



JOINT OPERATING AND PRODUCTION SHARING
AGREEMENTS-CONTRACTS ADMINISTRATION: DELIVERED
AT THE EXTRACTIVE INDUSTRIES TRANSPARENCY INITIATIVE
WORKSHOP IN ABUJA

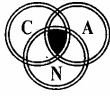
1. INTRODUCTION

This presentation aims at:

- (a) providing the Nigerian stakeholders an insight into the principles of the agreements under which co-investors with Nigeria Inc. and operators exploit and produce the nation's hydrocarbon resources;
- (b) illustrating as graphically as possible, the linkage between prompt decision making and control of costs of activities/works leading to the extraction and production of hydrocarbons; and
- (c) proffering suggestions, to correct the lapses in the existing operating principles that generate the distrust, and perceived lack of accountability between Nigeria stakeholders and those vested with the responsibility of protecting their interests on one hand; and the operators of the agreements on the other.

In the nascent period of government acquisition of interests in the multinational E&P companies operating in Nigeria, the activities were separately regulated by:

- a) Lease (Concession) Agreements which set out the lease areas and conditions of holding and release of same;
- b) Participation Agreements under which the Government acquired the participating interest in the leases, assets and working capital,



- c) Offtake/Scheduling and Lifting Agreement, which set out procedures for lifting the hydrocarbons, won under the operation of the agreements in (a) and (b) above.

Notwithstanding that by virtue of the Participation Agreements, each of the interest owners became responsible for all liabilities and obligations relating to the Oil Mining Leases, their specific terms were lacking in:

- 1) Explicit definition of responsibilities;
- 2) Transparency as far as:
 - (i) investment decisions
 - (ii) choice of contractor and
 - (iii) measurement of value for money expended on the various facets of operations were concerned; and
- 3) Verification of proper application of funds by the Operator.

The impact of the persistent decline of crude oil prices (Fig.1), which started in 1981 and reached an intolerably low level by 1986, brought home to the Nigerian authorities that the JV operations could not be run on the basis of trust alone given the size of expenditure involved (in comparison to the nation's annual budget).

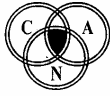
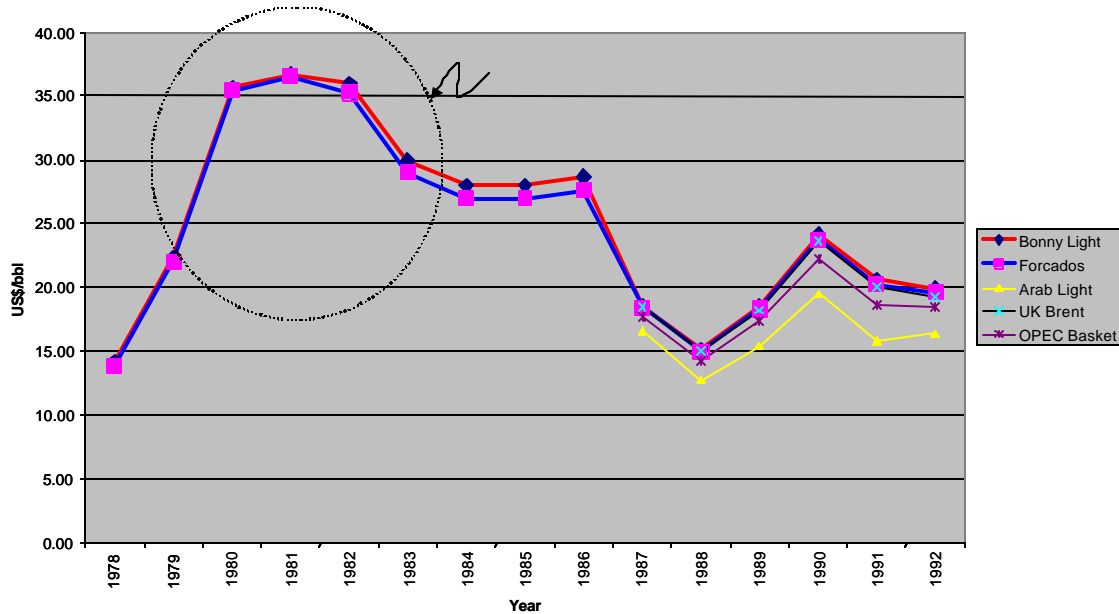


Fig 1: Average (Spot) Crude Prices



At a time when funds availability to meet oil exploration and production activities was seriously threatened, it was time to take a closer look at expenditures and set a proper basis for accountability. Discussions were thus initiated with the producing companies, to put in place a comprehensive agreement, the Joint Operating Agreement. The same principles with some amendment were later introduced to form the Production Sharing Contracts.

2. JOINT OPERATING AGREEMENTS (*signed 1991*)

As indicated in Figure 2 below, based on the internal and prevailing external environment analysis the **four principal objectives** which the JOA was designed to achieve were the:

- Control of activities
- Maximization of income
- Domestication of technology, and
- Nigerianisation

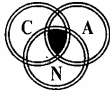
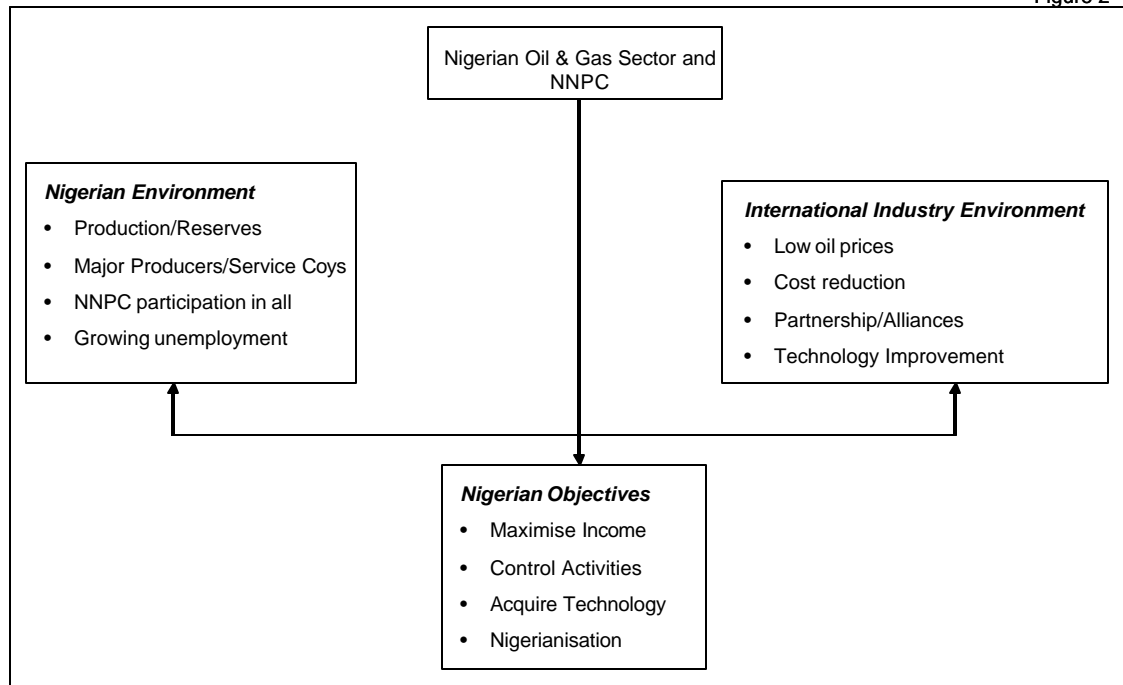


Figure 2



The essentially generic Joint Operating Agreements were designed to regulate the conduct of the operator in carrying out operations while concurrently stating the obligations and rights of both the operating and non-operating parties.

The obligations of the operator covered basically, the conduct of all operations on a safe and cost effective basis, where the Joint assets of both parties in the venture are properly accounted for and protected in line with standard industry practice.

The non-operator's principal obligation was to provide its share of funding required (under JV) and speedy approvals of related works (under JV and PSC) for the operations based on mutually agreed budgets and schedules.

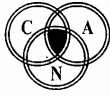
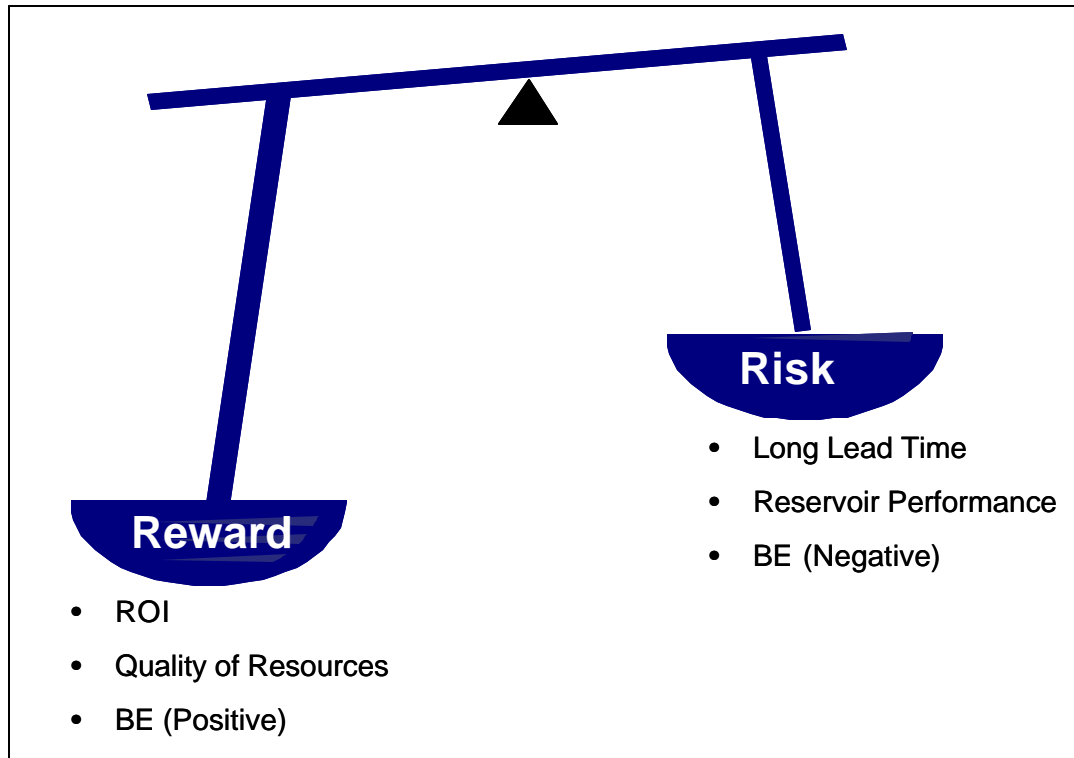


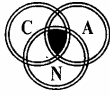
Figure 3: Risk/Reward Scale



Similarly the agreements covered the disposal of the oil won from the operations, as well as the ownership and access to all data arising from the joint operations. There are appropriate penalties for default by all parties.

Specifically, the provisions of the JOA are built around the following principal elements.

- Budget*
- Accounting Procedures*
- Level of Discretionary spending*
- Administration
- Project Implementation*
- Voting



- Sole Risk
- Local content*
- Information
- Post Activity Audits*

The following slides show the principal interrelationships of the six asterisked elements and how they impact on retrieving the four principal objectives noted earlier. They also show the present process of post budget approval.

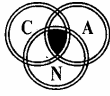
3. POST JOA ASSESSMENT

A number of post JOA assessments have been undertaken to review:

- (i) What have they added to the quality of the operations?
- (ii) What are the pitfalls?
- (ii) What improvements are necessary?

The services of Arthur D. Little were contracted in 1996 to evaluate these questions in the first post-JOA assessment. Here are some of the observations.

- The JOA has strengths for Nigeria such as the non-operating national company having:
 - a blocking vote; and
 - rights to take over some functions from operator
- The JOA further allows the national company to compare several large and active joint ventures with six very experienced operators and benchmark operations. The national company thus potentially



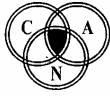
has a strong and well-informed position being better placed than most non-operators.

- But these strengths were weakened by inability and failure of Nigeria to exploit the following benefits which are available under the JOA to the fullest extent:
 - assignment and training of personnel
 - development of operator capability
 - pace of Nigerianisation
 - participation in contract award process* (capability in assessing adequacy of scoped work, often leading to significant cost overruns...)
 - acquisition and utilization of information*
 - sole risk
 - threat or use of blocking vote.

- The principal weakness derived from inability to meet timely, financial obligations.

- Another source of weakness is that certain clauses and provisions are either not in line with current best international practice, or limit the effectiveness of the non-operator. Specifically, the allowance of:
 - i) a level of overhead recovery by the operator that is too high by today's international practices; and

 - ii) operator, a 10% overrun on total annual budget (as opposed to 10% on each budget or AFE item). This occasionally led to game playing by operators and reduced the national company's control.

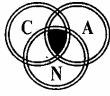


- An AFE approval procedure is lacking. Normal international practice allows for approval of Authority for Expenditure (AFE) for individual budget items, in addition to approval of Annual Budget and individual contracts. However, the AFE approval needs to be used as a mechanism for improving the JV operations and not as a bureaucratic delaying procedure.
- The timing and process of involvement in the award of contracts needs to be improved;
- Materials and expatriate labour cost need to be reduced
- The right and speed of access to information needs to be improved.
- The use of post activity audits left the national company without recourse where operator had committed funds to non-approved work.

The cumulative effect of these weaknesses have been cost overruns, unpaid cash calls that operators turned in arrears, while budget constraints made those unpaid cash calls “national debts”. The government authorities blamed NAPIMS for ineffective cost control, and the result is increasing layers of bureaucracy in granting approvals for contracts.

Compounding the inherent length of time to get approval with the low discretionary spending level granted the operator – these major problems have emerged:

- (a) significant delays in project implementation with attendant cost increase; and



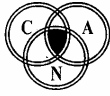
- (b) the number of personnel available cannot handle the large number of contracts going through the approval process; with contract processing becoming the principal activity of the NAPMS staffers! This was not the core of NAPIMS assignment.

4. NEW STRATEGIC DIRECTIONS

4.1 Issues for Government

The reality of persistent cost overruns and or underfunding is that the joint venture operating/production sharing agreements as currently is carries much greater risk than is acceptable for stable economic development of Nigeria. It has brought home the need to consider such options that emphasize short to medium term funding stability for joint venture operations along with PSCs under better cost control measures. At the Government level,

- government should as priority determine the level of funds it is prepared to invest in the upstream joint venture E&P activities during the relevant plan period so that the operating companies can plan adequately. Simultaneously government can within reasonable limits know its revenue expectation;
- in any year where the market realized price from the sale of crude oil exceeds the budget value, a proportion of the windfall should mandatorily be ploughed back to the sector;
- the cost of joint venture operations be reduced by demanding that fields in which the JV companies can not achieve the agreed technical cost under the Memorandum of



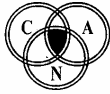
understanding (MOU) should be mandatorily released by the companies for rebid under PSC/SC arrangement;

- where a JV company has held a lease for more than ten years without significant development, such lease should also be released for bid under PSC/SC arrangement.
- In terms of revenue expectation, while collection of payable tax is the responsibility of the FIRS, the calculation of tax payable by joint venture and all service companies shall be coordinated between NAPIMS, the government agency brought out of NNPC, Federal Inland Revenue Service (FIRS) and the Central Bank of Nigeria (CBN) to ensure full realization of tax revenue;

4.2 Issues for NAPMS/Operators and Service Companies

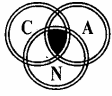
Until very recent times, the commitment of the operators to the national objectives of Nigerianisation was highly questionable. The adverse effects of the increasing restiveness of communities where the oil exploration and production activities are carried out is now forcing a re-think on how to enhance the participation of indigenous enterprises.

Multinational service companies who provide a variety of indispensable services to E&P companies and who account for nearly 40% of the expenditures have shown little commitment to the same objectives. Without the insistence of the present joint operators and future investors on service companies to participate in the set objectives, little of the expenditure flowing to them for services done will ever be recycled into the local economy.



Perhaps the most serious success factor for achieving the objectives is addressing the key integrity issue of agents/representatives interests vis-à-vis national interest when it comes to local content and technology acquisition.

- Both NAPIMS and Operators must commit to processes that reduce the present long lead time between project approval and project completion. This is a major factor impacting on costs, and needs to be addressed at two levels:
 - (i) Technical pre-qualification process that addresses active and continuing access by local service providers for local content purposes combined with shortening of the NNPC approval process; and
 - (ii) an upward review of the currently abysmally low level of discretionary approval
- Existing and future agreements must have AFEs for individual budget items in addition to approval of annual budget and individual contracts. The AFEs will be discharged at NAPIMS level without reference to the GEC/Board and within specified time limit. This requirement will help in eliminating wrong application of funds, and cost variations arising from poor scoping of work by operators. The Head of NAPIMS can then be held accountable of post activity value for money audits show the land of budget overruns that have become embarrassments to Government's spending limits!



5. CONCLUSION

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