

REDEFINING THE LEGAL ISSUES AND FISCAL RESPONSIBILITY CHALLENGES OF DEEP OFFSHORE PRODUCTION SHARING CONTRACTS IN NIGERIA OIL INDUSTRY*

Abstract

In oil exploration and exploitation, there are different forms of contractual arrangements between the host country/government and the exploration companies and one of which is the Production Sharing Contracts. This form of contract enables both parties, which is the oil-producing country and the oil company, to share the risks and rewards of oil exploration and exploitation activities. In Nigeria, Production Sharing Contracts was firstly regulated under the Deep Offshore and Inland Basin Production Sharing Contracts Act of 1999 before amendments was made to the legislation in 2019. The amendments were aimed at improving the revenue position of the Nigeria government and streamline some of the lacunas observed in the 1999 Act. Undoubtedly, the proposed amendment further explicitly affects the fiscal nature of the PSC agreements between the IOCs and the Nigerian National Petroleum Corporation (NNPC), creating new obligations and royalty regimes. It is based on this premise that the objective of this paper is set. Therefore, the paper seeks to evaluate the nature and effect of the amendments introduced in the PSC Amendment Act of 2019 while highlighting some of the challenges and problems posed by the PSC Amendment Act regarding the revenue ability of the Nigerian government. The paper will also highlight some of the possible impacts on PSCs in particular and on the Nigerian oil sector in conjunction with the whole economy.

Keywords: Deep Offshore, Production Sharing Contracts, Oil Industry, Legal Issues, Fiscal Responsibility Challenges, Nigeria

1. Introduction

In the oil and natural resources exploration and exploitation, there are different forms of contractual arrangements between the host country/government and the exploration companies. One such arrangement that has become quite popular over the last two decades is the employment of Production Sharing Contracts to share the risks and rewards of the oil exploration and exploitation activities between the parties. It can be said that a Production sharing contract (PSC) is a means of any agreement or arrangements made between an oil-producing country or its national oil company and any petroleum exploration and production company for exploration and production of oil in the Deep Offshore and Inland Basins¹. It is a distinct petroleum arrangement that has been adopted by many developing countries in the exploration and production of their petroleum resources as it guarantees the sovereign right of the state over these resources and meets their economic desires by providing capital and technology for their production². Various oil-producing countries have embraced it as a contract to explore and develop their gas and petrol resources, in particular the developing countries. In this arrangement, in the development of its petroleum resources, the government assumes minimal to no risk. Nigeria adopted it for the exploration and development of the offshore and inland basin in the early 1990s³. In Nigeria, the government enacted the Deep Offshore and Inland Basin Production Sharing Contracts Act of 1999⁴ which gave legislative backing to the fiscal terms granted by the Government to certain PSC models. Later in 2019, the Act was amended with the enactment of the Deep Offshore and Inland Basin Production Sharing Contracts Act (Amendment) Act 2019⁵ which was to review the nature of the PSC arrangements in Nigeria and to increase the revenue mobilization powers of the Nigerian government through the royalties' rates. It is expected that, with the introduction of the new fiscal regime, Nigeria will make an estimated \$1.5 billion from the revenue produced by the International Oil Companies (IOCs) operating in Nigeria by the new Deep Offshore and Inland Basin Production Sharing Contracts Act (Amendment) Act of 2019⁶. The proposed amendment explicitly affects the fiscal nature of the PSC agreements between the IOCs and the national oil company of Nigeria – the Nigerian National Petroleum Corporation (NNPC). The goal of this paper therefore is to emphasize the challenges and problems posed by the PSC Amendment Act regarding the revenue ability of the Nigerian government. The paper will also highlight some of the possible impacts on PSCs in particular and on the Nigerian oil sector in conjunction with the whole economy.

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¹ Section 17, Deep Offshore and Inland Basin Production Sharing Contracts Act 2004; Zhuo Feng, Shui-Bo Zhang and Ying Gao, 'On Oil Investment and Production: A Comparison of Production Sharing Contracts and Buyback Contracts' (2014) 42 *Energy Economics* 395.

² Muhammad LuthfanHadiDarus, 'Constitutionality in Production Sharing Contracts: Legal Policy on Petroleum and Natural Gas' (2020) 2 *Prophetic Law Review* 1.

³ TaiwoAdebolaOgunleye, 'A Legal Analysis of Production Sharing Contract Arrangements in the Nigerian Petroleum Industry' (2015) 5 *Journal of Energy Technologies and Policy* 1.

⁴ No. 9 of 1999

⁵ No. 17 of 2019

⁶ Bloomfield Law Practice, 'An Assessment of the Deep Offshore and Inland Basin Production Sharing Contracts Amendment Act 2019' (Bloomfield Law Practice 2019), p. 2 http://bloomfield-law.com/Publications/BLP_Article_Review_of_PSC_Amendment_Act_2019_Updated_Final_061119.pdf accessed February 21, 2021.

2. Nature of Production Sharing Contracts in Nigeria

Concept of Production Sharing Contracts

A PSC is one of the most common types of fiscal systems implemented by oil-producing countries. It has its origins in Indonesia in 1960⁷, and its main characteristic is that the ownership of the produced oil remains with the government, which rewards the companies with cost and investments recovery and a share of the profit oil. The PSC framework encompasses different fiscal system designs: from a fixed rate to several kinds of sliding scale methods to share the profit oil by imposing diverse percentage limits and depreciation schedule for the cost recovery⁸. According to various experts, the PSC arrangement provided a ready solution for both government and the operators⁹. While government no longer needs to meet its periodic cash call obligations to Joint Venture programmes, the operators on the other hand readily embraced the varying degree of fiscal incentives and convenient work programs offered by the PSC legislation¹⁰. PSC is a contract where the State, as the owner of mineral resources, engages an International Oil Company (IOC) as a contractor to provide technical and financial services for exploration and development operations¹¹. The State is traditionally represented by the government or one of its agencies such as the National Oil Company¹². The IOC acquires an entitlement to a stipulated share of the oil produced as a reward for the risk taken and services rendered. The State, however, remains the owner of the petroleum-produced subject, with only to the contractor's entitlement to its share of production. The Nigerian government, through the NNPC, usually has the option to participate in different aspects of the exploration and development process. Also, PSCs frequently provided for the establishment of a joint committee where both parties are represented and which monitors the operations¹³.

Although PSCs are the most common type of petroleum contracts particularly in developing countries, there is no universal model of this contract¹⁴. Duval et al¹⁵ observed that PSC has retained the following basic features:

The International Oil Company (IOC) is appointed by the Host Country (HC), directly or through its national oil company (NOC), as the exclusive 'contractor' (and not as a concessionaire) to undertake petroleum operations in certain area during specified time periods; The IOC operates at its sole risk, its own expense, and under the control of the HC; If petroleum is produced, it belongs to the HC, with the exception of a share of production that can be taken in kind by the IOC for cost recovery and for profit sharing; The IOC is entitled to recover its eligible cost under the PSC from a portion of the production from the area subject to the contract; After cost recovery, the balance of the production is shared, based on a predetermined percentage split between the HC and the IOC; The net income of the IOC is taxable, unless the PSC provides otherwise; The title to the equipment and installations purchased by the contractor pass to the HC either immediately or overtime, in accordance with the cost recovery schedules¹⁶.

Royalty constitutes an immediate cash flow to the government if it has to be paid in cash. If it is an in-kind payment, it provides a cost-free source of crude oil for the domestic market or export. In the case of cash payment, it is crucial how the value of output is determined¹⁷. Assume the PSC stipulates a posted price. If on delivery the posted price is higher than the spot (or market) price this is an advantage for the government. On the other hand, a posted price below the spot price benefits the foreign firm. Either way, royalty is guaranteed minimum revenue flow from the IOC to the government regardless of the profitability of the project. This implies that the lower the profitability the higher is the adverse impact of the royalty on the IOC. If the royalty payment is deductible from income tax liabilities, the

⁷ Kirsten Bindemann, *Production Sharing Agreement: An Economic Analysis* (Oxford Institute of Energy Studies 1999) p. 2

⁸ Ibid. p. 3

⁹ Ibid.; Inifome Usenu, 'The Impact of the Covid-19 Pandemic on Production Sharing Contracts in Nigeria' (*International Bar Association* June 17, 2020) <<https://www.ibanet.org/Article/NewDetail.aspx?ArticleUid=96b51357-81c8-44af-ab43-e8e11ec68f3a>> accessed February 20, 2021.

¹⁰ Patrick Okonjo, 'Nigerian Production Sharing Contracts Solve Cash Call Problems' (*Offshore Magazine* February 1, 2001) <<https://www.offshore-mag.com/business-briefs/company-news/article/16758984/west-africa-nigerian-production-sharing-contracts-solve-cash-call-problems>> accessed February 21, 2021.

¹¹ Lekan Dairo, 'Deep Offshore and Inland Basin Production Sharing Contracts (Amendment) Act 2019: Overview' (*TNP* January 30, 2020) <https://tnp.com.ng/insights/deep-offshore-and-inland-basin-production-sharing-contracts-amendment-act-2019-overview?utm_source=Mondaq&utm_medium=syndication&utm_campaign=LinkedIn-integration> accessed February 21, 2021.

¹² In Nigeria, it is the Nigerian National Petroleum Corporation (NNPC)

¹³ Kirsten Bindemann, n. 7, p. 1

¹⁴ Bernard Taverne, *An Introduction to the Regulation of the Petroleum Industry: Laws, Contracts, and Conventions* (Graham & Trotman 1994).

¹⁵ Claude Duval and others, *International Petroleum Exploration and Exploitation Agreements: Legal, Economic & Policy Aspects* (Barrows 2009).

¹⁶ Ibid. pp. 69-72

¹⁷ Kirsten Bindemann, n. 7, p. 3

government's overall revenue will be reduced. Hence, according to George Etomi et al¹⁸, the government would better off if it treated royalties as expenses.

PSCs are distinguished from other types of contracts in two ways. First, the IOC carries the entire exploration risk. If no oil is found the company receives no compensation¹⁹. Second, the government owns both the resource and the installations²⁰. In its most basic form, a PSC has four main properties²¹. The IOC pays a royalty on gross production to the government. After the royalty is deducted, the IOC is entitled to a pre-specified share of production for cost recovery. The remainder of the production, so-called 'profit oil', is then shared between the government and IOC at a stipulated share. The contractor then has to pay income tax on its share of profit oil.²²

Because of the foregoing, the essence of PSC is that the Host Government, through its representative agency, engages a competent contractor to carry out petroleum operations on the Host Government's wholly held acreage. The contractor undertakes the initial exploration and production risks and recovers his costs if and when oil is discovered and extracted. Under the Nigerian PSC, the contractor has a right to only that fraction of the crude oil allocated to him under the cost of oil (oil to recoup production cost) and equity oil (oil to guarantee a return on investment)²³. The contractor can also dispose of the tax oil (oil to defray tax and royalty obligations) subject to NNPC's approval. The balance of the oil, if any (after cost, equity and tax), is shared between the parties (profit oil)²⁴. Accordingly, the PSC ultimately divides the oil production between the host government and the oil company (contractor), after allowing the contractor to recover some or all of its past costs. The PSC has flexibility, through the cost recovery, production share and tax elements. Once the allocation of royalty oil, cost oil and tax oil has been made, the remaining oil is shared between the NNPC and the IOC following a previously agreed profit split based on cumulative levels of production. This is known as a production-based sliding scale model and is mainly utilised in the 1993 and 2000 model PSCs. At lower levels of production, the profit-sharing rates favour the IOC which shifts in the NNPC's favour as production increases. The 2005 model PSC on the other hand uses an R-factor sliding scale. The R-factor is calculated by dividing total contractor receipts over total contractor expenditures. A significant difference between both profit-sharing models is that the former does not affect NNPC's profit share when oil price increases, while NNPC's profit share rises with oil price increases in the R factor model. However, the Deep Offshore and Inland Basin Production Sharing Contracts Act of 1999²⁵, provided for an adjustment to PSC terms on profit sharing where the price of oil exceeds \$20 per barrel in real terms to ensure that any additional revenue becomes economically beneficial to the federal government. This section has been repealed by the Deep Offshore and Inland Basin Production Sharing Contracts Act (Amendment) Act of 2019²⁶.

3. Legal Framework for Production Sharing Contracts in Nigeria

Before 1993, the predominant contract model for exploration, development and production of Nigerian oil resources was the JOA (Joint Venture Arrangement), under which the Government of Nigeria, acting through NNPC, had to contribute substantial counterpart funding (cash calls) to meet equity participation in the joint ventures (JV), in which the government invariably had majority shares²⁷. The consistent inability of the Nigerian government to adequately meet its obligations under the JV arrangements led it to explore other modes of developing the nation's vast oil resources²⁸. Prior to 1999, there was no specific legislation/enactment, which dealt with the Nigerian PSC arrangement²⁹. All that existed were agreements between NNPC and under listed contracting companies' regulations, pronouncements and official statements, which went to reinforce the applicability of the PSC arrangement. This state of affairs provided the operators with problems, which were legal enforceability and difficulty in securing financing based on mere agreements that were not backed by law. The Deep Offshore and Inland Basin Production Sharing

¹⁸ George Etomi and others, 'An Overview of the Deep Offshore and Inland Basin Production Sharing Contract Bill: Issues and Considerations' (*Lexology*) <<https://www.lexology.com/library/detail.aspx?g=27403284-5efb-44bc-81c7-7607a6030dc4>> accessed February 21, 2021.

¹⁹ Mohammad Tavakoli, Vali Allah AeinehNegini and Adel Bahrami, 'Evaluation and Analysis of Fiscal Regime in Production Sharing Contracts (PSC)' (2016) 2 *Journal of Researches Energy Law Studies* 253 https://jrels.ut.ac.ir/article_62723.html?lang=en accessed February 22, 2021.

²⁰Ibid. p. 254

²¹Awa Diouf and Bertrand Laporte, 'Oil Contracts and Government Take: Issues for Senegal and Developing Countries' (2017) 43 *The Journal of Energy and Development* 213 <https://www.jstor.org/stable/26539574> accessed February 22, 2021.

²²Ibid. p. 215

²³ Section 10, Deep Offshore and Inland Basin Production Sharing Contracts Act 1999; Noma Garrick, 'The Nigerian Production Sharing Contract: An Overview' (*Energy Mix Report* May 30, 2017) <<https://www.energymixreport.com/the-nigerian-production-sharing-contract-an-overview/>> accessed February 21, 2021.

²⁴ Ibid.

²⁵ Section 16(1), Deep Offshore and Inland Basin Production Sharing Contracts Act 1999

²⁶ Section 3, Deep Offshore and Inland Basin Production Sharing Contracts Act (Amendment) Act 2019

²⁷YinkaOmorogbe, 'The Legal Framework for the Production of Petroleum in Nigeria' (1987) 5 *Journal of Energy & Natural Resources Law* 273

²⁸ Aaron Sayne, Alexandra Gillies and Christina Katsouris, *Inside NNPC Oil Sales: A Case for Reform in Nigeria* (Natural Resource Governance Institute 2015) <https://resourcegovernance.org/sites/default/files/documents/nrgi_insidennpcoilsales_mainreport.pdf>.

²⁹TaiwoAdebolaOgunleye, n. 4, p. 4

Contracts Decree No. 9 of 1999³⁰ finally came about after persistent pressure by affected operators, demanding a formal law to give legislative backing to fiscal incentives, as guaranteed by the government under the PSC arrangement³¹. Section 19 of the Act backdated the commencement date of the Act to the 1st of January 1993 to make it applicable to the 1993 PSCs executed before 1999. The Act only provided for fiscal incentives to oil companies operating the Deep Offshore and Inland Basin areas³². It applies to all PSCs executed for the exploration and production of oil in the deep offshore and inland basins. It fixed the duration of the oil prospecting licence operating under the PSC arrangement between 5 and 10 years³³. It amended the Petroleum Profit Tax Act³⁴ (PPTA) with respect to the determination of petroleum profit tax payable under a PSC and stipulated a 50% flat rate of chargeable profits as the petroleum profits tax payable under a PSC³⁵. However, it did not exempt the contractors from the payment of other taxes, duties or levies imposed by the Federal, State, Local Government or Area Council Authority³⁶. It granted an investment tax credit of 50% to NNPC or the holder and the contractor who has incurred capital expenditure entirely and exclusively on petroleum operation in the production sharing contracts executed before 1st July 1998³⁷. Similarly, it provided that parties to any PSC would be granted Investment Tax Allowance of 50% on their expenditure³⁸. It also provided for the payment of royalty at a graduated rate³⁹ in the deep offshore area while that of the Inland Basin was fixed at 10%⁴⁰. The rate as provided under section 5(1) of the Act were as follows:

Area	Rate
(a) In areas from 201 to 500 metres water depth	12 per cent
(b) From 501 to 800 metres water depth	8 per cent
(c) From 801 to 1000 metres water depth	4 per cent
(d) In areas in excess of 1000 metres depth	0 per cent

The Act further provided that the computation and payment of the petroleum profit tax must be in US Dollars⁴¹. The Act provided that royalty oil⁴² shall be allocated to the NNPC⁴³ while Cost oil shall be allocated to the Contractor⁴⁴. The Act also provided for the allocation of Tax oil⁴⁵ and Profit Oil⁴⁶. While Tax Oil is allocated to NNPC, Profit Oil would be allocated based on the terms of the PSC. According to Ogunleye, the negative aspect of the Act was that it had removed the flexibility that is usually associated with PSC and has effectively tied the hands of government by specifying the rate of taxes and royalty without stipulating a convenient way to review these provisions without having to amend the Act through the legislative process⁴⁷. There was no doubt that section 17 of the Act provided for a periodic review of the Act, which would be after a period of 10 years from the date of the commencement and every 5 years immediately thereafter. It however did not prescribe how it should be done whether by a regulation or by order. The absence of a mode of review has created ambiguity and a lacuna in the Act. Previously, under the original 1999 PSC Act⁴⁸, the National Petroleum Investment Management Services was the sole agency in charge of the management of all PSCs and JVs under the law⁴⁹. Nonetheless, this position of affairs has been an amendment in the consolidated Act of 2004⁵⁰. Thus, the day-to-day monitoring of the implementation of these obligations is presently overseen by National Petroleum Investment Management Services (NAPIMS) on behalf of NNPC⁵¹. The Amendment Act introduced a combined production and price-based royalty system to replace the existing production-based royalty system, which varies according to areas of operations⁵². Under the old Act, Royalties were calculated based on the water depth of the field. This ranged from 12% to 0%. The amendment eliminated the 0% rate. Royalties would now be calculated on a field basis, dependent on the chargeable volume of the crude and condensates produced per field.

³⁰ Later renamed as an Act and listed in the Laws of the Federation of Nigeria 2004 as 'Deep Offshore and Inland Basin Production Sharing Contracts Act, Cap. D3, Laws of the Federation of Nigeria 2004'

³¹ChukwumaOkoli, 'Production Sharing Agreements and Licences: A Distinction without a Difference?' (2012) *International Energy Law Review* 1 <http://hdl.handle.net/10993/20860> accessed February 20, 2021.

³² Sections 1 and 8, Deep Offshore and Inland Basin Production Sharing Contracts Act

³³ Section 2, Ibid.

³⁴ Cap. P13, Laws of the Federation of Nigeria 2004

³⁵ Section 3(1)

³⁶ Section 3(2)

³⁷ Section 4(1)

³⁸ Section 4(2)

³⁹ Section 5(1)

⁴⁰ Section 5(2)

⁴¹ Section 6

⁴² Royalty oil is the amount of proceeds equal to actual royalty payable during each month and the concession rental payable annually in accordance with the Production Sharing Contracts term

⁴³ Section 7

⁴⁴ Section 8(1)

⁴⁵ Section 9; 'Tax oil' is the proceed generated which is equal to the actual petroleum profit tax liability payable during each month

⁴⁶ Section 10; 'Profit oil' is the balance of available crude oil after the deduction of royalty oil, tax oil and cost oil.

⁴⁷TaiwoAdebola Ogunleye, n. 4, p. 5

⁴⁸ Deep Offshore and Inland Basin Production Sharing Contracts Act, No. 9 of 1999

⁴⁹ Section 16

⁵⁰ Deep Offshore and Inland Basin Production Sharing Contracts Act, No. 26 of 1999

⁵¹ Section 3, Deep Offshore and Inland Basin Production Sharing Contracts Act (Amendment) Act 2019; Inifome Usenu, n. 9

⁵² Section 2

The new royalty regime specifies a baseline royalty of 10% for crude oil and condensates produced in the deep offshore (greater than 200-meter water depth) and 7.5% for the Frontier and Inland Basin⁵³. In addition to the baseline royalty, a royalty based on the applicable price of crude oil, condensate and natural gas will apply, but only when the price exceeds \$20 per barrel. The graduated royalty rates are shown below:

Crude Oil Price	Rate
from \$0 up to \$20 per barrel	0%
above \$20 and up to US \$60	2.5%
above \$60 and up to US \$100	4.0%
above \$100 and up to US \$150	8.0%
above \$150	10.0%

The level of impact the new royalty regime would have on total Government revenue of royalty oil, tax oil and share of profit oil as well as the total Contractor's share of profit oil and cost oil under existing PSCs will depend on the current royalty rate applicable to the contract area, the applicable price and the volume of crude oil/condensate produced.

Furthermore, Section 16 of the old Act required a review of the Act after 15 years of commencement of the Act and every 5 years thereafter but this was never applied. This section has been deleted by the Amendment Act⁵⁴. It should be stated that the section had been a subject of controversy, even resulting in a consent judgment delivered by the Supreme Court of Nigeria in the case instituted by the Attorney-Generals of Rivers, Bayelsa and Akwa Ibom States against the Attorney-General of the Federation, where the issue for determination was the interpretation of the provisions of Section 16 of the Act⁵⁵. It can be seen that several stakeholders have agitated that the Deep Offshore and Inland Basin Production Sharing Contracts Act of 1999 should have been amended a long time ago to increase total Government take under PSC arrangements immediately the global price of crude oil exceeded \$20 in real terms⁵⁶. However, the procedures and responsibility for instituting a review of the Act were not clearly defined, and this might have been responsible for the non-implementation of the section. The PSC Amendment Act included a new section 17 which prescribed that all PSCs must be reviewed every 8 years⁵⁷. In effect, the section mandated the Minister of Petroleum Resources to compel the Nigerian National Petroleum Corporation (NNPC) to call for a review of the PSCs after the 8-year period. The implication of the PSC Amendment Act in this regard is that it provided a more specific term for the FGN to vary the terms of the PSCs rather than on the price fluctuation mechanism in the PSC Act. The Amendment Act introduced a fine of at least ₦500 million for non-compliance with any obligation imposed by the provision of the Act, or imprisonment for a period not less than five years, or both, upon conviction by a competent court of law⁵⁸. While these penalties will apply to the Act in general, they seem to have been introduced to compel the Minister of Petroleum Resources and the NNPC to initiate a review of the PSC every 8 years, as stipulated in Section 4 of the Amendment Act.

4. Issues and Challenges to the Effective Implementation of Production Sharing Contracts under the Act

Fiscal regimes and their implementation are critical to the overall strength of the resource sector decision chain. The effectiveness of a fiscal regime will depend on the clarity concerning its objectives, the instruments were chosen to meet those objectives and their administration, relative to the economic situation in the country⁵⁹. As noted earlier, PSCs are one of the most common types of fiscal systems implemented by oil-producing countries and the Nigerian Government has opted for this form of contractual arrangements to exploit the natural resources within the territory of Nigeria. Despite the attractiveness of the PSC arrangement, it is not without some faults. Some of the issues surrounding PSCs can be highlighted as follows:

Improved Economic Benefit to Nigeria: With the increased royalties which would accrue to the Federal Government of Nigeria from the activities of the IOCs, the PSC Amendment Act will ensure that the government has access to improved revenues which could positively impact the Nigerian economy and shore up earnings. The government has been deliberating on many ways to improve the revenue to its coffers as a way to improve its liquidity position, such as the proposed increase in the rate of Value Added Tax in Nigeria and the introduction of new tax regimes. The PSC Amendment Act will allow the government to increase its cash collections from the IOCs. These

⁵³ Section 2

⁵⁴ Section 3

⁵⁵ *Attorney-General, Akwa Ibom & 2 Ors v. Attorney-General, Federation* (unreported) Suit No: SC.964/2016

⁵⁶ Ejiofor Alike and Kasim Sumaina, 'FG, Shell Begin Production Sharing Contract Negotiations' *THISDAY* (May 27, 2019) <<https://www.thisdaylive.com/index.php/2019/05/27/fg-shell-begin-production-sharing-contract-negotiations/>> accessed February 21, 2021; Aaron Sayne, Alexandra Gillies and Christina Katsouris, n. 28, p. 6

⁵⁷ Section 4

⁵⁸ Section 5

⁵⁹ Oghenerume Ogolo and others, 'Assessing the Impact of Deep Offshore and Inland Basin Production Sharing Contract Amendments on the Economics of Deep Offshore E&P Assets in Nigeria,' *SPE Nigeria Annual International Conference and Exhibition* (2020) <<http://10.2118/203741-MS>> accessed February 21, 2021.

receipts can then be deployed to other viable sectors of the Nigerian economy. The President of the African Development Bank, Akinwunmi Adesina, PhD, recently stated that Nigeria has a liquidity problem and not a debt crisis⁶⁰. Thus, the increased royalties to Nigeria can be seen as a potential solution to the illiquidity issues currently plaguing the government. It is pertinent to note that the increased royalty liability consequent upon the PSC Amendment Act will lead to a substantial impact on the re-negotiations of some of the first set of Nigerian PSCs which are nearing the end of their primary tenures. It would most likely be the case, in which IOCs would capitalize on the increased royalties to oppose the quantum of the increased share of crude oil production revenue that the federal government may be aiming for. In the alternative, they may request a higher cap on cost oil than they were initially negotiating.

The Amendment Act and the Stabilisation Clauses in PSCs: Understandably, the Nigerian government intends to increase its revenue by taking what it believes is its fair and equitable share of the income derived from the exploitation of its natural resources. It is customary for PSCs to contain Stabilization Clauses that protect their capital investment in host countries from the risks associated with a change in the fiscal laws of a host country⁶¹. The degree of stability is important to IOCs as the less stable an investor perceives a project to be the less interested it is to enter into a long-term contract. The appropriate law that governs the validity of Stabilization Clauses is international law since it involves the national law of the host country and the *lex mercatoria*⁶². Essentially, Stabilization Clauses strike a balance between the sovereign right of host countries to impose taxes and modify legislation on the one hand and the legitimate expectation of IOCs that the host country will not do anything in the exercise of these sovereign powers to make their contracts with the host country less profitable. By agreeing to have a Stabilization Clause in a PSC, the host country accepts that the existing and future laws would affect the contractual terms agreed upon with the IOC and that there is, therefore, a need to maintain the initial contractual economic equilibrium agreed by both parties. Stabilization Clauses further ensure that the operators are compensated for the effect of any changes in the law or fiscal regime and that they are not adversely affected by such change.

Gridlock in Renegotiations of PSCs leading to Arbitration: Oil exploration and development projects are characterised by large capital investments, long lead times, incomplete information, and in most cases significant differences in the abilities of the parties to bear the risks involved in the venture. Thus, contracts are potentially unstable and one or both signatories may want to renegotiate at some point in time. Furthermore, the inherent instability of contracts may result in some projects not being developed although they are economically attractive in general. The uncertainties over risk and reward-sharing prevent one or both parties from going ahead with the venture. When a government or its NOC enters into negotiations with an IOC which it expects to provide capital, technology and expertise it wants to ensure that it obtains the best possible deal given the country's specific circumstances. The government, therefore, has to find the optimal, or efficient, contract form for its country. With the recent amendments, Many IOCs can expect to invoke the Stabilization Clauses of their different PSCs by demanding that NNPC consult with them to agree on changes to the PSCs to return them to the economic roles that they had previously occupied before the Amendment Act was implemented. The IOCs would possibly start arbitration proceedings against NNPC in case there is no agreement to review the PSCs. For instance, recent news reports indicate that Shell Nigeria Exploration and Production Company Limited are opposing Nigeria's demand for a total of US\$13.65Billion, and it intends to commence arbitration proceedings in respect of the issue⁶³. The crux of the dispute is that the FGN is unilaterally making adjustments in the PSC in respect of the Oil Mining Lease 118.

Increased costs to the IOCs: The royalty structure proposed under the PSC Amendment Act will no doubt result in increased cost of business to the IOCs under the PSC arrangement⁶⁴. Because under the PSC framework, the IOCs will still be liable to pay signature bonuses to the FGN upon the execution of the PSCs well as other relevant taxes applicable. Thus, the increased royalty structure could impact the cost to the IOCs' bottom line.

Lack of Clarity on Procedures for Reviewing Fiscal Terms: With the above price-based royalty structure, the PSC Amendment Act has deleted the provision of section 16 of the PSC Act which provides that PSC fiscal terms are subject to review to ensure that if the price of crude oil at any time exceeds US\$20 per barrel, real terms, Nigeria's government take in the additional revenue shall be adjusted to such extent that the PSCs shall be economically

⁶⁰Punch, 'Nigeria Has Liquidity Problem, Not Debt Crisis – Adesina' *Punch Newspapers* (September 26, 2016) <<https://punchng.com/nigeria-liquidity-problem-not-debt-crisis-adesina/>> accessed February 22, 2021.

⁶¹Banwo & Ighodalo, 'Stabilization Clauses in Production Sharing Contracts - How Relevant in the Light of Amendments to the Deep Offshore & Inland Basin (Production Sharing Contract) Act?' (*Banwo & Ighodalo* November 6, 2019) <<https://www.banwo-ighodalo.com/grey-matter/stabilization-clauses-production-sharing-contracts-new-amendments-deep-offshore-inland-basin-production-contract-act>> accessed February 21, 2021.

⁶²AFMManiruzzaman, 'The LexMercatoria and International Contracts: A Challenge for International Commercial Arbitration?' (1999) 14 *American University International Law Review* 658 https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1338060

⁶³Ade Adesomaju, '\$62bn PSC Revenue: Shell Battles FG over Demand for \$13.65bn' *I-ARB Africa* (November 11, 2019) <<https://www.iarbafrica.com/en/news-list/17-news/1119->>> accessed February 22, 2021.

⁶⁴KPMG, 'Deep Offshore and Inland Basin PSC (Amendment) Act, 2019' (KPMG Nigeria 2019) <https://assets.kpmg/content/dam/kpmg/ng/pdf/tax/deep-offshore-and-inland-basin-psc-amendment-act.pdf> accessed February 22, 2021.

beneficial to the country. Noticeably, the PSC Amendment Act is silent on how the dynamics of the royalty regime would be applicable in scenarios where the price of oil is upwards of US\$60. It is expected that the royalty rate from the applied field area would be deducted as the first instance. However, it is unclear if a graduated royalty deduction would be applicable if, for example, the price of oil is US\$110. No doubt, the applicability of the royalty regime in such instances will be of immense concern to both NNPC and the IOCs to avoid future disputes. Furthermore, the lack of certainty around the fiscal outcomes of impending PSC reviews may also be an additional disincentive for future investments in these assets.

Poor Tax Administration of PSCs: Tax administration over PSCs usually involves relatively straightforward activities such as the registration of taxpayers, issuance of tax assessments and the collection of tax. These functions ought to be easier in the resource sectors, since the number of taxpayers is typically few, and self-assessment is widely practised in these sectors. Yet, many countries face considerable difficulties in performing routine functions, attributable to, among other things: too many taxes with different filing rules; too many agencies involved; poor resources (in particular, poor IT systems); limited control over national resource company payments; and confused accountability. Improving these areas can contribute greatly to better tax administration efforts.

Lack of Effective Monitoring of PSC Operations: Effective monitoring of the operations of the contractors to ensure that the venture is profitable is another challenge for the government in the PSC arrangement in Nigeria. According to Umar⁶⁵, he noted that the National Petroleum Investment Management Service (NAPIMS), a unit of NNPC, who is charged with the responsibility of managing and monitoring the costs of the petroleum operations had not been effectively carrying out its responsibilities of monitoring the activities of the operations of the IOCs under the PSC while would inevitably lead to losses of revenue to the Nigerian Government.

'Fixed Water Depth' Royalty Regime and Profits of IOCs: 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 above 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 royalty payable there under, 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. Also, 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 offshore 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.

Transfer pricing abuse: The pricing of transactions with affiliates and related parties, whether in the sale of the resource or the purchase of goods and services is known as transfer pricing. This process is a necessary part of global business operations but involves a complex calculation of prices that cannot always be easily compared against a reliable benchmark, such as the market price of a good. This creates the opportunity to significantly misstate taxable income or any other payment based on value, e.g., royalties. Large resource investors often use affiliated services in extraction projects and sell output to affiliated entities, increasing the risk of such misstatements in the extractive industry. As a result, transfer pricing abuse has become a critical issue in the resource sectors. Tax rules usually require the use of 'arms-length' prices, i.e., an estimate of what the price of the good or service would be as if the transaction had occurred between non-affiliated sellers and buyers. However, application and monitoring are very difficult, particularly where the capacity of the tax authority is low.

Absence of Audit Provisions in the PSC Act: The absence of a suitable audit provision is a weakness noticed in all the PSCs executed in Nigeria. Audit provision can be employed to determine the actual cost the contractor can

⁶⁵ Mohammed Babangida Umar, 'Legal Issues in the Management of Nigeria's Production Sharing Contracts from a Study of the Nigerian National Petroleum Corporation's (National Petroleum Management Services') Perspective' (2005) 3 *Oil, Gas & Energy Law* <https://www.ogel.org/article.asp?key=1740> accessed February 21, 2021.

recover⁶⁶. Typically, it is in the PSC contractor's interest to keep the costs as high as possible to avoid paying taxes or profits to the government⁶⁷. Quarterman made the following observation about some of the Nigerian PSC arrangements⁶⁸:

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 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. In all the models of the Nigerian PSC, the provisions on an audit of the accounting records of the contractor's operation are simply to the effect that NNPC has the right to inspect and audit the accounting records of the contractor. It is not used to determine the cost incurred in the petroleum operations before it is recovered. The Audit provision in all the PSCs is basically the same.

An audit is only as effective as the law it seeks to enforce. Legal loopholes and costs that are prone to abuse may limit auditors' ability to protect government revenues. The lack of regular risk assessment relating to the petroleum sector reflects tax authorities' limited appreciation of the special characteristics of the industry. Also, it is difficult to obtain data to benchmark petroleum costs. Reporting requirements are unclear or incomplete, preventing governments from accessing certain information from companies. Again, there is a tendency to prioritize auditing only once oil is flowing, long after the development of the oil field has started. By that time, the government's audit rights may have expired and companies' legal obligation to keep records may have run out

Coronavirus Pandemic and Oil Production Capacity: The upstream oil and gas activities, which is contractually governed by the PSC has been greatly affected by the Covid-19 pandemic. Following the recent passage of the PSC Amendment Act, the gains which were expected under the legislation seem to have been eroded by the Covid-19 pandemic due to the low price of crude oil in the global market. With the COVID-19 pandemic wreaking havoc on global markets since mid-March international oil prices have remained highly volatile, dropping to a 20-year record low price of USD 18 per barrel. The plunge followed a steep reduction in global demand and a price war between major oil producers, notably Russia and Saudi Arabia⁶⁹. Furthermore, like many oil-producing developing countries which are non-diversified, sector-dependent economies, with oil contributing the majority of their exports and government revenues, the current fall in oil prices is limiting the ability of Nigeria to respond to the multidimensional domestic pressures produced by COVID-19, at a time when more money is needed to finance service delivery, mitigate health risks and ease macroeconomic pressure. The estimated drop in the net income for 2020 was between 50%-85%⁷⁰. A very steep loss of income

5. Conclusion and Recommendations

Across the world, the activities of exploration, development, production and marketing of oil and gas and their associated products are conducted within the framework of host government laws and commercial contracts. The state government and the oil companies are normally parties to these agreements. Whilst the investors (i.e. the oil companies) are concerned about those key contractual and legal issues, the host country is concerned about getting a fair share of any revenue that is derived from successful petroleum activities by any investor in the upstream petroleum sector. Nonetheless, it is difficult determining what is fair, as there is no universally accepted standard and the level of development together with the needs of each host country plays a critical role in determining what mechanism works best for such a host country. Many host countries usually modify their fiscal toolboxes in certain circumstances, such as level of economic development; need to encourage investments, level of income, level of hydrocarbons exploitation, oil prices etc., and change. In this regard, Nigeria is no different as it has now modified the fiscal toolbox of its production sharing contract regime from what was previously, at best, neutral (as far as government-take is concerned) to a more progressive/hybrid fiscal model. As noted above, the PSC arrangement offers a better option for the development of the offshore oil reserves as it relieved the Government incurring any financial burden that is associated with a joint venture arrangement. It also gives the Government a degree of control

⁶⁶Alexandra Readhead, Daniel Mulé and Anton Op de Beke, *Examining the Crude Details: Government Audits of Oil & Gas Project Costs to Maximize Revenue Collection* (Oxfam 2018) p. 5

⁶⁷ *Ibid.* p. 6

⁶⁸Cynthia L Quarterman, *Transparency and Change Management White Paper for Nigeria's Extractive Industries Transparency Initiative ('NEITI')* (NEITI 2005).

⁶⁹George Calhoun, 'The Saudi/Russia Oil Price War: Historic Blunder #1' *Forbes* (June 3, 2020) <<https://www.forbes.com/sites/georgecalhoun/2020/06/03/the-other-epidemic-a-cluster-of-historic-blunders---exhibit-1-the-saudirussia-oil-price-war/?sh=4d3bf9a74f7f>> accessed February 22, 2021.

⁷⁰IEA, 'Energy Market Turmoil Deepens Challenges for Many Major Oil and Gas Exporters' (*IEA* March 16, 2020) <<https://www.iea.org/articles/energy-market-turmoil-deepens-challenges-for-many-major-oil-and-gas-exporters>> accessed February 22, 2021.

over the operation of the oil companies. The PSC arrangement offers a great window of opportunity for the exploration of the Nigerian huge petroleum deposit particularly in the light of the diminishing revenue available to the Government.

On the 4th of November, 2019, President Muhammadu Buhari assented to the Deep Offshore and Inland Basin Production Sharing Contract (Amendment) Act which accordingly amends the Deep Offshore and Inland Basin Production Sharing Contract Act of 1999. The Principal Act was enacted to provide 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. With the recent amendments, it is hoped that they should 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. While there may be some issues and challenges, we have proffered some suggestions that we believe that the government may consider implementing fully utilized and derived full benefits as well as revenues from the present and future PSCs.

In this paper, we have reviewed and evaluated the provisions of the legislation regulating the operations of the PSC as well as the legal and institutional challenges that may hamper the effective implementation of the arrangements. In view of the analysis which has been done in the preceding sections, we are proposing the following recommendations as the panacea of the noted challenges:

Fiscal Stabilization:

Investors have a strong and legitimate interest in a stable and reasonably predictable fiscal environment. Particularly in countries with histories of political instability, investors will seek assurances concerning the stability of the fiscal regime. Once the investment is made, it is very costly or even impossible to transfer assets to another jurisdiction. 42 As such, investors need some assurance that governments will not take advantage of this and change or renege on the terms of the deal between the company and the government. 43 Since government also have a strong interest in attracting investment, it is useful to signal their credibility to investors. One way to provide such assurance is for governments to use stabilization mechanisms. The stability of certain elements in the fiscal regime may be guaranteed by law for particular periods, but often investors seek contractual guarantees stabilizing the regime, either as it exists in law or as provided as part of an investment contract with the government. Many countries, even low-income countries, will not enter into stabilization clauses as a matter of principle or because of constitutional or other legal prohibitions. Of course, countries with a history of stable government and investor protection should, in general, not require stabilization clauses to build confidence. Further, while stabilization may appear to offer a strong commitment to building investor confidence, such a commitment can prove brittle; an inflexible or unresponsive arrangement may not be robust to changing circumstances and may not, therefore, be credible over time. In considering the need for stabilization, it is also important to recognize that investors have other tools to protect themselves against significant changes. International investors are usually entitled to non-discriminatory treatment so that they cannot be singled out. Truly abusive changes may constitute a form of expropriation entitling the investor to compensation. Moreover, there are other mechanisms such as political risk insurance to protect against instability. Finally, questions remain as to whether such clauses are enforceable or if they are indeed effective in attracting investment. Nevertheless, such contractual assurances are commonly sought by investors and commonly given by many low-income countries such as Nigeria. While the scope of stabilization clauses is often simply directly negotiated, it is far better to practice to set out in statute what investments are entitled to stabilization. This can be done by specifying the size, nature and perhaps location in the country of resource projects, what elements may be stabilized and for how long, whether eligible entities are entitled to stabilization as a right, and if not, who may authorize it. This is usually the minister of finance together with the line minister. Where stabilization is provided it can take the form of freezing of certain elements of the fiscal regime as it applies to the investor, prohibiting any changes over time, or a compensatory arrangement, whereby certain changes in the regime give the investor the right to seek adjustments or compensation to restore the economic 'equilibrium' between the investor and the state. 'Frozen-in-law' arrangements are disfavored because they are too inflexible to take account of changing circumstances, in contrast to compensatory arrangements.

Resolving the Transfer Pricing Issue:

As a first step, the government should require detailed reporting of all affiliate transactions above a certain minimum value. Such reports should include identification of the transactions (some aggregation may be permitted), setting out the prices and providing contemporaneous documentation showing that the basis for determining individual prices meets the arms-length standard. These reports should be certified by the chief financial and executive officers of the company. In certain cases, an independent study confirming that prices are equivalent to arms-length prices may be required. Managing transfer pricing requires balancing accuracy, or at least reasonableness, with the ability of all parties to administer and comply with the system. Tools for striking this balance include advanced pricing agreements for commodity sales, recurring charges (e.g. a royalty for technology), or charges above a certain amount, as well as

the tying of transfer prices for commodity sales to public international commodity price indices. Confidence in the legitimacy of transfer prices can be improved by limiting payments on service or management contracts to affiliates by an amount or percentage of gross revenues (or costs) for most costs to facilitate administration while recognizing actual costs where reasonable.⁴⁹ One source of information on the level of such reasonable management fees is the fees charged within a company to other affiliates for the same services. For services that a company might self-supply, regulations may also require that they be supplied by an affiliate or related party at a cost—that is without a profit mark-up.

Review of the PSC Terms and Fiscal Structure:

A holistic review of the fiscal provisions for the oil and gas industry is desirable. This will reduce, if not eliminate, the uncertainty surrounding the delayed passage of the Petroleum Industry Bill (PIB) –legislation aimed at the wholesale reform of the entire petroleum industry/sector. The delay has negatively affected the flow of investment in the oil and gas industry as many projects are being put on hold. Interestingly, the PIB, which has been outstanding for so many years, also contains the provision for the computation of royalty based on price; though based on a different threshold.

Improving Institutional Structures:

In the petroleum and mining sectors, responsibility for fiscal administration is often shared between the ministry of finance or an independent or quasi-independent revenue authority (i.e. Federal Inland Revenue Service) and the sector ministry (i.e. NNPC). The Ministry of Finance or revenue authority is typically responsible for income tax administration, while the sector ministry, or in some cases, the national resource company, oversees royalty administration. This division of responsibility is based partly on the argument that the royalty calculation requires specialized expertise which is available in the sector ministry but not the finance ministry. For the same reason, the sector ministry or national resource (oil) company is charged with administering the fiscal provisions under production-sharing agreements, i.e., cost oil and profit oil calculations. Administration of a PSC requires monitoring costs, affiliate transactions, outputs, and revenues – all of the information required in the typical profits tax. While there is some apparent logic to this particular division of responsibility, dispersion of administrative authority inevitably increases the complexity of overall administration, limits the opportunities for economies of scope in tax administration, and the scope for errors or even corruption. It also places a premium on the clear definition of roles, transparency in operations and close inter-agency cooperation. These observations apply with equal or greater force where national governments have transferred fiscal responsibilities to subnational levels of government.

Compulsory Audit of PSC Operations:

It is recommended that the audit provision in the Nigerian PSCs should be reviewed and properly couched to enable the NNPC to use it in the cost recovery process. Audits should begin with the first year of activity and not wait until positive taxable income is declared. Delay increases the difficulty of conducting an audit of initial losses during the investment period, the size of which will often depend upon payments to affiliates. Governments should consider following the example of some producing countries in retaining professional international auditors to audit the returns of their most important taxpayers until sophisticated domestic capacity is in place. The amounts expended for such auditors are likely to be a small fraction of the revenue gain. Further, the prospect of such auditing is likely to make the investor maintain better accounting and controls in the first instance.