that temptation and must dig deep, which increases everyone's costs and the potential for disagreements between the contractor and the state. Since the state is not sharing in the losses of unsuccessful exploration efforts, the contractor's appetite for

> exploration may be suppressed. In the end, overall government receipts are likely to be lower in such a scenario because it is impossible to design an inexpensive administrative process that either finds cost overruns or provides incentives for contractors to hold costs down.

In the all the models of the Nigerian PSC, the provisions on audit of the accounting records of the contractor's operation are simply to the effect that NNPC has the right to inspect and audit the accounting records of the contractor. It is not used to determine the cost incurred in the petroleum operations before it is recovered. The Audit provision in all the PSCs is basically the same. For example Clause 13.2 of the 1993 PSC states thus:

> The CORPORATION and its external auditors shall have the right to inspect and audit the accounting records relating to this Contract for any Calendar Year by giving thirty (30) days' written notice to the CONTRACTOR. The CONTRACTOR shall facilitate the work of such inspection and auditing; provided however that such inspection and auditing shall be carried out within two (2) Calendar Years following the end of the Calendar Year in question. If not, the books and accounts relating to such Calendar Year shall be deemed to be accepted by the Parties as satisfactory. Any exception must be made in writing within ninety (90) days following the end of such audit and failure to give such written notice within such time shall establish the correctness of the books and accounts.

In the Trinidad and Tobago, the audit provision in the PSC is used to assess and determine the cost that can be recovered by the contractor. Article 18.7 of the 2006 and 2013 Model PSCs provides thus:

> Subject to the Accounting Procedure and the auditing provisions of the Contract, Contractor shall recover costs and duly verified in accordance with Article 17 of the Contract in respect of the Petroleum Operations hereunder to the extent of and out of the following maximum limits per Calendar Month of all Available Crude Oil and/or all Available Natural Gas from the Contract Area, (hereinafter referred to as "Cost Recovery Crude Oil" and/or "Cost Recovery Natural Gas" and collectively as "Cost Recovery Petroleum").

It is recommended that the audit provision in the Nigerian PSCs should be reviewed and properly couched so as to enable the NNPC use it in the cost recovery process.

Effective monitoring of the operations of the contractors to ensure that the venture is profitable is another challenge for the government in the PSC arrangement in Nigeria. It would appear that the National Petroleum Investment Management Service (NAPIMS), a unit of NNPC, who is charged with the responsibility of managing and monitoring the costs of the petroleum operations has not been effectively carrying out its responsibilities in this regard. Umar, M.B. (2005) observed that NAPIM has not been monitoring the activities of the contractors as it should and made the following remark:

> Information gathered by the author from review of several Account and Audit reports, minutes of some Management and Technical committee meetings, and the deliberations of the meetings of such committees personally witnessed, all indicate regular violations of some of the above contractual safeguards. These violations include, execution of work programme outside the approved budget; funding massive cost overrun without seeking the required management committee approval; over capitalisation of capital expenses and the ultimate write off of non-existent Capital assets; poor reporting of drilling expenditures; poor contract administration leading to value for money misfocuss; poor accounting for bank transactions; and over estimation of Capital expenses and the treatment of certain Pre-production expenditure as part of Capital expenditure for the purposes of computing head office overhead charges.
>
> For instance records obtained from the PSC accounts unit of NAPIMS show that from the cost verification exercise carried out on 3 companies in 2000 and 2001, the companies were found to have overstated their operating expenses by thirty six million seven hundred and fifty nine United States Dollars ($ US 36, 759,000.), which gives a possible indication of what to expect from other companies.

6. Conclusion

There is no doubt that PSC has assumed a place of prominence in the contractual arrangement in the Nigerian upstream petroleum sector with different models in place. Major discoveries have been made in Nigeria's deep offshore and inland basin through the PSC arrangement. PSC now covers an impressive percentage of Nigeria's crude oil production, which is about 32.8% particularly with fields awarded under the 1993 PSC model. However, government take is very low. The 2005 PSC model is a step forward in ensuring adequate government take but the fields awarded under this model are yet to come on stream. A political and amicable approach may be required to resolve the dispute over the interpretation of some provisions of the 1993 PSC even though Arbitration Awards have been made. This notwithstanding, PSC arrangement is a better option for development of the offshore oil reserves as it relieved the Government incurring any financial burden that is associated with joint venture arrangement. It also gives the Government a degree of control over the operation of the oil companies. The PSC arrangement offers a great window of opportunity for the exploration of the Nigerian huge petroleum deposit particularly in the light of the diminishing revenue available to Government.

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