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CONTENTS

Sr. No.	TITLE & NAME OF THE AUTHOR (S)	Page No.
1.	**THE ECONOMIC RATIONALE OF GOLD IN INDIAN CONTEXT** *DR. M B MOHANDAS*	1
2.	**A STUDY ON APPLICATION OF BALANCED SCORE CARD TO THE DEPARTMENT OF COMMUNITY MEDICINE IN MEDICAL COLLEGE & HOSPITAL** *DR. SUBITA P. PATIL & DR. R. M. CHATURVEDI*	5
3.	**HUMAN RIGHTS CONDITION OF ELDERLY PEOPLE: THE RURAL BANGLADESH CONTEXT** *DR. GOLAM AZAM & DR. HAFIZ UDDIN BHUIYAN*	12
4.	**ORGANIZATIONAL COMMITMENT AND OCCUPATIONAL STRESS OF EMPLOYEES IN PUBLIC SECTOR BANKS: A COMPARATIVE STUDY OF SBI AND PNB BANKS** *MEENU SAINI & DR. NIRMALA CHAUDHARY*	16
5.	**RESILIENCE: SELF ASSESSMENT OF MANAGEMENT STUDENTS – A STUDY CONDUCTED IN A BUSINESS SCHOOL** *DR. CHARU YADAV & DR. BHARATI DESHPANDE*	20
6.	**ACHIEVING INCLUSIVE GROWTH THROUGH MGNREGA AMONG THE RURAL POOR IN INDIA** *DR. PARVATHAMMA.G.L.*	28
7.	**TALENT RETENTION STRATEGIES FOR SUCCESSFUL ORGANIZATIONS** *MOHAMMED RAFEEQ & ZAMEER AHMED*	31
8.	**CORPORATE SOCIAL RESPONSIBILITY AND COMMERCIALISATION OF AGRICULTURE IN INDIA: AN OVERVIEW** *S. M. JAWED AKHTAR & SABA PARVEEN*	38
9.	**ENTRY MODES' CHOICE OF FOREIGN FIRMS IN ETHIOPIAN MARKET** *GIRMA TILAHUN*	43
10.	**A COMPARATIVE STUDY ON THE SERVICE QUALITY OF BANKS WITH REGARD TO OCCUPATION AND INCOME OF THEIR CUSTOMERS** *DILIP KUMAR JHA*	52
11.	**PRE AND POST-MERGER FINANCIAL PERFORMANCE ANALYSIS OF RELIANCE POWER LIMITED** *DR. PRATIBHA JAIN*	56
12.	**A STUDY ON THE OPERATIONAL RATIO OF THE DISTRICT CENTRAL COOPERATIVE BANKS IN TIRUNELVELI REGION, TAMILNADU** *DR. A.MAHENDRAN & TOLERA MERDASA*	59
13.	**A COMPARATIVE STUDY OF EMPLOYMENT PARTICIPATION IN PUBLIC AND PRIVATE SECTOR IN INDIA** *FASALURAHMAN.P.K.PATTERKADAVAN & MOHAMMED SALIM.P.K*	64
14.	**PERFORMANCE EVALUATION OF TOP PERFORMING MUTUAL FUND MANAGERS: AN ANALYTICAL STUDY FROM INDIA** *SHIVANI CHAUDHRY & DR. MOONIS SHAKEEL*	71
15.	**IMPACT OF DIVIDEND ANNOUNCEMENT ON STOCK RETURNS: A STUDY WITH REFERENCE TO DIVIDEND ANNOUNCEMENTS OF BANKING AND NON-BANKING SECTORS IN INDIA** *DR. KUSHALAPPA. S & LAXMI ACHARYA*	77
16.	**NIGERIAN JOINT VENTURE AGREEMENT AND PRODUCTION SHARING CONTRACT - PROS AND CONS: A REVIEW OF LITERATURE** *DR. SANI SAIDU*	82
17.	**EFFECTS OF SUPPLY CHAIN COLLABORATION: A STUDY OF AUTOMOBILE MANUFACTURING COMPANIES IN INDIA** *ASAD ULLAH*	86
18.	**RELATIONSHIP BETWEEN SUSTAINABLE DEVELOPMENT AND CORPORATE SOCIAL RESPONSIBILITY** *ASHWANI K. GUPTA & DEEPAK SONI*	92
19.	**HIGHER EDUCATION AND GROSS DOMESTIC PRODUCT IN INDIA: AN EMPIRICAL INVESTIGATION** *TAMANNA KHAN & NASIM ANSARI*	95
20.	**RURAL NON-FARM SECTOR IN INDIA AND THE ISSUES RELATED TO EMPLOYMENT AND POVERTY** *SWETA SHARAN*	101
	REQUEST FOR FEEDBACK & DISCLAIMER	106

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NIGERIAN JOINT VENTURE AGREEMENT AND PRODUCTION SHARING CONTRACT - PROS AND CONS: A REVIEW OF LITERATURE

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ABSTRACT

Most oil and gas producing states adopt Joint Venture Agreement (JVA) or Production Sharing Contract (PSC) for the exploration and exploitation of their petroleum resources. Legitimate stakeholders in the sector assess the extent of returns and benefits as well as pros and cons associated to each of the agreement in order to determine the most appropriate agreement between the two in the context of their country. Thus, this study reviewed and assessed joint venture agreement and production sharing contract adopted by Nigeria in the course of exploring its petroleum resources. In particular, the study gauged pros and cons of the two agreements (PSC and JVA) with the view to assessing which between the two agreements is appropriate for Nigeria taking environmental characteristics into consideration. A literature based methodology was adopted, whereby provisions of the two agreements and other related literature were critically analyzed. The findings suggest that, taking Nigerian environmental characteristics into account, Production Sharing Contract is most appropriate for the exploration of Nigerian oil and gas resources compared to the Joint Venture Agreement.

KEYWORDS

Joint Venture Agreement, Multinational Oil Companies, Nigerian National Petroleum Corporation, Production Sharing Contract.

1.0 SYNOPSIS OF NIGERIAN OIL AND GAS SECTOR

Right from late 1960s Nigeria is increasingly moving from agricultural economy to mono dependent economy, particularly petroleum resources. Thus Nigeria's economic and social performance has totally depended on oil and gas. Presently, oil and gas accounts for 40 percent of the country's GDP, 70 percent of budget revenues, and 95 percent of foreign exchange earnings, Nigeria's dependence on petroleum is much greater than many major oil producing countries (EIA, 2014). To this effect, a brief overview of Nigeria's petroleum sector, right from pre to post-colonial period is given in the following sections.

1.1 PRE-COLONIAL PERIOD

The search for crude oil began in Nigeria as far back as 1908, when a German company the Nigerian Bitumen Corporation explored for oil in the Araromi area between Ijebu Ode in the present Ogun State and Okitipupa in the present Ondo State (Nwokeji, 2007). This pioneering effort was terminated at the outbreak of hostilities between Britain and Germany in the First World War in 1914. Given the fact that Nigeria was under the territorial control of the United Kingdom, and Germany's loss of the war, the German company's operations were not resumed after the war (Gidado, 1999). The British colonial rule has impacted and still impacting over the Nigerian oil industry, because it was under British rule when the first discovery of oil in commercial quantity was made in 1956 at Olobiri, in Present River State (Atsegbua, 1999). The shell-BP got this opportunity to sign an agreement from their brother British government. Thus during the whole colonial period only British companies and those of other western nations were duly permitted by the Britain to engage in oil production (Gidado, 1999 and Frynas and Mellahi, 2003) therefore shell-BP employed their expertise rapidly and made first export within the next three years, that's 1958, in which production reached about 5,000 barrels per day, so Nigeria had to make it is first shipment of crude oil to Europe same year. This had really encouraged Nigerian government to put more interest in the oil sector instead of earlier traditional practice particularly agriculture.

1.2 POST-COLONIAL PERIOD

Shell-BP hitherto monopoly, has virtually started gotten threat by a new policy of granting licenses to other major and minor companies Atsegbua (1999) highlighted that with the repeal in 1958 of sec 6(1) of the mineral oil ordinance of 1914, which disqualified non-British companies from receiving oil exploration licenses, the monopoly of exploration right given to shell-BP in 1938 was gradually broken. This was a tremendous effort by the independent government of 1960, which has immensely reduced the level of over dependence on one favored company. Belgore (2003) further added that some other foreign oil companies were attracted in the exploration/development activities in the country, such as Mobil Oil, Texaco, Agip; the Italian state owned company as well as its France counterpart of Safrap which later became Elf. The appearance of this multinationals oil companies have really open up new phase of advancement in the Nigerian oil industry. According to Gidado (1999) in 1994 the Gulf oil company made the first the off shore discovery of oil in Delta state. Nigeria increasingly re-involving itself in the oil and gas activities formally dominated by the Multinational Oil Companies (MOC), Prior to 1971 the principal legislation under which companies operate was mineral act 1914 in which their profit was tax in accordance with the petroleum tax act 1959 (Gidado 1999) therefore the involvement of the government was very limited. But following it is registration as a member of Organisation of Petroleum Exporting Countries (OPEC), Nigeria was committed to taking stake in the general activities of oil companies (Gidado 1999) therefore different structural reconstructions were made in the industry, which led to the formation of Nigerian National Oil Corporation (NNOC) and later merge ministry of petroleum resources with it and formed Nigerian National Petroleum Corporation (NNPC) in 1997. On one hand, it is common knowledge that most of the oil and gas producing states are developing nations and are incapacitated technologically and financially (Nwokeji, 2007). Irrespective of this financial and technological incapacitation, the countries did all possible to maximize revenue from the endowed natural resources (Johnston, 1994). In consequence, these countries search for an ideal fiscal regime that will help them maximize the said revenue from the potential operations. Two of the most effective and efficient frequent used regimes adopted by most oil producing states are Production Sharing Contract (PSC) and Joint Venture Agreement (JVA). Johnston (2003) defines the former "PSC" as a contractual agreement between a contractor and a host government whereby the contractor bears all exploration costs and risks and development and production costs in return for a stipulated share of the production resulting from this effort. This type of agreement has two major characteristics; (i) entire exploration risks are borne by IOCs, and receive no compensation if no oil is found; and (ii) both the resources and installations are owned by the host country (Smith et al, 2000). On the other hand, joint venture is an agreement by two or more entities to jointly share resources, benefit and cost within legal entity (Johnson and Houston, 2000). Similarly, Black and Dundas, (1993) had earlier defined Joint Venture Agreement as a critical relationship that involved two or more natural or legal person, combining property and expertise to carry out a single business enterprise in which they have a single propriety interest, a joint right to control and share profit and lost. Hence, this study aims at reviewing and assessing joint venture agreement and production sharing contracts adopted by Nigeria in the course of exploring its petroleum resources. In particular, the study will critically gauge pros and cons of the two agreements (PSC and JVA) with the view to assessing which between the two agreements could be most appropriate for the country taking environmental characteristics into consideration.

2.0 OVERVIEW OF NIGERIAN JOINT VENTURE AGREEMENTS

Having seen the continual domination of MOCs in the Nigerian petroleum sector particularly in the early stage of the operations, Nigeria realizes the need for total participation in the exploration and production activities in the oil sector, whereby the government is authorized under petroleum act 34(a) to participate in all licenses and leases granted since 1969. The country was re-motivated by OPEC resolution of 1968, where all oil exporting countries were advised to involve

fully in oil and gas production operations through joint venture agreement, which will enable them to share in ownership and control over their resources (Nwokeji, 2007). The Nigerian joint petroleum operations are mainly between Nigeria National Petroleum Corporation (NNPC) and MOCs, these MOCs include; Shell, Chevron, Total, Phillips, Elf and Agip, and in each venture NNPC has the largest equity and acts as a non-operator while MOC act as an operator (NNPC, 2014). The MOCs function as operators include conducting operation in a safe, technically sound and financially prudent manner and are also expected to prepare and implement work program and budget, provisions of report and information to the non-operators (Nigeria) (NNPC, 2014).

2.1 BENEFITS OF JOINT VENTURE AGREEMENTS IN NIGERIAN PETROLEUM SECTOR

As discussed earlier, Joint Ventures are a common mode of doing business in the international oil industry, where companies' partners up for large scale or for high risk venture in order to diversify good risk management (Johnston, 2003). Black and Dundas, (1993) posited that JV agreement possess certain qualities that none of contract does, as both the parties have certain role to play, in terms of monitoring the activities of one another, therefore under JV agreement accountability is collective responsibilities as both the parties involve has the legal rights and responsibilities to discharge for the benefit of the enterprises (John and Ashley 2001). Joint ventures and alliances are important forms of inter-organizational cooperation because they allow parties to achieve complex mutual tasks, otherwise impossible using simple arm's-length contracts, but without actually acquiring one another (Moskaley and Swensen 2007). In addition, JV agreement helps in achieving not only the business aspect of the contract but the economic, social and general aspects (Moskaley and Swensen 2007). In his course of explaining non-financial benefits attach to JVA, McPherson, (2004) earlier elaborates non-financial objectives of JVA to include: development of indigenous capacity (acquisition of managerial and technical expertise and operating experience); influence over domestic procurement; superior access to industry information; and policy implementation. Of course in many cases developing countries relied on these benefits while presenting reason of adopting JV. According to Berg et al. (1982), there are three primary reasons for the creation of joint ventures: (1) the creation of greater market power by combining resources or generating economies of scale; (2) the avoidance, reduction, or sharing of risk; and (3) the acquisition or sharing of information. Kent, (1991) further added that the two reasons are enough to inter in to joint ventures, first in order to overcome cultural, political, or legal impediments, or to meet host country requirements and lastly to manage rivalry in an industry by turning potential competitors into allies.

Furthermore, Lung, (2006) argues That JVA has rapidly increased during the past decade, providing benefits and opportunities to staying competitive and the possibility of participating in long-term projects. He further added that JV has played a tremendous role in minimizing international differences, particularly, through provision of join management. This of course has been the case in Nigeria as the country persistently learns from MOCs activities. Nonetheless, literature indicates that actors within the country's petroleum sector need to enhance their operational skills (Nwakeji, 2007). This position was earlier posited by Gidado, (1999) where he argued that Nigerian JVA has exposed the country's personnel in virtually every aspect of the operations; such as right to ownership, decision making, and acquisition to requisite technology and managerial and technical skill. It emerged from the above discussions that JVA is very important for a less develop country like Nigeria considering the total number of benefits the country derives from the venture.

2.2 PROBLEMS ASSOCIATED WITH JOINT VENTURE AGREEMENTS IN NIGERIA

Upon all the benefits associated with the joint venture agreement, literature and experiences indicate that the arrangement has certain inherit problems. Firstly, it is arguably posited that inadequate financial and technological capability forced most developing countries to engage into a joint venture agreement. However, due to complex requirement or nature of this agreement, particularly financial contribution (cash call) and other related requirements, many developing countries like Nigeria with mono source of income and different projects to implement couple with high population rate find it difficult to meet these requirements. Thus, inability to meet this requirement considered to be the most challenging issue in governing a successful joint venture agreement.

Secondly, insecurity in an area where petroleum operations are been conducted is one of the problems hindering a smooth running of a joint venture agreement. This in particular, includes instability or misunderstanding between the contributing parties or amongst host communities. The consequence of insecurity and misunderstanding between the contributing parties to JVA is that they share the cost and consequences resulting from securing or condoning the unexpected instability. Indeed, if the parties haven't initially made provision for these challenges prior to the commencement of the JVA, the budget and expenditure will definitely increase. Therefore, the parties to the JVA found the decisions difficult. Nonetheless, participating parties to this type of agreement take political and general atmosphere of the potential exploration areas into consideration before establishing a joint venture agreement. This has been considered a major challenge for the parties intending to form a joint venture agreement.

3.0 PRODUCTION SHARING CONTRACT: A DEVELOPING COUNTRIES' NEW DIMENSION

Production sharing contract is an arrangement whereby the company bears all the risks of exploration, and is often in charge of the operations and management of the contract area, when oil is discovered in commercial quantities the company is entitle to recoup its investment from the crude oil produced in the contract area (Smith et al, 2000 and Omorogbe, 1986). This type of agreement was initially devised by Dr Ibru Sutowo (Johnston 1994) and Indonesia is believed to be the first country to apply it to petroleum operations (Barrows, 1993). Right from it is inception a significant acceptance is been recorded especially in the developing countries. Walde (2002) argued that "It has become, over the last 30 years, probably the most dominant form of granting access to oil and gas exploration and development to international petroleum companies in developing countries". Thus nearly half of the countries practice PSC (Johnston, 1994). This increasing acceptability of PSC must not be in connection with the non-commitment of cost and risk attached to the entire system (Ayoola, 2007). Discussing from political point of view, Pongsiri (2004) stressed that PSCs are widely used in developing and transitional economies as they are in line with government aspirations to be more proactive and involved in managing the oil and gas resources.

3.1 OVERVIEW OF NIGERIAN PRODUCTION SHARING CONTRACTS

Production Sharing Contract is the second accepted and largest contractual agreements adopted in Nigerian petroleum sector (Nwokeji, 2007). As the level of oil and gas production and exploration activities increases, Nigeria continues weighing all the available means of reducing risk and increasing return (Nwokeji, 2007). On this note Nigeria diversified its options by engaging PSC in addition to the existing JVA, indeed, the country engages more than eight companies in this agreement. PSC was first introduced in Nigeria in 1973, in a contract between Nigerian National Oil Corporation, the predecessor of the NNPC and Ashland Oil Nigeria Company for OPL 98/118 for duration of 20 years and renewable for another five years. Under this contract the Ashland is to provide all technical and financial requirements, until the oil is discovered in commercial quantity (Gidado, 1999) The First round of the PSCs were executed in 1993 and the second round in 2000.

3.1.1 BENEFITS OF PRODUCTION SHARING CONTRACT TO NIGERIAN ECONOMY

Most of the developing countries are not capable of meeting daily needs of their citizens, not to talk of having surplus for investment, even though they have natural resources such as oil and gas. Agreements like joint venture as earlier pointed out, needs huge amount of capital (cash call), this mandatory equity contribution seems to be problem to virtually most of the developing countries. In his argument Ayoola (2005) stress that PSC in developing country like Nigeria proved to be more beneficial than any other contractual agreements, because lack of sufficient capital (cash call) distorted not only the contract (JV) but the entire budget of the fiscal year, he further noted that under (PSC) the concession belongs to the government through NNPC and also operators bear the cost, risk of exploration, development and operation, in addition contract can be terminated at no cost to the government when there is no oil found. Smith et al, (2000) added that one of the primary goal of PSC is to attract multinational corporations that will risk their capital and indeed, use of the technological expertise to develop a country's reserves for eventual operation by delegation of the sovereignty. Of course any developing country that is been successful in securing MOC might enhance the level of it is technology and improve the employment status of citizenry. On the other hand, most of the developing countries decide to engage in PSC because of the nature of resource control. Therefore Gidado (1999) said the ultimate responsibility for control and management of the enterprise, in principal at least is in the hands of the host country. Thus contractor has no title to the oil deposit. Bindemann (1999) and Gallun et al, (2001) urges that PSAs are distinguished from other types of contracts in two ways. First, the FOC carries the entire exploration risk. If no oil is found the company receives no compensation. Second, the government or host country owns both the resource and the installations. Many benefits as well are being attributable to PSC, enjoyed by host country, such as high tax, profit oil and so on. Pongsiri (2005) stresses that in addition to royalty, petroleum income tax, and profit split, a PSC also contains a clause covering special advantages that a contractor may offer to the government in return for being awarded the contract. These advantages

normally offered are items such as scholarships, training, grants to government authorities or educational institutions, production bonuses, domestic market obligations (DMO), and public participation options. In addition to that David and Hodgshon (1999) perceive that the key factor influencing the attraction of PSC for most government include the receipt of significant revenues from day one of production through production sharing mechanism and the exercise of control over the operations without direct participation. Even though the benefits are view from different angle by many researchers.

Kemp (1987) argues that the fiscal and financial arrangement between host country and the contractor may be influence by wider government objectives, though most of the non-contractors have common motive such as obtaining high share of revenue, integration of fiscal system levied on petroleum exploration with the tax system applied across the economy in general. Moreover Kemp, (1987) further stress that host government may be not only to increase the state take but to increase the local ownership on national resources. In his submission Walde (2002) argues that PSC helps in exposing national oil and gas business as early as possible to competition and mean while introduce as much objectivity and transparency as possible. Pongsiri (2005) equally added that this could maximize accountability of the inevitable decision making that must be left with the state such as licensing, tax collection, and rule and regulation implementation for public interest issues, e.g. safety and the environment.

One of the most interesting features and merit of PSC as stated by Gidado (1999:159) is that it frees the host country from directly bearing the cost of the initial operations since all are borne by MOC thereby allowing the country's resources channeled in to another pressing engagement. Most of developing countries lack expertise, especially in petroleum activities, therefore utilizes every opportunities acquired or enjoyed such PSC to advance it technological expertise. Bindemann (1999) stress that among the factors countries considered in PSC are the benefit of technology transfer and termination of contracts at no cost to the government if no oil was found at commercial quantities. Yumiseva (2005) added that Production Sharing Contract could be design towards improving transparency in the management of oil and gas revenue. Of course these can be achieved through proper implementation of lied down rules (contracts) that stipulate each party's responsibility. To achieve contractual obligations, a theoretical considerations needs to be taken on the relationship between the principal (NOC) and its agent (IOC) during the contracting process and the way in which informational aspects are integrated in a contract to minimize the monitoring costs associated with the problems of moral hazard and adverse selection (Pongsiri, 2004).

3.1.2 PRODUCTION SHARING CONTRACTS AND INHERENT CHALLENGE IN NIGERIA

Production sharing contracts are virtually practice by developing countries alone. Many people believed that it just signifies the in ability of the countries rather than benefits. Hassan (2005) stress that the relative success of the PSC model seems to lie into government political and to the company commercial satisfaction, rather than economic benefit or that petroleum is paid to the government in lieu of cash. Moreover, most of the countries leaders' uses it as excuse of avoiding JV because of the risk attached to it, such as cash call. Moreover many countries would have prepare to execute the entire exploration activities alone so as to reap the benefits alone but considering the surrounded challenges they had it necessary to involve the other party.

Pongsiri, (2004) stress that owing to difficulties in gaining access to risk capital and lack of expertise needed for resource exploration and development, most developing countries grant development rights to foreign companies, which have adequate capital, technology and expertise, including capabilities to manage investment risks towards their diversified portfolios. In the same vain, Hassan (2005) concluded that a review of countries by countries petroleum laws indicates that the Production Sharing Contract is popular in developing and transition countries. These countries have limited financial and managerial resources, but need to assert conspicuously the sovereignty. On the other hand, the Production Sharing Contract is absent in countries where foreign investment in oil and gas does not affect national sensitivities such as all developed and liberalization countries. It is really a challenge for the developing countries, while formulating its contractual terms, to consider the surrounding factor that might affect the attraction of the other party. Even though every fiscal and structuring and taxation aim is to capture all economic rent but also is good to provide a sufficient return to the oil companies. Johnston, (2003) highlighted that, although the objective of host government is to maximize wealth from its natural resources by encouraging appropriate levels of exploration and development activity, but these can only be accomplished when it design a fiscal system that provide a fair return to the industry, avoid undue speculation, provide flexibility and create healthy competitive and market efficiency. This shows the level of assessment and challenge developing countries take in to consideration in order to attract MOC before adopting a fiscal system.

Nature of supervision, executing and general monitoring of exploration and production activities determines the power and level of control in any relationship. In contrary PSC is been executed by the operator (MOC) alone, this signifies a loophole, even though there is element of monitoring, but in most cases is not sufficient due to informational asymmetry. To avoid these uncertainties and asymmetric information, the principal (NOC) needs to design an incentive contract that induces the agent international oil company (IOC) to undertake actions that will maximize the principal's welfare (Pongsiri, 2004). Production sharing contracts are one of the most popular forms of contractual system used in petroleum agreements around the world, but the manner in which the fiscal terms are presented seems to be complicated and not well understood (Kaiser, 2006). This complication has to do with the general allocation of resources, such cost oil, profit oil, taxation and any sort of revenue distribution. Gallun, et al (2001) stress that the evaluation of cost and allocation of the revenues are likewise issue that involves considerable accounting attention. Thus developing countries lack expertise and any technological advancement. Moreover the lukewarm attitude towards running the activities of the contract are seems to be undermined.

4. CONCLUSION

This study reviewed and assessed joint venture agreement and production sharing contracts adopted by Nigeria in the course of exploring its petroleum resources. In particular, the study looked at pros and cons of the two agreements (PSC and JVA) with the view to assessing which between the two agreements is most appropriate for the country taking environmental characteristics into consideration. It is argued that for a party to successfully enjoy a bilateral relationship in the joint venture agreement that party has to have adequate financial and non-financial resources (Nwokeji, 2007). This is because JVA is a relationship that parties share cost and benefits in an agreed proportion. It is obvious that Nigeria may find it difficult to contribute the required financial obligation (cash call). The country's alleged involvement in corruption practices, the high population and corresponding uncountable demands by the citizens from the little and squandered resources generated by the country make cash contribution unattainable. Hence, the country may find it very difficult to meet its JVA obligation. Equally, considering the countries of lack technological progress, it is hard to believe that Nigeria can contribute technologically into venture. This incapacitation makes it difficult for the country to be a good partner in a JVA. However, this may not be good for the country in the near future as it may not learn much from the operations. Indeed, looking at Nigeria's contemporaries, such as Malaysia, Brazil and Saudi Arabia, one can posits that Nigeria as a country that has been in petroleum operations for more than 50 years has really been backward. On the other hand, discussion within the study indicated that production sharing contract is an agreement whereby contractor bears all the risk and cost involved in petroleum exploration and production activities. This signifies that the host country, such as Nigeria bears no any risk, particularly cash contribution and human resource involvement. This had made it easier for third world countries that have little financial and technological capabilities. In this regard, it is arguably fair to conclude that production sharing contract is most appropriate fiscal regime for Nigeria.

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