



MEMORANDUM

April 12, 2005

TO: Nigerian National Stakeholders Working Group

FROM: Cynthia L. Quarterman<sup>1</sup>

RE: Transparency and Change Management White Paper for  
Nigeria's Extractive Industries Transparency Initiative ("NEITI")

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**I. Executive Summary**

Nigeria is a nation whose great achievements in many areas and well-deserved importance to the extractive industry are clouded by the unfortunate perception and historical reality of wide-spread corruption. That perception extends to the dealings of the government in the extractive industries. This memorandum makes recommendations on to ameliorate this perception. To do this, we do not believe it is necessary for the government to relinquish all involvement in the extractive industry — certainly not its role as regulator. Rather, we believe a great deal can be achieved by introducing transparency in, and sunlight on, the Nigerian government's relationships with the extractive industries operating on and off the nation's shores. We note specific recommendations on how to implement transparency based on the most positive and proven practices of in a number of countries, including the United States, Brazil, Norway, and Sao Tome and Principe, as adapted to reflect Nigerian realities.

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The course that the Nigerian oil and gas regime has followed, even through the lens of hindsight, is not substantially different than the one followed by nations around the world. Nigeria shares its original decision to create a state-owned oil company with nations such as the United Kingdom and Norway.<sup>2</sup> Nor were the joint ventures the Nigerian-owned oil company entered with national oil companies unique to its regime. Nigeria's latter-day production sharing contracts are in good company with those of oil producing nations worldwide. Accordingly, it is no surprise that the same troubles and concerns that have historically plagued oil rich nations are now rampant in Nigeria. Top among those is the public's crisis of confidence in the government's oversight of the extractive industries, and the perception of widespread corruption.

There is a growing consensus among the government, the Nigerian public, the national oil industry and the world at large that Nigeria is at a tipping point with respect to its exploitation of its natural resources. That is, a point at which its oil and gas regime could just as easily devolve into total chaos as to monumental reform. We believe that the timing is propitious to enact, implement and enforce the recommendations contained herein to create an oil and gas regime that is far simpler, more transparent and, significantly, stable.

The discussion that follows sets forth our understanding of the current problems facing Nigeria's oil and gas regime, the source of its current problems, including a description and critique of that regime, a comparison of Nigeria's system to other nations and three broad

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<sup>2</sup> This paper refers to the laws of several jurisdictions other than the United States. The discussion that follows is based on the memorandum provided to me by the Nigerian counsel you engaged in this case, Akinboyejo Akinola, and publicly available materials regarding the laws of Nigeria, Norway, Brazil, Sao Tome and Principe and other jurisdictions other than the United States. We are not licensed to practice law and do not hold ourselves out to be experts in the laws of those jurisdictions. The materials appearing herein regarding those laws are merely our understanding of the laws currently in place based on commonly available materials and are for purposes of background only. This memorandum does not constitute a legal opinion as to the application of those laws.

recommendations to embrace change, keep any new regime simple and invest for tomorrow today.

In summary, our recommended course of action is to create a broad-based Legislative Commission to propose changes to Nigeria's existing laws, which would include provisions to:

- Commercialize the Nigerian-owned oil and gas company by
  - Creating an independent body to determine which assets the company should retain;
  - Defining the parameters to be used in reaching those asset determinations;
  - Establishing safeguards against unfair advantages in the government's future dealings with that entity;
  - Moving its regulatory functions to a new regulatory agency;
  - Providing for open competition between that entity and other oil companies;
  - Determining whether, to what extent and/or how its shares should be made public;
  - Establishing a transition to a new competitive environment; and
  - Renegotiating terms of existing agreements.
- Make open competitive bidding processes mandatory;
- Consider use of a competitive leasing system;
- Simplify the financial terms of the government's take;
- Require publication of all future extractive industry contracts;
- Enforce contractual and legal requirements;
- Require stakeholder involvement in decisions regarding the extractive industries;
- Publish extractive industries' revenue and production payments and receipts;
- Audit tax and royalty receipts;
- Require financial disclosure of government employees involved in oversight of extractive industries;
- Establish conflict of interest laws for those involved in the oversight of the extractive industries;
- Review government contracting laws with a view towards transparency;
- Create a new extractive industries regulatory agency whose mission would include —
  - Simplifying the extractive industries' leasing system;
  - Simplifying the extractive industries' revenue terms, calculations and collections;
  - Publishing revenue and production data;
  - Overseeing extractive industry operations;
  - Establishing revenue collection controls;
  - Collecting oil and gas revenues;
  - Auditing oil and gas revenue receipts and production volumes; and
  - Involving stakeholders in its decision making process.
- Establish a Nigerian Extractive Industries Trust Fund.

The discussion that follows sets forth in detail the rationale supporting the recommendations set forth above.

## II. Current Problems Facing Nigeria's Oil and Gas Regime

According to the 2004 Transparency International Corruption Perceptions Index ("CPI"), Nigeria is perceived as being among the top three most corrupt countries in the World.<sup>3</sup> The CPI is comprised of a poll of polls by business people and country analysts. Nine of eighteen polls by twelve independent organizations rank the perceived corruption level in Nigeria.<sup>4</sup>

Transparency International notes that "the Corruption Perceptions Index 2004 shows, oil-rich . . . Nigeria . . . has extremely low scores. . . . public contracting in the oil sector is plagued by revenues vanishing into the pockets of western oil executives, middlemen and local officials."<sup>5</sup>

The perception of corruption linked to the extractive industries is shared by NEITI's National Stakeholders Working Group ("NSWG") and many in the Nigerian and world public. The cause of this perception is multifaceted and is discussed in more detail below. Some of the more common complaints with respect to Nigeria's extractive industries follow:

- Absence of integrity in oil and gas laws;
- Unclear oil and gas laws, regulations and policies, including in bidding, contracting, exploring, developing and producing phases;
- Failure to enforce the terms and meet the requirements of the existing oil and gas laws, regulations and policies;

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<sup>3</sup> Transparency International Perceptions Index (2004) at [www.transparency.org](http://www.transparency.org).

<sup>4</sup> Those nine polls are Columbia University's 2003 report, the Economist Intelligence Unit's 2004 report, Information International's 2003 report, A Multinational Development Bank's 2002 report, Merchant International Group's 2004 report, World Markets Research Centre's 2004 report, and the Global Competitiveness Report of the World Economic Forum's 2002-2004 reports.

<sup>5</sup> Transparency International Press Release (Oct. 20, 2004).

- Unclear or overlapping roles and responsibilities among governmental and quasi-governmental agencies;
- Flaws in budgeting for oil and gas production and in using budgeted funds;
- Illegal, unknown or non-beneficial contractual arrangements;
- Absence of stakeholder involvement in decision-making;
- Inappropriate payments, arrangements and understandings with governmental and non-governmental entities relating to oil and gas production, allocation and trade;
- Absence of independent oversight of oil and gas operations; and
- Failure to report oil and gas production and revenue data publicly.

### **III. Source of Nigeria's Current Problems**

The primary cause of the perception of corruption in the Nigerian extractive industries is the lack of transparency. While natural resource wealth is immediately and visibly positive, it is “that which is not seen” that could cause damage to Nigeria in the long term. The complaints mentioned about Nigeria's system above exist because there is little or no transparency in the way the extractive industries operate and how the government oversees those operations. Historically, it appears that at almost every step, Nigerian laws, regulations, policies and practices governing the extractive industries have the, perhaps unintended, effect of obfuscating rather than illuminating. Contributing to the perception of corruption is the absence of simplicity and stability in Nigeria's oil and gas fiscal regime. Such perceptions are unlikely to persist under a government system that is simple, stable and transparent. We recommend that should be Nigeria's goal.

## A. The Nigerian Oil and Gas System

According to the Nigerian Constitution, all minerals, oil and gas belong to the federal government.<sup>6</sup> Commercial quantities of oil were first produced in Nigeria in 1956.<sup>7</sup> Today's oil production in Nigeria is approximately 2.1 million barrels per day.<sup>8</sup> Oil revenues constitute nearly 80% of total federal revenues, 90-95% of export revenues and over 90% of foreign exchange earnings.<sup>9</sup> Nigeria is looking to its offshore oil resources, especially in the Niger Delta and deep water, to increase its production capacity to 4 million barrels by 2010.<sup>10</sup> It also hopes to expand production of its extensive gas reserves and eliminate flaring of gas associated with oil production by 2008.<sup>11</sup> The way that Nigeria has managed its oil and gas wealth has varied over time, but most of its oil is produced pursuant to two kinds of contractual arrangements.<sup>12</sup>

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<sup>6</sup> Item 39 of the 2<sup>nd</sup> Schedule to the Nigerian Constitution.

<sup>7</sup> Executive Summary, Nigeria 2005 Licensing Round for Oil and Gas Exploration and Production Blocks, Introduction at 5 (hereinafter "Licensing Round Executive Summary").

<sup>8</sup> See U.S. Department of Energy, Energy Information Administration, Nigeria Country Analysis Brief (Aug. 2004) at [http://www.eia.doe.gov/emeu/cabs/ngia\\_jv.html](http://www.eia.doe.gov/emeu/cabs/ngia_jv.html) (hereinafter "EIA Nigeria Country Brief").

<sup>9</sup> See *id.* at <http://www.eia.doe.gov/emeu/cabs/nigeria.html>.

<sup>10</sup> *Nigeria: Selected Issues and Statistical Appendix*, IMF Country Report No. 03/60 at 7 (Mar. 2003) (herewith "IMF Country Report No. 03/60").

<sup>11</sup> *Id.*

<sup>12</sup> The discussion that follows is limited to joint ventures and production sharing contracts. Nigeria also uses other contractual arrangements, however, we do not focus on those here because there are relatively few of those arrangements.

## 1. Joint Ventures

Most of Nigeria's oil production (approximately 95%) is produced under joint ventures ("JV") between large subsidiaries of U.S. and European major oil companies (Royal Dutch/Shell, ExxonMobil, ChevronTexaco, TotalElfFina, ConocoPhillips and Agip)<sup>13</sup> and the state-owned Nigerian National Petroleum Corporation ("NNPC"). NNPC owns the controlling interest of those JVs, usually 60%.<sup>14</sup> The oil companies operate those JVs, but each partner is responsible for funding its equity portion of the operation. After production occurs, NNPC is responsible for, among other things, marketing and exporting the government's share of production and allocating a portion to local sources for refining.<sup>15</sup> An NNPC subsidiary, the National Petroleum Investment Management Service ("NAPIMS"), is charged with managing Nigeria's portion of the JV and monitoring the costs of its oil company partners.<sup>16</sup>

Nigeria receives oil revenues in the form of fees, rents, royalties, petroleum profit tax ("PPT"), and equity dividends. The fees and rents per square kilometer are set forth in the Petroleum Regulations.<sup>17</sup> The royalty rate varies depending upon whether the production is onshore or (by water depth) offshore.<sup>18</sup> The royalty is paid on the "price" of the crude net of

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<sup>13</sup> See EIA Nigeria Country Brief at [http://www.eia.doe.gov/emeu/cabs/ngia\\_jv.html](http://www.eia.doe.gov/emeu/cabs/ngia_jv.html).

<sup>14</sup> The only exception is the Shell JV in which NNPC owns a 55% interest. See *id.*

<sup>15</sup> Nigerian National Petroleum Corporation Act, Chapter 320, Part 1, Section 4 (1990).

<sup>16</sup> [http://www.nnpc-nigeria.com/index2.php?option=com\\_content&task=view&id=34&Itemid=...](http://www.nnpc-nigeria.com/index2.php?option=com_content&task=view&id=34&Itemid=...)

<sup>17</sup> Petroleum (Drilling and Production) Regulations, Regulation 60c (2003).

<sup>18</sup> *Id.* at Regulation 61.

certain handling, storage and transportation costs and other crude loss and lease use deductions.<sup>19</sup> That “price,” which is supposed to bear a fair and reasonable relationship to posted prices, is established by and paid to the Minister of Petroleum Resources of the Department of Petroleum Resources (“DPR”). DPR is also responsible for issuing licenses and collecting royalties and other fees.

Our understanding is that the JV agreement details the legal and administrative relationship between the partners and the rules and procedures to be followed under the mining license. Each JV is also subject to a Joint Operating Agreement (“JOA”) with NNPC, relating to the administrative terms of the partnership.<sup>20</sup> Each partner is obligated to treat all data under the JV and JOA as confidential and prevent its disclosure.<sup>21</sup> Under the JV arrangements, NNPC and its partners are supposed to contribute to projects according to their equity ownership. The NNPC, however, has frequently been unable to meet that requirement in the past because the Nigerian legislature has failed to appropriate sufficient funds for it to meet its financial obligations. It is our understanding that NNPC now covers its share of JV expenses from its export revenue collections before transferring them to the government.<sup>22</sup> The terms of the JVs have been amended several times by Memoranda of Understanding (“MOUs”). The JVs currently operate under the terms of MOUs entered into with the Nigerian government in 2000 that revised the government take. The financial terms of the MOUs are complicated, assigning minimum guaranteed notional margins for each partner and offsets against taxes based on the

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<sup>19</sup> *Id.*

<sup>20</sup> *Id.* at 2.

<sup>21</sup> *Id.* at 7.

<sup>22</sup> IMF Country Report No. 03/60 at 14.

level of capital investment. These MOUs appear to amend the financial terms of the Petroleum Act ostensibly to reflect negotiated arrangements.

Our understanding of the way in which the revenue collection works is as follows:<sup>23</sup> The Federal Inland Revenue Service (“FIRS”) collects the PPT and passes it on to the Office of Accountant General (“OAGF”). DPR collects fees, rents and royalties and passes those on to the OAGF. NAPIMS is responsible for transferring oil dividends from NNPC’s equity participation in the JV. Eventually OAGF passes on its receipts to the Central Bank of Nigeria (“CBN”).

## **2. Production Sharing Contracts**

More recent Nigerian contracts for offshore production have been in the form of production sharing contracts (“PSC”).<sup>24</sup> Production sharing agreements became popular in the 1950s and 1960s in countries like Iran and Indonesia because ownership in the underlying resources was clearly retained by the state.<sup>25</sup> Under those agreements, the major oil company operator contracts with the NNPC to develop resources. The contractor receives a share of the production; in exchange it covers the costs of exploration and production in the first instance and pays the government royalties on the produced oils based on water depth.<sup>26</sup> After royalties are paid, the second call on the production is for the contractor’s costs (so called “cost oil”) other than fees and bonuses, and capital expenses, which are recovered over a five year period.<sup>27</sup> After

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<sup>23</sup> *Nigeria: Selected Issues and Statistical Appendix*, IMF Country Report No. 04/242 at 65-69 (Aug. 2004) (hereinafter “IMF Country Report No. 04/242”).

<sup>24</sup> *Id.* at 66; *see also* IMF Country Report No. 03/60 at 16. Nigeria also has some PSCs in place with local companies.

<sup>25</sup> *Typical World Petroleum Arrangements* by Professor Ernest E. Smith, University of Texas at Austin Law School (hereinafter “*Typical Arrangements*”).

<sup>26</sup> *See* Section 5, Production Sharing Contracts Act of 1999.

<sup>27</sup> IMF Country Report No. 03/60 at 15-16.

the contractor has recouped its expenses, tax is paid at a PPT rate lower than that of JVs.<sup>28</sup> Finally, profit oil is apportioned based on NNPC's sharing arrangement, which adjusts on a sliding scale.

### 3. Upcoming 2005 Licensing Round

Nigeria has a licensing round planned for July 2005 that is being administered by DPR. That licensing round is for both onshore and offshore leases. However, it is clear that the great hope for the round is with respect to the deepwater offshore areas.<sup>29</sup> As mentioned above, Nigeria has targeted to increase production to 4 million barrels per day by 2010. It expects most of that production to come from the offshore licenses. The 2005 licensing round is advertised as being based on a new "Brazilian-type open bidding process."<sup>30</sup> Under that new process, bidders must meet certain qualifications for bidding such as providing evidence of financial wherewithal, technical capability, and a commitment to the environment and local content.<sup>31</sup> A Bid Committee will be involved in this qualification process to among other things "allow ... for the possibility of forming consortia."<sup>32</sup> The bids are to be evaluated based on four weighted factors: a cash bonus bid above a prescribed minimum amount (40%); a ceiling for "cost oil" recovery below the prescribed maximum of 80% (20%); the dollar value of its mandatory local content

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<sup>28</sup> The legislature is currently considering enacting a provision that would unilaterally change the tax terms of the PSCs to the same percentage as the JVs. *See* AllAfrica.com, *FG Threatens Investment in Nigeria's Deepwater Oil/Gas* by Hector Igbikiowubo at <http://allafrica.com/stories/200503220465.html> (Mar. 22, 2005).

<sup>29</sup> *Nigeria 2005 Licensing Round for Oil and Gas Exploration and Production Blocks, Executive Summary* (hereinafter "Licensing Round Executive Summary" at 13.

<sup>30</sup> Licensing Round Executive Summary at 1.

<sup>31</sup> *Guidance Information for Prospective Bidders of the Year 2005 Licensing Round* at 6-7 (Feb. 2005).

<sup>32</sup> *Id.* at 8.

activities (20%); and the dollar value of its work program commitments above the prescribed minimum levels (20%). The sealed bids will be opened, verified, evaluated and announced on the spot. Equity allocations to non-operators are capped at 30%. The bidding process is to end with the signing of a PSC, “including the company data and adjusting specific clauses of contract.”<sup>33</sup> In spite of the provision that the bids will result in a PSC, the bidding guidance also states that the contractual arrangements may be chosen by the government at its discretion.<sup>34</sup> The State reserves the right to participate in the operations of any block at its option.<sup>35</sup>

#### **4. Gas Production**

The other major Nigerian governmental initiative mentioned above is to increase Nigeria’s production and recovery of natural gas. It is estimated that Nigeria has 159 trillion cubic feet of proven gas reserves.<sup>36</sup> However, most of that gas is *in situ* or is being flared or re-injected during oil production. There are several current projects to tap those gas reserves by converting gas to liquefied natural gas (“LNG”) for shipment to Europe and the United States, for use domestically and for transportation via pipeline to neighboring countries. The Nigerian government has used a “carrot-and-stick” approach to gas production thus far, penalizing those who flare gas and providing financial incentives to upstream producers who utilize the gas (*e.g.*, operating and capital expense tax deductions from oil income and royalty and tax holidays or

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<sup>33</sup> *Id.* at 10.

<sup>34</sup> *Id.* at 4 and 14.

<sup>35</sup> *Id.* at 4 and 10.

<sup>36</sup> EIA Nigeria Country Brief at 6.

exemptions).<sup>37</sup> The LNG facilities already built and those in process are by a consortium including NNPC.

## **B. Critique of the Nigerian System**

At the first step in designing an oil and gas system, there are two alternative approaches for a state to consider to convey mineral rights to the private sector; that is, through a non-competitive or competitive system. A competitive system is by definition the most transparent because competition demands openness and ease of access. The non-competitive approach is accordingly less transparent because the state assigns exploration and production rights through negotiated agreements. Those negotiated agreements usually take the form of concessions, production sharing or service contracts. Historically, concessions were the earliest mechanisms (and arguably the least sophisticated) used by states to transfer oil and gas resources.<sup>38</sup> They usually involved the transfer of exclusive rights to explore for or develop resources in large areas for long periods of time. Over time those arrangements evolved into ones with more limitations, increasing the host government's participation or take and specifying diligence and socioeconomic requirements (*e.g.*, local hiring, purchasing, investment and processing).<sup>39</sup> State-owned companies often formed joint ventures with the concessionaires to explore for and develop resources. One example of such a system is the old Norwegian system, which is discussed in more detail below. Under that system, benefits to the state came in the form of

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<sup>37</sup> IMF Country Report No. 03/60 at 17-19.

<sup>38</sup> Strictly speaking a concession is simply a contract granting a right. However, in the oil and gas arena it has become virtually synonymous with the earliest agreements such as the 60 year concession William Knox D'Arcy negotiated on behalf of the forerunner to British Petroleum to explore for oil throughout the entire Persian Empire in 1901. *See Typical Arrangements* for a discussion of world oil and gas arrangements.

<sup>39</sup> *Id.* at 9-17 to -20.

equity stakes, royalties and taxes on income and special or excess petroleum profits.<sup>40</sup> The traditional concession arrangements eventually gave way to PSCs, which gave governments more control over their resources and put oil companies in the role of a mere contractor. PSCs have been particularly popular in African and Far East countries.

Non-competitive, negotiated agreements such as the JV and PSC used historically in Nigeria — though not transparent — do have some advantages.<sup>41</sup> For example, they give the government a great deal of flexibility in creating an arrangement that meets its non-financial objectives such as requiring local content as well as in varying the terms according to the situation. Negotiated agreements also ensure that the government retains physical control over its resources.<sup>42</sup> The large size of the areas conveyed could, at least theoretically, lead to more discoveries and less duplication of exploratory effort.

However, with those advantages come a multitude of pitfalls.<sup>43</sup> By virtue of providing more flexibility and control over governmental resources, the non-competitive systems introduce more opportunity for abuse. Whenever a state and a private industry group negotiate the terms of a contract in secret, the potential for corruption is introduced. That is precisely why government procurement processes are often the source of substantial regulation and oversight.

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<sup>40</sup> The earliest concessions were not particularly remunerative for the states and many were later revised or overturned. *See id.*

<sup>41</sup> *See Regime for the Acquisition of Mineral Rights (Draft)* by Walter Cruickshank, MMS Office of Program Review at 5 (Aug. 26, 1988) (hereinafter “*Mineral Regimes*”).

<sup>42</sup> It is just such government flexibility that has led at least one commentator to conclude that the U.S. competitive system discussed below should be supplanted by a non-competitive system such as the one used by the United Kingdom in the North Sea. *See “The Challenge of Offshore Leasing Regimes on Commercial Oil Activity: An Imperial Analyses of Property Rights in the Gulf of Mexico and the North Sea,”* by Christopher F. Richardson, 17 *Geo. Int’l Env’tl. L. Rev.* 97, 106 (Fall 2004).

<sup>43</sup> *Mineral Regimes* at 5.

Because of the large sums of money involved, the potential for corruption increases exponentially in negotiations relating to the extractive industries (as well as the military industries). One commentator has summarized the problem with corruption in extractive industries this way:

...It can be very difficult to estimate how much money is going to the government. There are several sources of government revenue: the bonuses, the profit splitting, and the taxes. Each different payment stream is determined by a variety of inputs such as production of the commodity, capital expenses, and operating expenses. The contract determines the parameters for the payment, but without details of the arrangement it is impossible to know from normal public records alone how much money the government is actually receiving.<sup>44</sup>

It requires a strong and mature government to override the natural tendency for corruption in such circumstances by putting in place extensive administrative controls, checks and balances and a well managed negotiating arm. Otherwise, government negotiators open themselves up to claims of favoritism in both the choice of partners and contractors, and the terms of the agreements they have negotiated. Because, the negotiated terms are not based on market forces they do not necessarily result in the best financial offer or the choice of the most skilled partner or the most efficient operations. Instead, the terms are crafted to meet some governmental policy dictated by the state often at considerable expense. Since the wisdom of the policy itself may be the subject of controversy in some quarters, the resulting contracts will almost certainly be questioned. Finally, because the negotiated terms are essentially political in nature, new or different markets or political conditions can cause unexpected changes in the arrangements. This is often the case in less stable oil and gas producing states where a change in

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<sup>44</sup> “*Oil, Diamonds, and Sunlight: Fostering Human Rights Through Transparency,*” by Andreanna M. Truelove, 35 *Geo. J. Int’l J.* 207, 220 (Fall 2001).

regime often means erasing the contractual slate and starting afresh.<sup>45</sup> In such situations, the government system is not transparent, simple or stable because the underlying contracts are not themselves.

That is certainly the case with respect to Nigeria's JVs and PSCs. The public was not privy to the negotiating process or the ultimate terms of the agreements. Although the government became intimately involved in the development of oil and gas resources in Nigeria through NNPC, the operations of NNPC are not open to the public. The public has no way of knowing what arrangements are being made between NNPC and its JV partners. In fact, NAPIMS, which reports to the Board of NNPC, is responsible for overseeing both its partners and itself when it comes to determining how much money is needed to invest, operate and maintain a project. Given this conflict of interests, it is not surprising that the Nigerian legislature has often questioned and sometimes refused to meet the budgetary requests of NNPC for funding its share of a JV. Once NAPIMS has the government's share of production for marketing, what it does with that share, its costs for marketing that share and the reasonableness of how much money it receives in exchange for that share does not appear to be subject to any independent scrutiny.

The flow of revenues for oil and gas operations in Nigeria also follows an obscure path. With respect to JVs, the existing Petroleum Law regulations have been superseded by MOUs. And the MOU formula for determining the amount a company must pay to the state is far too complicated. Beyond the formula itself there are other complications. The fact that the royalty is to be paid on gross revenues is commendable and increases the transparency of those

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<sup>45</sup> For example, Vietnam's offshore area has gone through several hands since the 1970s when oil and gas companies first competed for exploration rights. Its oil assets have been subject to US-Japanese, Vietnamese-Soviet, and US-Vietnamese joint ventures over the years depending upon the government in power. *See also* discussion of Mexico at note 68, *infra*.

payments. However, some deductions are permitted on royalties, and it is unclear whether any entity within the government determines the reasonableness of those deductions. NAPIMS in its role in the JV might be responsible for performing this function. But because it has a stake in whether the deductions are deemed reasonable, its determinations are open to question. Ideally, an independent third party should make that determination. We do not know whether that occurs.

Similarly, the calculation of taxes due and owing requires even more complicated deductions relating to the JV's costs of production. Again, it is not clear whether any governmental agency determines the reasonableness of those costs. NAPIMS in its role in the JV might be privy to information necessary to determine the reasonableness of those costs, but a disinterested third party is better situated to make that finding. Once a company's royalties and taxes are calculated, each of those payments passes through two governmental organizations before reaching the CBN. Neither the companies nor any of those agencies report their payments or receipts publicly. In addition, NNPC pays its proceeds for marketing the government's share of crude oil to the CBN. The contractual arrangements, methods of operation and results of those marketing efforts are completely opaque. We are aware of no incentive that NNPC/NAPIMS has to keep its own costs low and, by extension, to discipline the operating and maintenance costs of its JV partner. It is unclear whether any governmental agency determines whether the expenses of NNPC/NAPIMS in marketing the government's crude and participating in the JV are reasonable. Nonetheless, the NNPC/NAPIMS is currently able to withhold its operating and maintenance costs from its receipts. According to the IMF, the amounts reported by the NNPC, OAGF and the CBN do not match — a disturbing irregularity.<sup>46</sup>

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<sup>46</sup> IMF Country Report No. 04/242 at 69.

Compared to the completely closed door contracting of the JVs, Nigeria's fiscal oversight of PSCs is simpler and, therefore, of greater appeal.<sup>47</sup> However, some of the same questions raised with respect to the JVs apply here as well. For example, it is unclear whether any governmental entity is responsible for determining that the costs deducted during the cost oil calculation are reasonable. 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. The role of NAPIMS after negotiating the PSC is also unclear. If it has no operational role but has free access to the PSC's operational data it may be reasonable for NAPIMS to determine the reasonableness of the PSC contractors' costs. However, if NAPIMS is in a separate JV relationship with that same PSC contractor, it would not be sufficiently disinterested to perform this function. It is unclear what if any role DPR has in the determination of cost oil, but it could conceivably take on an auditing function. It is also not clear whether FIRS becomes involved in determining whether the PSC contractor has made adequate tax payments, but such involvement is possible.

After the initial royalty payment has been made under the Nigerian PSCs, they have similar disadvantages to net profit share royalty systems because they require a great deal of administrative work to make sure that the state is receiving its fair revenue share.<sup>48</sup> 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

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<sup>47</sup> Not everyone is so kind in their assessment of PSCs. At least one commentator has stated that "the government-private sector partnership is simply a bridge to legitimize the return of colonialism." She calls the oil companies "de facto cartels" that "foster, promote, and fortify 'monarchs' of the twentieth and twenty-first centuries...[that] defeats the ultimate objective of free enterprise: the spreading of wealth and attainment of prosperity." *Partnerships with Monarchs: Two Case Studies* by Wendy N. Duong, 25 U. Pa. J. Int'l Econ. L. 1171, 1187, 1232 (Winter 2004).

<sup>48</sup> For a discussion of those disadvantages, see *Mineral Regimes* at 11-12.

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.

Nonetheless, Nigeria's planned 2005 licensing round is a step toward a more transparent system. The advance publication of the acreage for license, the requirements on bidders and the basis on which bids will be evaluated is laudable. There are also fiscal and political advantages to using sealed bids in the auctioning process. There are, however, several aspects of the new system that could be made more transparent. For example, the four-part weighting of criteria for evaluation of bids unnecessarily complicates the system.<sup>49</sup> The fact that each prong of the criteria must be expressed in monetary terms permits the evaluators to, at least in theory, determine the total amount being offered and compare bids on that basis. There may, however, be some temporal problems in comparing bids that promise different amounts of money at different points of time in the future. It is also unclear how the Bid Committee, whoever they might be, will decide between bids that invest more in one bid criterion instead of another. For example, is a larger bonus bid paid today better than a comparable amount pledged to be spent several years in the future for local content or to meet work commitments? Considerations to be weighed with respect to work commitment pledges are that, on the one hand, those pledges may offset higher upfront bonus costs thereby essentially lowering the industry's cost of exploration, which could lead to earlier discoveries. But, on the other hand, they lower up front cash

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<sup>49</sup> See *Mineral Regimes* at 13, noting that combination bidding systems should be avoided.

payments to the government, encourage exploration even when it may no longer make sense and create administrative burdens to verify and enforce the commitments.<sup>50</sup>

Unless there is one bidder who is the clear winner in all categories, there may not be an easy way to determine a hands-down winner. While the combination of four criteria may be intended to explain to the world what items are most important to Nigeria, by including so many goals it risks achieving none. In the final analysis, the state's ultimate goal is to maximize its revenues from the extractive industries. A simple cash bonus bid should meet that goal.<sup>51</sup> The state can achieve all its other goals through the legal and regulatory system. For example, with respect to local content, the essence of a state's responsibility is to ensure that its citizenry is receiving adequate resources — no one should be doing a better job of that than the state. If so, the state needs more fundamental reforms than just those of its oil and gas regime. To the extent the government wants third parties, such as oil license holders, to further that goal, it can do so by imposing laws or regulations that ensure preferences to local vendors for certain goods and services.<sup>52</sup> Similarly, with respect to work commitments, the government can require through regulations that contractors be diligent in exploring tracts within a certain time period on pain of either relinquishing their licenses or facing increased rental rates. Furthermore, rather than requiring companies to cap its "cost oil" percentages, the government could impose a higher royalty rate without any other contingencies. The government could also audit companies to

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<sup>50</sup> See *Mineral Regimes* at 12.

<sup>51</sup> Not all agree with this approach. Some commentators have suggested that industry-sponsored local content programs should be substituted for cash bonuses. 25 U. Pa. J. Int'l Econ. L. at 1187.

<sup>52</sup> Brazil has adopted regulations requiring oil companies to devote a percentage of their investments to local vendors. EIA Brazil Country Brief at 5; see also *International Petroleum Encyclopedia 2004* at 72.

ensure that no unreasonable costs are accepted before tax and profit oil is paid. In the United States, the government sets a royalty rate and audits companies' files for compliance with tax and royalty rules.

Another concern with the new licensing round is that it leaves open questions about what contractual vehicle will be involved. The proposed PSC has not been published, nor have any of the other possible contracts the government may employ at its discretion once bidding has closed. And what sort of "consortia" companies and the Bid Committee might be discussing is unknown. What "specific clauses of contract" might require adjusting after the bidding has been completed is also unknown. Finally, another unknown is the manner in which the Nigerian Government might decide to participate. Those unknowns, would ideally be ascertained in public before a PSC is signed.

As to Nigeria's natural gas system, it is extremely new at this phase, so there is an opportunity for the country to make changes based on lessons learned from its oil system to build transparency in at the outset. Ideally, the same overarching rules should apply to both sectors.

#### **IV. International Best Practice Survey**

The primary differences between Nigeria and other oil producing countries today is that it does not maintain an independent regulator of the extractive industries, does not impose transparent contracting rules on the industry, and does not compete on a level playing field with unaffiliated oil companies for tracts.

##### **A. Brazil**

Since the 2005 licensing round in Nigeria was built on a "Brazilian-style open bidding process," Brazil's oil and gas fiscal regime is a natural candidate for comparison here. Like Nigeria, Brazil has its own state-owned oil and gas company, *Petróleo Brasileiro S.A.*, commonly referred to as Petrobras. Unlike NNPC, Petrobras began operations with the

exclusive right to explore for and develop Brazil's petroleum resources in 1953.<sup>53</sup> Beginning in approximately 1977, however, Petrobras began to enter into risk service contracts similar to PSCs that allowed it to hire service companies to work in the country's oil fields.<sup>54</sup> Under those agreements, foreign companies would contract to explore for and develop leases and were given an option to buy back certain quantities of the oil produced in the field. Petrobras would take over operation of producing wells after development was complete. Argentina and Ecuador employed similar arrangements.<sup>55</sup>

Petrobras' exclusive rights over Brazil's resources remained in place until 1995 when the Brazilian National Congress enacted Constitutional Amendment No. 9, which ended Petrobras' monopoly in exploring for, developing and producing oil and gas in Brazil.<sup>56</sup> This allowed the government to contract with any state or private company to carry out upstream and downstream activities in Brazil. On August 6, 1997, Law No. 9478 was approved by the National Congress, establishing the conditions for exercising those economic reforms in the oil and gas area. It also created a new agency to regulate the economic activities of the oil industry called Agência Nacional do Petróleo ("ANP").

ANP became responsible for determining which of Petrobras' existing exploration, development and production sites would remain within its portfolio. The ANP process of reviewing Petrobras' application for certain areas and its creation of a draft concession contract

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<sup>53</sup> See Brazilian Law 2004.

<sup>54</sup> See *The New Oil and Gas Industry in Brazil: An Overview of the Main Legal Aspects* by Marilda Rosado de Sa Ribeiro, 36 Tex. Int'l Law J. 141, 145-7 (2001) (hereinafter "*New Brazil Overview*") for a discussion of Brazil's oil and gas industry.

<sup>55</sup> *Mineral Regimes* at 4.

<sup>56</sup> A description of the changes to the laws and Brazil's solicitation rounds appears at [http://www.brasil-rounds.gov.br/geral/historico\\_das\\_rodadas.asp](http://www.brasil-rounds.gov.br/geral/historico_das_rodadas.asp).

was open, and comments were accepted over the internet.<sup>57</sup> Initially, Petrobras was awarded 115 blocks for exploration.<sup>58</sup> The agreement with Petrobras is reportedly similar to the contracts the government later entered into with private parties.<sup>59</sup> The remaining areas were then to be offered by ANP for exploration in subsequent bidding rounds. The transition to a new regime took some time. However, ANP's drafting of regulations and the administrative process is said to have remained open throughout.<sup>60</sup>

It was two years before the first licensing round occurred. Every year since 1999, Brazil has held a licensing round. The next and 7<sup>th</sup> licensing round is scheduled for October 2005. So far there are 40 companies with equity investments from 14 countries exploring for and/or producing oil and gas on 343 blocks in Brazil.

The oil companies gain the exclusive drilling and production rights in a given area and own the resulting production. With prior approval from ANP, the companies may export the crude, participate in JVs with other companies, or assign their interests. Each potential bidder must meet certain technical and financial bidding qualifications. Winning bidders are chosen based on three factors: the signature bonus bid, a commitment to use local goods, and a work commitment.<sup>61</sup> A winning company pays a signature bonus and signs a contract, which divides its activities into two phases — exploration and production. Exploration may last 2 years of the

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<sup>57</sup> *New Brazil Overview* at 155.

<sup>58</sup> *Id.* at 162.

<sup>59</sup> *Id.* at 163.

<sup>60</sup> *Id.* at 155.

<sup>61</sup> See FAQ, Licensing Rounds Procedures, "What are the evaluation criteria for the bids?" (Dec. 14, 1999) at [http://www.brasil-rounds.gov.br/genal\\_english/FAQ\\_proced\\_imentos2.asp](http://www.brasil-rounds.gov.br/genal_english/FAQ_proced_imentos2.asp).

8 year term of the contract. Following production, companies are required to pay royalties, taxes, and, in cases of large production, special participation and rental fees.

Petrobras remains a state-owned company, but now it must compete within Brazil for oil and gas licenses and it operates in several countries around the world. The change in regime does not appear to have caused it to suffer. Its production since 1997 has doubled.<sup>62</sup>

In August 2003, ANP initiated a project to establish a model of development for the natural gas industry in Brazil. The project is in four phases: Phase I will analyze the experience of several selected countries; Phase II will diagnose the Brazilian system; Phase III will consider two different models for Brazilian institutional involvement in the natural gas industry — cooperative and competitive; and Phase IV will evaluate the potential natural gas market in the country. Brazil, like many other countries, is looking to natural gas to fulfill its future energy needs.

While by no means perfect, Brazil has inarguably moved toward a more transparent system, which is a lesson Nigeria can learn from. Nonetheless, several critics have noted that Petrobras still dominates the oil and gas scene in Brazil and has been awarded and continues to be awarded the most desirable licenses.<sup>63</sup> These criticisms do not undermine the transition process used in Brazil, but they do suggest improvements that could have been employed there by, for example, setting mandatory limits on the assets Petrobras was permitted to retain and ensuring that geological and geophysical information was equitably distributed. Another apparent problem Brazil shares with Nigeria is its use of a combination weighting system when

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<sup>62</sup> See <http://www2.petrobras.com.br/portal/ingles/petrobras.htm>.

<sup>63</sup> See, e.g., Brazil Country Brief at 2-3 at <http://www.eia.doe.gov/emeu/cabs/brazil.html> (stating that “[e]nergy privatization has stalled, and Petrobras’ presence in the oil and natural gas sectors remains pervasive, possibly slowing the development of competitive markets and the attraction of foreign investment.”).

choosing a licensee. It may be that weighting causes Brazil's preference of Petrobras over other potential bidders.

## **B. Norway**

In addition to being patterned after the Brazilian system, Nigerian officials have indicated that the 2005 licensing round was modeled on the Norwegian system.<sup>64</sup> Long recognized as a vigilant guardian of its oil and gas resources, Norway provides another good basis for comparison to Nigeria. It is also a good model because Norwegian oil and gas resources have been produced exclusively on the Outer Continental Shelf ("OCS"), which is where Nigeria expects its new production to primarily originate. Norway has other similarities to Nigeria and Brazil because it too began production with participation by its state-owned oil company, Statoil.

Norway employs a multi-level production licensing system.<sup>65</sup> First, licenses are granted for exploration through seismic surveys. Based on that information, in participation with industry, blocks are identified for licensing. Potential lessees submit their technical and financial qualifications for participation in a licensing round. During the first 14 licensing rounds, individual companies submitted applications. The Ministry of Industry and Energy would evaluate the applications and negotiate with applicants over the geographic extent, operatorship, participating interest, work obligations, duration, relinquishment and other terms of the production license. In addition, Norway has granted production licenses outside the licensing rounds. Statoil would participate as a working interest holder in those licenses. Beginning in

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<sup>64</sup> See *Nigeria 2005 Licensing Round for Oil and Gas Exploration and Production Blocks*, Letter to Investor from Dr. Edmund Daukoru, Presidential Adviser of Petroleum and Energy (Mar. 2005) at [http://www.indigopool.com/inf/\\_html/sig/nigeria/index.jsp](http://www.indigopool.com/inf/_html/sig/nigeria/index.jsp).

<sup>65</sup> *Final Report on Benchmarking Work with Norway* by the United States, Department of the Interior's Minerals Management Service ("MMS") (Oct. 28-Nov. 1, 1996) provides an overview of Norway's oil and gas regime.

1985, Norway divided Statoil's interest into an equity interest for the company and an additional interest for the State Direct Financial Interest ("SDFI"), which Statoil managed.<sup>66</sup> Through the SDFI, the state has a direct interest in most fields and pipelines. It gains a portion of revenues and production and pays a portion of costs corresponding to its interest. A portion of SDFI (21%) has been divided primarily between Statoil and another partially state owned company, Norsk Hydro. The remaining assets in the SDFI (including pipelines and land-based facilities) are managed by a new state-owned company called Petoro. The Statoil and SDFI interests historically constituted a minimum of 50 percent of a license, with an increasing interest pursuant to a sliding scale for the development and production phases. In 1993, the sliding scale for the government's ownership interest was abolished. The next year, joint applications were permitted by potential licensees. Beginning with the 15<sup>th</sup> round in 1996, the state share was no longer necessarily 50% and Statoil began to compete against other companies for participation in licensing rounds. By the 16<sup>th</sup> round the SDFI was reduced to 15%. The production license grants exclusive rights to explore for and develop petroleum within an area for a period of 6-10 years. Norway is currently accepting nominations for its 19<sup>th</sup> round of licenses.

Norway collects oil revenues in the form of royalties,<sup>67</sup> rents, corporate taxes, a special petroleum tax, and a carbon dioxide (CO<sup>2</sup>) tax, the SDFI interest, and dividends and capital gains in Statoil and Norsk Hydro. In 1976, the Norwegian government established a Petroleum Price Board that set petroleum product prices for purposes of taxation and royalty. In 1990, Norway

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<sup>66</sup> *Energy Policies of IEA Countries: Norway 2001 Review*, International Energy Agency at 88-89 (describes changes to the Norwegian licensing system).

<sup>67</sup> Norway has chosen to phase out royalties in hopes of extending oil production in the mature North Sea province.

created a Petroleum Fund to finance non-oil budget deficits, and offset oil price volatility and economic fluctuations.

In 1972, at the same time Norway created Statoil to participate in the oil business, the Norwegian Parliament, Storting, also created the Norwegian Petroleum Directorate (“NPD”) to manage the licensing process, perform inspections, and collect rent, royalty and CO<sup>2</sup> fees. The NPD was further subdivided in 2004 to move the supervision of safety and working environment to the Petroleum Safety Authority Norway.

In 2001, 18.2% of Statoil was floated on the stock exchange. An additional 4.6% was sold in 2004. Norway has stated that it intends to reduce its holding in Statoil to 66%.

As Norway’s oil production trends downward, its gas production has ramped up and become a more important resource. Its gas production increased 165% between 1995 and 2003. Norway is now the second largest gas exporter in Europe. Initially, in 1993, Norway established a Gas Negotiations Committee (“GFU”) including Statoil, government and private producer representatives to coordinate gas marketing and negotiate gas sales contracts. However, GFU’s price setting was criticized by the European Union. Therefore, it was disbanded in 2002 in favor of private marketing efforts by individual producers. Norway has created its own state-owned company for transporting natural gas called Gassco. While production taxes are still collected on gas, Norway abolished its royalty on gas in 1992, presumably to encourage gas production.

Norway’s involvement in the development of its oil and gas resources has historically been very hands on and arguably overreaching, especially with its tendency to try to set prices. The Norwegian system is by no means perfect. Its oil production remains dominated by state owned operators and has not been hospitable to smaller operators. Its state owned companies are only now looking to other regions of the world to expand. Its labor costs have been so high that

some have speculated, to be profitable, that a field in the Norwegian portion of the North Sea must be four times larger than a field in the United Kingdom's portion of the North Sea.<sup>68</sup> It is unlikely that many countries in the world could exercise the level of control Norway has without extensive corruption. In spite of these issues, Norway's oil and gas system has been viewed by many as sound. Nonetheless, Norway has acknowledged that it too can improve its system by moving toward a more transparent one where its state owned companies compete.

### C. United States

The United States' oil and gas fiscal regime is unique in some respects. One unique aspect is simply that ownership in the mineral estate for vast regions of the country is not owned by the federal government.<sup>69</sup> The United States' ownership of oil and gas resources is primarily limited to federally owned lands onshore and the Outer Continental Shelf ("OCS") beyond the point at which coastal states own the seabed (usually 3 miles, but 3 leagues in a few instances). Another difference is that, both on its federal onshore and OCS lands, the United States has historically employed a competitive leasing system for assigning exploration and production rights.<sup>70</sup>

On the OCS, the United States holds a series of scheduled sales of nine square mile-sized blocks usually leased for a term of five or ten years. Those sales are derived from a labor intensive 5-year planning process that identifies areas of potential industry interest and evaluates geologic, geophysical and environmental considerations. That process involves a series of open

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<sup>68</sup> EIA Norway Country Brief at 2-3 at <http://www.eia.doe.gov/emeu/cabs/norway.html>.

<sup>69</sup> For a time a similar regime was in place in Mexico until that country expropriated national oil companies' assets and transferred them to its own state owned company, Petróleos Mexicanos, commonly referred to as Pemex. *See Typical Arrangements* at 9-11 to 17.

<sup>70</sup> As mentioned in note 41, *supra*, not everyone is necessarily enamored with a more competitive system. *See* 17 *Geo. Int'l Env'tl. L. Rev.* at 108.

public meetings, written public comment periods and discussions with coastal states.<sup>71</sup> The actual lease sales evolving from that process also involve extensive public commentary, including comment on the appropriate geographic scope and financial and environmental conditions for the sale. Everything in that process and the decisions emanating from it, with the exception of the government's internal deliberations and the companies' confidential trade secret materials, are subject to public disclosure.

The lease sales themselves are public events held with the opening of sealed bids for each block from applicants that meet specified technical and financial requirements. The terms of the lease sale — both financial (*e.g.*, royalty rates) and legal (*e.g.*, contract terms) — are all set before bidding and publicly available. The only criterion used in evaluating the bids is the amount of the cash bonus bid, which must meet a certain minimum fair market value requirement that is determined by the government agency overseeing the bidding, the MMS.<sup>72</sup> The cash bonus bid system has many advantages. It is administratively simple. Bonus bids correlate to the expected net present value of the blocks; therefore, winning bidders are usually those most interested and likely to explore most rapidly. Finally, all the risk is borne by the industry. The only disadvantages to such a system are that smaller operators may be shut out of the competition and potentially productive blocks valued below the minimum bid level may not be leased.

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<sup>71</sup> This paper only discusses the OCS leasing program. It is the most relevant point of reference because most current and expected future federal U.S. oil production is concentrated offshore. Moreover, the OCS leasing program is the one most recently developed by the U.S. It is also not substantially different from the federal onshore leasing system. However, the onshore system is implemented on a state-by-state basis (by one federal agency), and there are some minor differences in application between states.

<sup>72</sup> In its role as an independent regulator, MMS is privy to all seismic, geologic and geophysical information regarding any given area of the OCS. That data provides it with the best information available to determine the fair market value of a given block.

The bonus bids, once accepted, are transferred by MMS to the U.S. Treasury. In addition to that bonus, the lessee is required to pay set fees for rents, royalties and taxes as set forth in the lease, legislation and/or regulations. The MMS collects rents and royalties and transfers them to the appropriate U.S. account (*e.g.*, the National Historic Preservation Fund, the Land and Water Conservation Fund, the Reclamation Fund, the General Fund, or to producing states). The Internal Revenue Service (“IRS”) in the Treasury Department collects the taxes. Those two agencies establish the regulations that must be followed pursuant to U.S. laws and audit and inspect lessees’ records and, in the instance of the MMS, production facilities.

There is not much that is invisible in the U.S. oil and gas system. Certainly there are requirements before a lessee can engage in certain activities, and there are provisions for lessees to request royalty relief, but all the steps required and the results are publicly available. In addition, extensive financial controls are in place when money is received. Royalty, rental and bonus bid revenue information is published on an aggregate basis periodically by the MMS. It is also likely that requests for more detailed data in different formats would also be made available under the United States’ Freedom of Information Act. Employees of the U.S. government are required to make certain financial disclosures and adhere to strict ethical conflict of interest requirements that place their activities under close scrutiny.<sup>73</sup> In addition, the area of government procurement and contracting is heavily regulated to curb misappropriation of funds and ensure uniform policies and practices across agencies pursuant to federal acquisition

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<sup>73</sup> See 18 U.S.C. §207 (post-employment), 18 U.S.C. § 208 (conflict of interest), 18 U.S.C. § 209 (dual compensation), 18 U.S.C. §§ 1001 and 3571 (penalties and prosecution), 43 U.S.C. §§ 31, 1355, and 7342, 5 C.F.R. §§ 2635 (gifts) and 43 U.S.C. § 11 (no interest in public land).

regulations.<sup>74</sup> While certainly no panacea, the U.S. competitive-based oil and gas leasing system is one of the most transparent systems in existence. It provides an excellent model for Nigeria to consider when developing its own new regime.

## **V. Recommendations**

### **A. Embrace Change**

There is little doubt in our view that the existing Nigerian oil and gas fiscal regime has outlived its usefulness. The system that started with JVs between NNPC and oil companies operating in Nigeria was a natural first step in the evolution of its oil and gas fiscal regime. As illustrated above, that system was in keeping with the system in several other nations in the world, which wanted to jump start their resource production while learning from the best in the business — the international oil companies. With NNPC, Nigeria has created a potentially valuable financial resource for the country that it now has the opportunity to free from its existing constraints and original outdated mission. The experiences of Petrobras in Brazil and Statoil in Norway augur well for the future of NNPC acting as a national oil company in a competitive marketplace around the world.<sup>75</sup>

Nigeria's second step, embracing more sophisticated contractual vehicles in the form of PSCs, was also reasonable. The PSCs help to transition the country's fiscal regime away from

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<sup>74</sup> See 48 C.F.R. Chapter 1 for the Federal Acquisition Regulations. The United States even has a separate court, the Court of Federal Claims, to hear primarily money claims founded upon the Constitution, federal statutes, executive regulations, or contracts, express or implied-in-fact, with the United States.

<sup>75</sup> In fact, the Nigerian Production and Development Company ("NPDC"), the upstream arm of NNPC, has already made strides in reinvigorating its efforts. See "*NPDC bid to revive state oil development*," African Energy, Issue 84 at 23-24 (Mar. 2005). Having NPDC compete with national oil companies is the next logical step in its progression.

extensive NNPC involvement and towards a more hands-off model similar to the transition occurring in other countries. Therefore, that step too was laudable.

The third step, of bringing the country's licensing regime into the sunshine with a more open bidding process and a statement of the parameters for evaluating bids, was monumental. But more remains to be done.

The next course we recommend that Nigeria follow is also in step with its models, Norway and Brazil. Oil and gas experts recognize that there are essentially two mechanisms for a government to exercise control over its oil and gas regime. "It may be done directly through a governmental agency, which attempts to develop reserves itself, or indirectly through the means of authorizing development."<sup>76</sup> We recommend that Nigeria turn to the second course and completely disengage the regulation and administration of its oil and gas fiscal regime from its state-owned company NNPC. To achieve this goal we recommend that NNPC's mandatory involvement in future oil and gas contractual arrangements be discontinued. Just as Petrobras and Statoil before it, NNPC should begin to compete with other oil companies in its own right in Nigeria and around the world. In addition to discontinuing future mandates requiring NNPC's involvement, we recommend that Nigeria put in place a transition and review process akin to the one followed in Brazil to decide the extent to which NNPC should remain involved in its formerly granted concessions.

A precursor to this step is legislative action. Nigeria has already begun an effort to amend the Petroleum Act of 1969.<sup>77</sup> That effort could be used to make this and other necessary changes in Nigeria's laws. However, we recommend that any legislative reform proceed at a

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<sup>76</sup> *Typical Arrangements* at 9-21.

<sup>77</sup> "Oil Legislation Revamped," Africa Energy Intelligence Newspaper (Mar. 15, 2003) (efforts to change royalty rates for deepwater production).

measured pace to make comprehensive changes to Nigeria's oil and gas regime. A potential model for drafting such legislation is what was done in Sao Tome - Principe. There, an *ad hoc* national oil commission consisting of representatives of the President, government and National Assembly including opposition party members worked for months to reform the law.<sup>78</sup> We recommend creation of an independent Legislative Commission made up of a coalition of private citizens, experienced practitioners, academicians, the Nigerian government and the governments of a few select oil producing countries working with the public to create a legislative proposal.

New oil and gas legislation would not be complete without an evaluation of the adequacy of the existing regulatory regime in Nigeria and a recommendation on the necessary changes to reform it. We recommend that the first step toward reform should be to disassemble or relocate oil and gas oversight functions now within NAPIMS to an independent organization. Next we recommend evaluation of the role of DPR, and creation of an agency to oversee leasing, exploration, development, production and revenue collection functions. We recommend that the new agency build upon Nigeria's progress to date in open bidding. The transition process Brazil followed in creating ANP might be a good model for how to make such a change in Nigeria. We also recommend that the Legislative Commission, should be asked to prescribe more openness in the bidding process, and to examine whether to retain a non-competitive leasing system. There are several detailed elements to this examination including, for example, the size of tracts for bidding. The United States leases markedly smaller blocks than most of its peer oil producing states, which has caused very heavy development and competition in the U.S. Nigeria is already

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<sup>78</sup> See *Sao Tome and Principe Enacts Oil Revenue Law, Sets New Transparency, Accountability, and Governance Standards* by Joseph C. Bell and Teresa Maurea Faria at 2, (Mar. 3, 2005).

considering such changes in its process and undoubtedly needs to examine these and other related matters further.<sup>79</sup>

In addition, the Legislative Commission should review and strengthen the laws and regulations relating to government contracting, financial disclosures and ethical conflict of interest standards for both those within the government and those in private industry that contract with the government. At least as to its own employees, we recommend that the government impose the strictest of financial disclosure requirements, ethical standards, penalties and criminal sanctions, perhaps going so far as to obtain advance waivers from employees entitling it to access banking information in foreign accounts. Although not strictly speaking an oil and gas legislative issue, a government's contracting laws are extremely important to the extent that it contracts for services in those areas. Therefore, we recommend that the Legislative Commission review those provisions as well with an eye toward more transparency and ensuring sufficient controls.

Finally, Nigeria needs to institutionalize a means for its public citizenry to become involved in the government's decision making process with respect to oil and gas projects. Natural resources such as oil and gas are non-renewable resources entrusted to the federal government for the benefit of its citizens; therefore, citizens should be involved in how those resources are used. This is especially true with respect to environmental matters, the appropriate development of resources, the effects on the community and the financial returns involved.

#### **B. Keep Things Simple**

We recommend that the new extractive industries regulatory agency be instructed to review the existing regulatory regime and reengineer it to its essentials and that those essentials

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<sup>79</sup> See "*Blocks Halved in Nigeria Offering*," by Barry Morgan, *Upstream* at 28 (Mar. 11, 2005).

be laid bare. For example, the leasing process, which is well on its way to becoming more open, should become even more open. We recommend that the basis for evaluating a successful bidder should be reviewed with the mind set that the simpler it is, the more transparent for bidders, the government and the public. If the Legislative Commission recommends that a non-competitive system should be retained, we recommend that the new regulatory agency should ensure that it operates as closely to a competitive system as feasible. Namely, draft contracts should be published, as in Brazil, and final contracts should be publicly available, as the Sao Tomeans require.<sup>80</sup> As much of the guess work and room for negotiation (and corruption) should be removed from the bidding system as possible.

With respect to revenue management and collection, the best way to make this function transparent is once again to keep things simple. Ideally, we recommend that the government consider adopting revenue formulas for rental, fees, tax and royalty calculations that are as simple as possible. The simpler the equation, the more likely the payor will get it right the first time and the lower the administrative costs for all involved. A gross royalty on production like the first step in the PSC is the simplest to administer.<sup>81</sup> Any calculation that requires extensive consideration of costs and other deductions is extremely costly to administer, subject to deceit and corruption, and we believe it should be avoided. With that in mind, we recommend that the new regulatory agency should consider how to address the convoluted formulas currently in

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<sup>80</sup> See Democratic Republic of SaoTome and Principe National Assembly Law No. /2004, Oil Revenue Law, Chapter IV, Section I, Article 17, ¶ 2(K); Section II, Article 20.

<sup>81</sup> Simple though a gross royalty calculation is, there will always be the need for the government to verify that production volumes are reported accurately and that any deductions taken are correct. The price or value of oil on which the royalty should be paid can be a controversial question, but the new regulatory agency will have the opportunity to review approaches by other governments for an answer such as establishing a price or value for royalty purposes based on some publicly available independent benchmark.

place in both the JV MOUs and the latter steps of the PSC with the goal of creating a new simple approach that could be applied across the board to both scenarios. With respect to existing arrangements, we recommend that those changes occur after negotiation with, and with the acquiescence of, oil company partners and contractors. We make this recommendation because we believe that respect for the existing and any future legal regimes is a necessity for the long term success of Nigeria's oil and gas program. The stability of a state's legal regime is an important factor weighed by companies in making investment decisions. We also recommend that the determination of that formula should be established with public input, so the public is made aware of what the current formula is, why there is a need for change, what that change would be and why the proposed solution is better and more transparent than the present situation.

We recommend that the new revenue collection regime should incorporate as much public disclosure of revenue information as feasible without prejudicing the companies involved in oil and gas operations. The Sao Tome law provides a good model for the kind of information that should be made public, excluding only proprietary intellectual property.<sup>82</sup> We recommend that public disclosure extend to all payments made by oil and gas operators on a periodic basis by category of payment. Also, we recommend that the revenue collector, whether the new extractive industries regulator or FIRS, should disclose its receipts and transfers. Ideally those transfers would be made directly to the federal account at the CBN rather than through another intermediary like OAGF. Alternatively, the Legislative Commission might require oil companies to make direct electronic fund transfers to the CBN with copies of their proof of deposit made to the new revenue management agency with an explanation of the payment. We recommend that the entire payment process be mapped out with adequate controls to guard

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<sup>82</sup> *Sao Tome* at 5.

against corruption. We also recommend that the Legislative Commission create an independent oversight and verification process. That function could reside with an independent government accounting or inspector general organization, perhaps OAGF, or with an independent private contractor or with both. Sao Tome and Principe provide for two levels of audit.<sup>83</sup>

### **C. Invest for Tomorrow Today**

In the recent past, oil prices have reached heights not seen in decades. Nonetheless, it is difficult to predict whether those levels will be sustained or decrease. It is easy in a time of great excess to overreach financially. This is as true of a public budget as a private one. As guardians of the public interest, however, it is incumbent upon states to meet the present and plan for the future needs of its citizens. That burden is none the less and perhaps all the more for a state rich in natural resources. The heavy burden oil wealth bears on the backs of the poor is a common refrain throughout the world. A competent state should recognize the cyclical nature of oil prices and the nonrenewable nature of those resources and make financial investments for its citizens' future. We recommend that Nigeria should make such provisions.<sup>84</sup> There are many examples of states rich in oil that have set up trust funds to cushion the blow of oil price lows and prepare for the impending post-oil future.<sup>85</sup> The most recent states to do so were Sao Tome and Principe,

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<sup>83</sup> *Sao Tome and Principe Oil Revenue Law*, Chapter III.

<sup>84</sup> A related question that we do not address here, but that has received and still requires extensive examination, is the ideal allocation of funds between federal and local governments. Several articles have been written on this subject with respect to Nigeria and it continues to be a bone of contention even in mature producing areas such as the United States' Gulf of Mexico region. *See, e.g., Managing Oil Revenues for Socio-Economic Development in Nigeria: The Case for Community-Based Trust Funds*,” by Emeka Duruigbo, 30 N.C.J. Int'l L. & Com. Reg. 121 (Fall 2004).

<sup>85</sup> *See, e.g., Sao Tome and Principe, Oil Revenue Law*, Law No. \_\_\_/2004, Chapter II (unofficial translation); Alaska Permanent Fund Corp. at <http://www.apfc.org>; The World Bank and IFC Chad-Cameroon: Petroleum Development and Pipeline Project (Apr. 13, 2000);

but Norway has also made similar provisions.<sup>86</sup> We recommend that the Legislative Commission survey the options pursued by other countries rich in oil and set up a stabilization fund that would also provide for Nigeria's future.

Another investment in the future will be to free NNPC to act as a competitive oil and gas company.<sup>87</sup> The Nigerian public could reap substantial benefits from NNPC's operations if it succeeds as a partially or fully independent entity. The discipline of market competition will force efficiency gains to the benefit of all Nigerians. We recommend that NNPC's operations be fully commercialized and the Legislative Commission considers selling a portion of its equity to the public.

## **VI. Conclusion**

We believe that if Nigeria were to accept our recommendations and enact, implement and enforce new petroleum laws and regulations that are transparent and simple, it would create a more stable oil and gas program that would attract more investment in the country. In conclusion, we believe transparency promises a bright future for Nigeria so long as it is willing to let in the sunshine.

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Agreement Between the Inuit of the Nunavut Settlement Area and Her Majesty the Queen in the right of Cada at <http://www.tunngavit.com>.

<sup>86</sup> Sao Tome and Principe have established a national oil account for all oil revenues from their joint development zone with Nigeria. Transfers out of that account to the annual budget can only be made at specified maximum levels of the account balance (20% once a year). Once production begins, the remainder is to be transferred to a Permanent Fund. Management of the Fund has been extensively addressed in legislation.

<sup>87</sup> Even the strongest critic of existing oil and gas regimes concedes that "the only hope for true ownership of petroleum by the 'people' is when the SOEs [state owned enterprises] that are the commercial arms of the host government...are eventually privatized, and shares are offered to the public for direct purchase." 25 U. Pa. J. Int'l Econ. L. at 1232.