Review of the Enacted Deep Offshore Production Sharing Contract Amendment Act

The ultimate aim of the amendments therefore should be to encourage investments and new projects in the deep offshore of the Nigerian oil and gas industry while also ensuring that the government's drive to improve revenue generation is also achieved.

Introduction

On the 4th of November, 2019, President Muhammadu Buhari signed the Deep Offshore and Inland Basin Production Sharing Contract (Amendment) Bill ('Deep Offshore PSC Amendment Act') into law which accordingly amends the Deep Offshore and Inland Basin Production Sharing Contract Act, Cap. D3 Laws of the Federation of Nigeria 2004 (the 'Principal Act'). The Principal Act was enacted with the intention of providing fiscal incentives to encourage contractors to develop the frontier areas, i.e. the deep offshore and inland basins, under Production Sharing Contracts (PSCs).

The PSC arrangement in Nigeria was adopted to address: (i) the funding constraints encountered under the Joint Operating Agreement regime; (ii) the high geological risk associated with deep water and inland basins exploration; (iii) the desire of the Federal Government of Nigeria to retain title to the oil concession; (iv) the aspiration to increase the nation's reserve base; and (v) the need for a suitable agreement structure, which would encourage foreign investment in the deep offshore area. (Taiwo Adebola Ogunleye, 2015)

The Principal Act amended the Petroleum Profit Tax Act and provides that the petroleum profit tax payable under a PSC is to be a flat rate of 50% of chargeable profits (Section 3 of the Principal Act). It also grants investment tax credit/investment at a flat rate of 50% of the qualifying expenditure where any of: the Nigerian National Petroleum Corporation ('NNPC'), the holder of an oil prospecting license/oil mining lease, or a contractor incurs any qualifying capital expenditure wholly, exclusively and necessarily for the purposes of petroleum operations carried out under the PSCs. Furthermore, it sets out a graduated rate for the payment of royalty in the deep offshore area, and a fixed rate of 10% for the inland basins.

This article sets out and analyses the highpoints of the Deep Offshore PSC Amendment Act and its potential impact on contractors and their investments in the Nigerian deep offshore area.

Highpoints of the Deep Offshore PSC Amendment Act

The Deep Offshore PSC Amendment Act introduces the following innovations:

a) **Fixed Water Depth Royalty Regime:**
The Deep Offshore PSC Amendment Act introduces a fixed water depth royalty regime (i.e. calculated on a field-by-field basis). This replaces the graduating/incremental water depth royalty rate previously payable under the Principal Act. Under the new regime, the royalty payable is a percentage of the chargeable volume of the crude oil and condensates produced from the relevant area in the relevant period. Consequently, in respect of deep offshore areas greater than 200 meters water depth, the royalty payable is 10%, while in frontier/inland basins, the royalty payable is 7.5%.

b) **Royalty by Price:**
The "Royalty by Price" framework, has been introduced to allow for royalty flexibility based on changing prices of crude oil, condensates and natural gas. This royalty is to be paid in addition to the fixed water depth royalty. The royalty rate is identical for the various water depths in the deep offshore (beyond 200 meters water depth), including frontier acreages for crude oil and condensates. The "Royalty by Price" regime is based on increase in prices/increase in value of crude oil and condensates over the sum of $20 per barrel.

The table below highlights the proposed Royalty by Price framework:

Prices per Barrel ($)	Royalty Rate per Barrel (%)
US$0 to US$20	0%
US$20 and up to US$60	2.5%
US$60 and up to US$100	4%
US$100 and up to US$150	8%
above US$150	10%

c) **Periodic Reviews:**
The Minister of Petroleum is now required to cause the NNPC to call for a review of PSCs after every eight years.

d) **Penalty for Non-Compliance:**
The newly introduced regime introduces a fine of five hundred million naira and/or imprisonment for a period of not less than five years, on any person for non-compliance with any obligation imposed by the Deep Offshore PSC Amendment Act. The Deep Offshore PSC Amendment Act is, however, silent on whether the imprisonment penalty will apply to companies, and if so

applicable, which officers of the company will be liable to face such imprisonment.

Implications of the Proposed Reforms in the Oil and Gas Sector

In view of the prevailing low oil prices at the time of enactment of the Principal Act in 1993, the Principal Act was enacted with the intention to provide fiscal incentives to attract operators to the Nigerian deep offshore, allow for rapid cost recovery and provide assurance on bankability. On the other hand, it appears that the provisions in the Deep Offshore PSC Amendment Act are motivated by the current economic realities of deep offshore production and the recent volatility of crude prices.

The amendment is enabled by Section 16 of the Principal Act, which provides for a review of the Principal Act where the price of crude oil exceeds $20 per barrel. Thus, the previous legal framework for operations in deep offshore and inland basins was not intended to be fixed but rather susceptible to changing market realities.

The key potential impacts of the amendments in the oil and gas sector are highlighted below:

A. Impact of the New Royalty Regime

(i) **"Fixed Water Depth" Royalty Regime**
The graduating water depth royalty regime formerly applicable under the Principal Act is a distinctively lower royalty regime when compared with the fixed water depth royalty regime under the Deep Offshore PSC Amendment Act. Under the former graduating water royalty regime, operators in the deep offshore (areas from 201 meters to 500 meters) pay a royalty at the rate of 12%. For petroleum operations in areas from 501 meters to 800 meters, the operators pay a rate of 8%; while petroleum operations in areas in excess of 1,000 meters depth do not attract any royalty. In effect, the regime incentivized exploration activities and investments in the deep offshore, especially in areas with water depths greater than 1000 meters where most of the deep offshore exploration activities under PSCs occur.

Under the current fixed water depth royalty regime provided under the Deep Offshore PSC Amendment Act, all activities in water depths beyond 200 meters now attract a fixed royalty of 10%. While this is beneficial to the Federal Government, in terms of the potential increase in revenue from the royalties payable thereunder, this introduction will lead to a reduction in the amount of available profits to be shared between the contractors under the PSC arrangement and NNPC. It also has the potential impact of altering the revenue projection of operators. This is particularly true for operators

currently undertaking or intending to undertake activities in water depths beyond 1000 meters, which formerly attracted a 0% royalty rate under the Principal Act. This notwithstanding, the new royalty regime will be beneficial to operators in water depths of 201 meters to 500 meters as there will be a 2% reduction in royalty rate to be paid by these operators.

In addition, there is the impact that the "Fixed Water Depth" royalty regime may have on the multinational oil and gas companies that have divested their interests in their onshore assets due to the unrest and militancy in the Niger Delta and have moved into deep offshores to take advantage of the fiscal incentives provided under the Principal Act, amongst other benefits. The new amendments in the royalty regime will likely be unfavourable to these companies and will likely adversely increase the cost of their operations.

(ii) **"Royalty by Price" Regime**

Under the royalty regime in the Principal Act, additional royalty is payable on all crude oil, condensates and natural gas where the price per barrel stays above the $20 benchmark. The current Royalty by Price regime has altered the Principal Act regime such that royalty is determined by the price of crude per barrel.

B. Comparative Analysis of Royalty Regime

The changes in the royalty regime introduced by the Deep Offshore PSC Amendment Act is similar to the Kashagan PSC regime in Kazakhstan (an offshore oil field in Kazakhstan's zone of the Caspian Sea), where extremely favourable conditions were granted in order to attract investors and develop the energy industry. However, after eleven years, the government renegotiated the terms of the PSC to introduce a floating royalty structure under which the operators would pay the Kazakhstan State 3.5% of output when world oil prices are above $45 per barrel; 7.5% - 8% at $130 per barrel; and 12.5% at $195 per barrel. This linked the royalty rate to the price of oil.

It is instructive to note that in Colombia, Canada and Romania, varying royalty rates ranging from the lower end of 3% in Columbia, to the higher end of up to 45% in Canada, are applicable depending on varying indices, including level of production, well productivity and wellhead price (The Law Library of Congress). It is therefore clear that the new range of royalty rates and the concept of "floating" royalty structure are not unique to Nigeria and specifically, the floating structure is becoming popular in the oil and gas industry globally. We note, however, that the basis on which the new royalty regimes (fixed water depth and royalty by price) were determined are unclear. Such significant change should ideally be driven by industry data after consideration of risks and challenges peculiar to Nigeria.

The introduction of the new royalty by price is likely to increase Federal Government revenue and may lead to a reduction in the projected profits to be earned by operators. However, considering our local dynamics where these companies operate in harsh economic conditions (e.g. high taxes and deficit of infrastructure), there is a school of thought that believes that this new rate, in the true sense, may not be competitive globally.

C. Periodic Review

The Deep Offshore PSC Amendment Act provides that the Minster of Petroleum is to call for a periodic review of PSCs by the NNPC after every eight years. This amends Section 16 of the Principal Act, which called for a review and the adjustment of royalty rates under PSCs where crude price exceeded $20 per barrel. The Principal Act also provided that the provisions of the Principal Act should be reviewed after a period of fifteen years from the date of its commencement and every five years thereafter. The Principal Act was however silent on the mode of reviewing the PSCs. It was not clear if these reviews can be done without having to amend the Principal Act itself.

This appears to have now been addressed by the Deep Offshore PSC Amendment Act, which provides for a more convenient mode of periodic review, i.e. by reviewing the individual PSCs as opposed to having to review the Principal Act or other legislation.

The amendment to the review process under the Deep Offshore PSC Amendment Act will alter the dynamics of the review process under existing PSCs. It will also form a part of the key consideration by parties to PSCs when drafting new PSCs. Reviews of PSCs are typically done at the end of the term of such PSCs (this is of course subject to a prior agreement by the parties). However, with the introduction of the new review process, PSCs will now have to be reviewed after every eight years in so far as such PSCs are still subsisting. This may be a welcome development or a potential source of dispute between the parties, especially in relation to the key terms of the contract, such as the rights and obligations of each party and the revenue sharing structure, which either party may not be keen on renegotiating.

Concluding Remarks

The changes introduced by the Deep Offshore PSC Amendment Act generally mirror what is currently obtainable in other jurisdictions. However, it appears that the balance tilts more in favour of the government in the sense that there will be increased revenues for the government from royalties received while the contractors will appear to have an increase in their financial obligations.

The counter argument is that (i) considering the fiscal incentives initially enjoyed by the contractors, and (ii) the potential loss of revenue suffered by the government as a result of its failure to review the Principal Act when the price of crude rose above $20 per barrel, the Deep Offshore PSC Amendment Act may be viewed as creating a fair balance for both parties under the PSCs. The merits of this argument are watered down by uncertainties surrounding the depth of research and consultation carried out during the drafting of the Deep Offshore PSC Amendment Act. Little is known as to whether the drafters considered other factors and challenges peculiar to the nuances in the Nigerian oil and gas sector.

We expect that there was an effective stakeholder engagement between contractors and the government to consider all the factors and challenges peculiar to the Nigerian oil and gas industry before the amendment was passed into law. The drafters and stakeholders are expected to have utilized available industry data to arrive at the present royalty regime contained in the Deep Offshore PSC Amendment Act for the Nigerian oil and gas industry. The ultimate aim of the amendments therefore should be to encourage investments and new projects in the deep offshore of the Nigerian oil and gas industry while also ensuring that the government's drive to improve revenue generation is also achieved.

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Disclaimer: This Article was written based on the Deep Offshore PSC Amendment Bill passed by the Senate on 15th October 2019. A copy of the Deep Offshore PSC Amendment Act that was recently assented into law by the President is yet to be publicly available. However, we assume that the provisions of the Deep Offshore PSC Amendment Act are the same in substance with the Deep Offshore PSC Amendment Bill as passed by the Senate.