KPMG

Nigerian Oil and Gas Update

Quarterly Newsletter

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Introduction

The Oil and Gas (O&G) industry has continued to be the mainstay of the Nigerian economy despite Government's best efforts at diversification into Agriculture and Mining. Even though the sector is less than 10% of the country's GDP, it contributes about 65%[1] of Government revenue and 88%[2] of Nigeria's foreign exchange earnings. It is no wonder that happenings in the industry tend to have an impact on the other sectors of the economy. It is, therefore, important for players in the Nigerian economy to continue to be aware of developments in the O&G industry and monitor the happenings therein.

In October 2016, the Federal Government (FG) launched the 7 Big Wins Agenda with the overriding objective of creating a stable and enabling environment. The expectation is that it will maximize investment opportunities in the sector and generate increased and sustainable growth in the economy. Consequently, the Government aspired to increase daily oil production to 2.8 million barrels (reduced from the 4 million barrels the government had previously set as its 2010 vision). The Government also resolved to transform the country from an oil-based economy to a gas-based economy by developing gas infrastructure, commercializing gas flare, implementing a gas commercial framework and maximizing the use of gas to power economic development.

There is no doubt that the Government is working to achieve the objectives of the 7 Big Wins Agenda. This Newsletter highlights some of the recent tax and regulatory developments in the sector.

- ### Back duty tax assessment for Production Sharing Contract (PSC) operators

Government has imposed additional tax assessment of about USD20 billion against PSC operators. This appears to be the result of consent judgment between the FG and three (3) States – Rivers, Bayelsa and Akwa Ibom. The judgement was given based on the failure of the Government to review the provisions of the Deep Offshore and Inland Basin Production Act which should have been triggered when the price of crude oil exceeded USD20 per barrel in real terms.

Based on Section 16 (1) of the Act, the share of the Government in relation to profit oil, as defined in the respective Production Sharing Contracts, is to be adjusted in such a way to economically benefit the Government when oil price exceeds USD20 per barrel. In other words, the percentage of profit share for the Government should increase. However, the Act does not prescribe the basis for doing this. There is, therefore, no agreement for determining the additional profit oil that is due to government.

Nonetheless, it is important that Government enters into discussions with the PSC operators with a view to agreeing a mutually beneficial framework for implementing this provision. The current stance of the Attorney General of the Federation in appointing a debt collecting agent to enforce the consent judgment is certainly not the way to resolve this issue. This will not enhance the desire of Government to create an enabling business environment that will accelerate income for the country in all the sectors of the oil industry.

- ### Tax deductibility of gas flare charges

Exploration & Production (E&P) Companies typically re-inject gas into oil reservoirs. This process increases the pressure in an oil reservoir which then drives additional oil to the wellbore. The gas that E&P companies is unable to re-inject into the wells or utilize in any other form may be flared. Gas flaring may also be triggered for safety reasons to avoid blowout of the oil wells.

The Associated Gas Reinjection Act (AGRA) indicates that flaring will only be allowed in certain circumstances as may be decided by the Minister of Petroleum Resources (The Minister) who may issue a certificate in that respect. Thus, a company can only flare gas after obtaining such approval/ certificate from the Minister. The Minister is also empowered to permit a company

[1]https://eiti.org/es/implementing_country/32
[2]https://africacheck.org/reports/nigerias-economy-services-drive-gdp-but-oil-still-dominates-exports/

to continue to flare gas in the particular field or fields if the company "pays such sum as the Minister may from time to time prescribe for every 28.317 Standard cubic meter (SCM) of gas flared based on Section 3(2)(b) of AGRA.

In practice, however, companies which flare gas do not currently obtain certificates from the Minister. These companies compute, on the portion of gas flared, a **"charge"** in the manner stipulated by both the AGRA and Petroleum Act (PA) and then pay over the amount to the Department of Petroleum Resources (DPR). The amount paid is usually described as "**penalty for gas flaring**" in the receipt issued by DPR. The receipt is expected to suffice in the absence of a certificate issued by the Minister. The companies, therefore, deduct the payment as an allowable expense in arriving at their assessable profits when determining their tax position for the relevant period.

Over the years, there has been debate over this practice until recent court judgments on this matter. The thrust of these judgments is that companies cannot deduct gas flaring charges without the Minister's written approval to flare. It is instructive to note that there are no provisions in the tax laws that preclude penalties and fines from being deducted as expense for income tax purposes, regardless of whether or not they are consistent with public policy. The overriding principle contemplated in the law for the deductibility or otherwise of an expense is based on whether the expense satisfies the wholly, exclusively and necessarily ("WEN") Test. These companies might have had to shut down operations and thus lose income (on which tax is subsequently paid) if they were unable to flare the gas. Therefore, the payment should satisfy the WEN test.

Until this ruling is reversed, operators would have to proactively approach the relevant Government agencies to discuss this matter and agree a process for obtaining the necessary approval in a way that does not put at risk either their ability to continue to earn revenues or claim the expense as tax deductible.

- **Multiple tax audits and aggressive tax collection drive**

Given the contribution of the oil industry to the economy, tax authorities and other regulators have mainly focused on the sector to meet their revenue budget. Currently, the sector is facing myriad of audits, which include Federal Inland Revenue Service (FIRS) and States tax audits, Nigeria Extractive Industry and Transparency International (NEIT) audit, local content compliance audit, and the Nigerian Export Supervision Scheme (NESS) audit.

These audits, which are time-consuming, have placed enormous burden on the operators and distracted from their ability to deliver on their growth objectives. Though periodic compliance review with the enabling laws and regulations is desired, it needs to be properly and effectively performed to ensure that it does not constitute a problem. Moreover, it is important that the consultants engaged by the relevant government agencies for this purpose have a very good understanding of the industry to facilitate a timely and effective closure of these audit exercises.

- **Accelerated lease renewal program**

Oil Mining Leases (OML) grant holders the rights to the oil fields of interest for an initial period of 10 years with another 10-year renewal option. On the other hand, Oil Prospecting Leases (OPL) grant holders access for a 3 year period with a maximum extension option of up to two years. Prior to now, oil licences were not renewed as and when due. In fact, the operators were working with expired licences. This, therefore, created uncertainty for the operators and significant loss of revenue for government.

To address this perennial problem, the Government (through the DPR) has recently launched the accelerated lease program. Under the program, the holder of an OML can apply for renewal of the lease at least one year to expiration. However, operators that have not fully settled all outstanding royalty payments cannot participate in the program. Based on information provided by the DPR, a total of 45 leases are due for renewal in the first quarter of 2019. The DPR also noted that, as at 31 January 2019, 25 applications for renewal had been received; out of which the President had approved 22. The renewal program has generated about USD1billion to the Nigerian Government.

Government has also committed to a timely review of oil licences of operators that have not complied with the terms of the award. Recently, the President announced the revocation of 7 licences in this regard. The Minister of State for Petroleum has stated that the FG may not be awarding new oil blocs any time soon. This is because there are existing acreages which are yet to be harnessed either due to unwillingness, or lack of financial and technical capabilities of the existing rights holders. He has therefore called on International Oil Companies (IOCs), which hold blocs that are below their commercial threshold, to release same to local operators. This would help to achieve the country's objective of increasing the contribution of indigenous companies to total oil and gas production from the current 11% to a minimum of 30% within the shortest possible time.

The accelerated early lease renewal program is a laudable scheme that should assist with providing some of the required revenue to fund the 2019 budget deficit. Furthermore, the focus of reallocating oil blocs deemed below the commercial threshold of the IOCs to indigenous players will help boost investments in the marginal field space which is already seeing improvements and lots of positive activities in recent times.

- **Launch of oil and gas production volume and vessels movement systems**

One of the major challenges facing the Government has been lack of adequate and reliable information about the average crude oil and gas production levels in the country. The government depended on the information supplied by the operators for this purpose. Furthermore, crude oil theft remains a huge issue in Nigeria's oil industry. A report on "Crude Oil Theft in Nigeria", commissioned by the Nigeria Natural Resource Charter (NNRC) in November 2018, showed that Nigeria had lost about ₦3.8 trillion between 2016 and 2017 to oil theft. It is against this backdrop that the DPR launched the National Production Monitoring Systems (NPMS) and the Computerized Crude Oil and Liquefied Natural Gas Tracking (COLT) system in the first quarter of 2019.

The NPMS, which is an online oil and gas production and data gathering system, should ensure that production volume is monitored in a timely and efficient manner while the COLT system is designed to use Automatic Identification System (AIS) to track Maritime Vessels (i.e. Ocean going vessels} carrying oil and gas, with knowledge of volumes being shipped across the globe and by whom in real-time. It will analyse seaborne flows, cargo by cargo, revealing hidden patterns and trends in the market which could otherwise go unnoticed. The COLT system will also provide data on vessel operations and movement including loading, cargo details, ship details, destination (country/continent), discharges and trade activities. The data obtained would enable the DPR to track all the crude oil produced and quantity loaded to vessel(s) to its final destination, stop overs and the applicable discharges, and cargos imported into Nigeria, all in real time. The DPR also noted that the COLT system has the ability to track and identify "rogue" or "dark" ships on a real-time map, to ensure that there are no leakages that may occur in the transportation of crude and liquefied natural gas.

It is hoped that these initiatives will help to address the issue of production volume and oil theft in the sector. However, as with any other online platforms, their effectiveness will depend on the quality of data uploaded and the timeliness of the data upload. Where there are delays in uploading data, as it is being currently experienced, the value to the economy will be limited. It is also important that all the twenty-six (26) crude oil export terminals in the country are connected as soon as possible. Based on available information, only six (6) are currently running online. Most importantly, there should be real time data gathering process with minimal human interface to guarantee the integrity of the systems.

The policy position of the FG has always been that gas flaring is unacceptable. However, it has not been able to implement the zero-gas flare policy.

- **Commercialisation of flare gas**

Liquified Gas is expanding speedily in popularity due to its many uses and the overall rise in natural gas production. Natural gas is an under-exploited energy and chemical resource in Nigeria, despite the country having about 184 trillion cubic feet of natural gas reserves. Currently, about 10% of the associated gas produced is flared. Though there are safety and economic reasons for this, it deprives the country of the potential benefits that can be derived from alternative use of the resource.

The policy position of the FG has always been that gas flaring is unacceptable. However, it has not been able to implement the zero-gas flare policy. Notwithstanding, the FG has now implemented a number of initiatives to reaffirm its commitment to ending the practice of gas flaring in Nigerian oil fields. The FG has now ratified the Paris Climate Change Agreement, and signed on to the Global Gas Flaring Partnership (GGFR) principles for global flare-out by 2030 whilst committing to a national flare-out target by 2020.

In recognition that there are available innovative technologies which could be used to harness flared gas in order to stimulate economic growth, drive investments, provide jobs in oil producing communities and indeed Nigeria as a whole, the Federal Executive Council (Nigeria's cabinet) has approved the Nigerian Gas Flare Commercialisation Programme ("NGFCP"). The NGFCP is designed to attract investment to develop the gas market, through a competitive procurement process of allocating gas flare sites to potential investors, and is hinged on the ***New Flare Gas (Prevention of Waste and Pollution) Regulations 2018 (Regulations)*** made pursuant to existing legislation ***– Section 9 of the Petroleum Act and Section 5 of the Associated Gas Reinjection Act (AGRA)***. Based on the Regulations, associated gas, which is not being utilized by the Licensee or Lessee of a licensed or leased area inclusive of marginal fields, is to be made available to third party licensees under the procurement process for commercialization.

The commercial framework underpinning the programme contemplates an agreement between the FGN and the Flare Permit holder (Flare Licensee) for the sale of contracted Flare Gas volumes to the Flare Licensee - **Gas Supply Agreement**; an agreement in respect of the connection of the respective facilities of the Operator and the Flare Licensee - **Connection Agreement**; and an agreement between the Operator and the Flare Licensee under which the Operator guarantees to supply an agreed volume of flared gas to a Flare Licensee - **Deliver or Pay Agreement**.

The registration and submission of Statement for Qualification (SOQ) for the NGFCP was initially scheduled to end on 20 January 2018. However, due to logistic delays, the deadline was extended to 28 February 2019. The SOQ will be the first step for prospective bidders to submit information for evaluation in order to determine their eligibility and subsequent selection to participate in the auction process. Based on the timetable provided in the NGFCP Programme Information Memorandum, the evaluation of proposals and award of bids are scheduled to be completed by Q4 2019. The preferred bidders, once selected, will be required to enter into the Commercial Agreements (Connection Agreement, Gas Supply Agreement, Deliver-or-Pay Agreement, and if relevant, Milestone Development Agreement), substantially in the form of the templates that will be included in the Request for Proposal (RFP). This is pursuant to the issuance of a permit to access flare gas.

The NGFCP and its enabling regulations are good initiatives and should bring a breath of fresh air in terms of a cleaner, safer environment for the people of the Niger Delta, curb the waste of natural resources, attract new investments for the development of the gas sub-sector and improve employment opportunities. However, one key issue that needs to be addressed is the economics of the program as Government currently regulates the price of domestic supply of gas, even though the price payable by the permit holders will be discounted relative to international market rate.

- **Restructuring of Joint Venture (JV) operations**

The withholding of assent by the President with respect to the Petroleum Industry Governance Bill (PIGB) has greatly hampered the proposed reforms of the industry. Notwithstanding, the Government appears to be committed to the restructuring of the JV operations. There are plans to sell down government interest in the JVs. Currently, Government holds 55% and 60% in Shell JV and other JVs, respectively. However, the timing for the sale is critical to obtain maximum value. The general expectation is that oil price will stay around USD70 per barrel as a result of the slow-down in inventory in the Permian Basin and the relative success of Organisation of the Petroleum Exporting Countries (OPEC) and its partners in maintaining its daily production cut.

There are also plans to transform the current JV model into an incorporated joint venture model similar to the Nigeria LNG Limited. However, this will require the enactment of the Governance Bill. It is hoped that the 9th National Assembly will timely address the concerns that led to the President withholding his assent and pass the revised Bill to the Presidency for assent.

How we can help

At KPMG, our purpose is to inspire confidence and empower change. We have an Oil and Gas Team, which comprises professionals with diverse experience and knowledge in accounting, tax, immigration, rewards, mergers and acquisitions, advisory and regulatory practices. You can, therefore, count on us as a valuable partner with respect to meeting your needs in the industry. Please contact the following for additional information:

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