Downstream Oil and Gas Sector Watch

Newsletter

September 2019

Introduction

Sixty-three (63) years after the discovery of crude oil in Nigeria, the Nigerian downstream sector (i.e., petroleum product refining, storing, marketing and distribution) is still evolving and yet to reach its full potential. Ranked as the 13th largest crude oil producer in the world with an average daily output of about 2 million barrels per day, one would expect that the downstream sector would be abuzz with significant investments and activities. Unfortunately, this is not the case. The sector is currently bogged down with numerous challenges, such as inappropriate product pricing, bridging product supply, insecurity, irregular gas supply, pipeline vandalism, inadequate pipeline infrastructure, non-functional/ under functioning refineries etc.

As expected, the journey to sustainable development is not without challenges. In this newsletter, we have highlighted some of the recent developments in the downstream sector of the Nigerian oil and gas industry, and events that are likely to impact the industry in the coming years.

Product pricing and the subsidy scheme

Most economists believe that to maximize social welfare, the prices of goods and services should be determined by the interaction of market forces. However, in practice and especially in developing countries, such as Nigeria, policies are often driven more by political considerations rather than rational economic theory.

Given the importance of petroleum products and its impact on the social welfare of its citizens, the Federal Government of Nigeria (FGN) had historically subsidized the products pump price; bridging the actual cost of the pump price and the official pump price petroleum products are dispensed at the pump. The subsidy scheme attempts to make up for the difference between the importer's cost and the official pump price of the products, as capped by the FGN.

However, the product price cap and resulting subsidy on products has not availed citizens that much, in reducing the hardship experienced. Until recent times, the Sector was bedeviled with acute seasonal product scarcity, hoarding, smuggling, adulteration, long queues and several strike actions by participants in the sector. These issues deny the citizens the intended benefit of the product subsidy, as the subsidy claims continue to increase over the years, at the expense of other pressing needs: education, healthcare, infrastructural development, etc.

A remarkable attempt at eliminating the subsidy on petrol by the FGN, under the previous administration in January 2012, was strongly opposed. With the restrictions in sourcing foreign exchange, private marketers have since stopped the importation of refined petroleum products. NNPC is currently the sole importer of petrol into Nigeria.

The subsidy scheme[1] currently places a huge burden on the nation, as the Government has had to continually fund the difference between the actual landing cost, which currently stands at 180[2] per liter of petrol and the regulated pump price of ₦145. Other implicit costs associated with the subsidy scheme include the compensation for exchange rate loss suffered by the importers due to differences between the prevailing exchange rate on the importation of the products and on subsidy settlement and the zero-interest charge on loans linked with the petrol subsidy between June 2017 and December 2018.

Opponents of the subsidy scheme view it as a corrupt scheme that enriches oil marketers and believe the scheme has little or no impact on the welfare of the masses, as was originally intended. In comparison with neighbouring countries, the

regulated pump price of petrol at ₦145/liter is significantly lower, creating an arbitrage opportunity for smugglers who divert petrol meant for the local market to neighbouring countries[3]!

Given the issues noted above, and the unsustainable nature of the subsidy scheme, in the light of economic growth, there have been numerous calls for the complete deregulation of the sector. Deregulation pre-supposes market forces as the determinant of prices rather than an arbitrary manner of fixing pump prices by the government through a fiat. In a bid to clear up the arrears of subsidy

[1]Currently, there is no subsidy on diesel and kerosene.

[2]https://punchng.com/petrol-landing-cost-now-n180-per-litre-says-kachikwu/

[3]The Petroleum Product Pricing Regulatory Agency reported that the average daily consumption of petrol is 56 million liters. However, most people believe that the actual consumption is much less than this. The balance is diverted and smuggled out of the country

owed to oil marketers, and in fulfilment of the Promissory Note and Bond Issuance Programme to settle outstanding government debt, the FGN has commenced the issuance of the first tranche of promissory notes totaling ₦236 billion[4] to oil marketers. The promissory notes have an immediate liquid access value and are tradeable on the Nigerian Stock Exchange.

Upon clearing the backlog of outstanding subsidy claim debt, it may be a good time to completely deregulate the sector and allow market forces to determine pump prices of petrol. This will also allow for the reallocation of the subsidy funds into other productive use that would have a direct bearing on the welfare of the citizens. However, it appears that the Government is waiting for the completion of the Dangote Refinery before acting. Unfortunately, freight may be the only difference between the current landing cost and the expected cost as other costs, such as product cost, NPA charge, jetty throughput cost may still be the same. The other issue is that, by the time the Dangote Refinery comes to stream, it may be time for another election.

Funding

- **Chinese National Petroleum Corporation promises to fund the NNPC Ajaokuta-Kaduna-Kano (AKK) gas pipeline project**

  In recent times, China has become Africa's biggest and strongest ally. The Nigeria-China alliance has grown over the years and is more visible in areas such as construction, trade, and strategic partnerships. The currency swap arrangement between the two countries is no longer a news item. The arrangement has been instrumental in creating an enabling business environment and eased the flow of funds and investments.

  The Chinese National Oil Company had promised to provide NNPC with about 85%[5] of the total funds required for the successful completion of AKK gas pipeline project. The AKK gas pipeline should address some of the issues around irregular gas supply caused by the inadequate pipeline infrastructure for gas transportation in Nigeria. When completed, the pipeline facility should enhance the gas distribution network in the country, as it would connect the eastern, western and northern regions of Nigeria. Hopefully, this will have a positive impact on power generation and industrial growth across the country.

- **Oil swap contracts with the NNPC**

  In a bid to ensure the sustained supply of refined petroleum products (imported petrol and diesel) in the country, the NNPC signed crude-oil swap deals with both local and international traders. Initially signed in May 2017, the deals came into effect in June 2017 and were due to end after one year.

  The successful completion of the first agreement and its resultant impact on the steady supply of products during the period led the NNPC to roll over swap contracts worth about $6 billion by six months until the end of 2018.

  Recently, NNPC has awarded 15 consortia the right to lift Nigeria crude's oil under the Direct Sale, Direct Purchase (DSDP) Agreement, for a one (1) year period, effective 1 October 2019.

  About 90% of the petroleum products demand are imported, with the DSDP contracts accounting for approximately 70%[6] of Nigeria's refined products. It is essential that the Corporation and its trading partners honour their obligations as and when due, to ensure minimal disruption in the supply of petroleum products in the Country.

  Sustained capital investment, favorable foreign exchange policies and other investment-friendly incentives within the sector would help strengthen it and assist to grow investment therein.

- **Investment in FGN-owned refineries**

  The four refineries owned by the NNPC currently have installed capacity of approximately 445,000 barrels per day[7]. Despite these refineries, the country still imports a significant portion of the petroleum products consumed in the country. This is mainly due to the comatose status of these refineries.

  The FG has given indications that the refineries will be operational at 1.1 million BPD in 2020[8]. Achieving this feat would mean a lot to all the stakeholders' including the FGN, as a successful commencement of operation by these refineries will mitigate the subsidy payments on imported petroleum products, allow for the reallocation of the subsidy funds, ensure an improved level of economic activities while also guaranteeing a steady supply of products among other benefits.

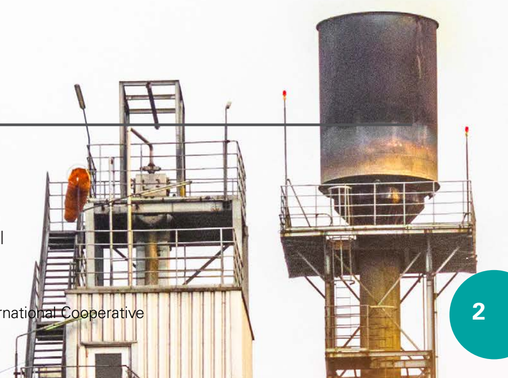
  However, based on experience and given the amount of investments already made in these refineries by way of turn around maintenance, it is doubtful if the refineries will become operational. It may, therefore, make sense to sell them.

- **Licencing of private refineries**

  Between 2015 to 2018, a total of 45 refinery licences were issued. The Department of Petroleum Resources had reported that 38 of the 45 licences were under various stages of execution. However, 17 of the licences had expired. A couple of the current on-going refinery construction works include the Dangote Refinery and Petrochemical Company Lagos State and Azikel Refinery in Bayelsa State.

  When completed and operational, these refineries are capable of increasing local production from the current installed capacity of 445,000 barrels per day. It is hoped that this would ease the supply of petroleum products.

[4]https://www.pmnewsnigeria.com/2018/12/17/subsidy-nigerian-govt-pays-oil-marketers-freezes-interest-on-loan/
[5]https://www.energymixreport.com/chinese-national-oil-firm-guarantees-funding-for-nnpcs-akk-pipeline-project/
[6]https://allafrica.com/stories/201810190407.html
[7]https://allafrica.com/stories/201906120191.html
[8]https://www.premiumtimesng.com/news/top-news/297733-refineries-now-to-be-fixed-in-2020-not-2019-kachikwu.html



Security in the downstream sector

The downstream sector has continued to face significant challenges, such as pipeline vandalism, product theft. These issues have been sources of concerns in the sector. NNPC had reported that a total of 257 pipeline points were vandalized as at December 2018[9] (for a 1-year period reviewed). Pipeline vandalism has troubled operators, as its incidence has continued to erode value and hinder operational efficiency.

The value erosion includes loss of revenue from product theft, the extra cost of repairs and in some instances reconstructing vandalized pipelines and the overall increased cost of engaging security operatives to guard pipelines and personnel.

This lingering issue has hindered the development and growth of the sector. NNPC has continued to appeal to the public for improved collaboration and support, to achieve zero vandalization of the Nation's oil and gas infrastructure. To reinforce its commitment to improving the security situation in the sector, the FGN has continued to deploy security operatives to the affected regions.

Tax issues in the downstream sector

- **Recoverability of qualifying input Value Added Tax (VAT)**

  The VAT Act provides that a VATable person should offset allowable input VAT suffered on purchases against its output VAT from sales, provided that the input VAT was incurred on goods purchased or imported for direct resale, or goods forming the stock-in-trade for production of other goods on which output VAT is charged. The VAT Act also imposes an obligation on companies operating in the oil and gas industry to deduct VAT at source from their vendors and remit same to the Federal Internal Revenue Service (FIRS).

  The above creates a situation where companies selling products/equipment may not be able to recover their qualifying input VAT, as their customer will withhold the related output VAT at source.

  Thus, the deduction at source provision in the VAT Act places companies in oil and gas industry with valid input VAT in a disadvantaged position. Companies in this category include those that are involved in the manufacturing/ importation and sales of lubricants, spare parts, gas compressors. These companies will be in a perpetual input VAT refund position. Such companies can, however, request a refund of the excess VAT paid. Unfortunately, under the current dispensation, the FIRS will need to carry out a 'special audit' covering not only VAT but also other taxes, to validate the claim for refund.

- **Taxation of outstanding interest and foreign exchange (forex) claims receivable from Petroleum Product Pricing Regulatory Agency (PPPRA) for imported PMS**

  Importers of premium motor spirit (PMS) incur significant interest payment and foreign exchange loss on the cost of importation due to the combined factors of delays in the receipt of subsidy payment from the Petroleum Product Pricing and Regulatory Agency (PPPRA) and exchange rate between the landing cost of the product and the benchmarked rate by the PPPRA.

  Claims form and calculations submitted by importers are usually subject to reconciliation between the parties i.e., the Regulator and the importer, to establish the veracity of the claim and agree on the approved amount payable. In some instances, the final amount is not paid until several months after approval. Thus, resulting in accrued interest.

  The interest portion of the transactions is straightforward, as the interest expense is treated as a tax-deductible item in the year it was incurred and the interest income (when reimbursed by PPPRA) would be taxed in the year it is received. However, the main challenge is the treatment of the unrealised foreign exchange loss recognised by companies prior to the payment by PPPRA. Unrealised foreign exchange losses are notional in nature, thus, they are non-deductible expenses for tax purposes.

  A key tax planning point for companies affected by this issue is to ensure that the portion of the money received, which relates to the unrealised exchange loss, is identified and tracked. In the period payment is received, the income that relates to the previously taxed unrealised foreign exchange difference should be adjusted as 'exempt income' in the tax calculations. This approach will ensure that taxpayers are not subjected to double taxation on the same transaction.

- **FIRS' 2019 revenue target and its potential impact on the downstream**

  Over the years, the FIRS have proven to be a significant revenue collection agency for the FGN and the year 2018 marked a significant height for the agency as it claimed to have collected a record 5.32trillion in taxes. This feat should be applauded given that the economy was only slowly recovering from a recession.

  However, given the 2019 deficit budget and the role of the FIRS in revenue generation towards funding the budget, the FIRS will attempt to meet and surpass its set targets in the coming years. This suggests that the FIRS may continue in its aggressive revenue drive.

  Companies in the downstream sector may witness more audits, investigations and desk reviews as the tax authorities seek to improve the level of compliance within this space.

  In light of the above, companies in this sector may proactively conduct tax audit readiness checks to ensure that they are up to date in respect of all tax compliance requirements.

[9]https://www.energymixreport.com/nnpc-records-34-increase-in-pipeline-breaches-nationwide/

Conclusion

The downstream sector may not witness any remarkable growth until the various issues plaguing the sector are addressed. It is, therefore, important that Government takes all the necessary steps to ensure the survival of the sector. Otherwise, it is unlikely that we would see any significant investment in the sector.

We can help

It Is important that your company has an effective tax strategy to manage its tax risk. Identifying and proactively planning for those risks is therefore critical to survival of the company. We, in KPMG, can equip your finance and tax team with the knowledge for making strategic tax decisions. Contact us to learn how we can help you achieve your goals.

For further enquiries on the above and information on how KPMG can assist you, please contact:

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