Commentary on the Petroleum Industry Bill 2012

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Contents

1. Summary

Following is a commentary on the Petroleum Industry Bill 2012 ("PIB 2012") made at the request of various parties. With respect to some items, comparisons will be made with the previous House Bill 159 and with the Government Memorandum (Sept 2010). The Government Memorandum represented the consolidated advice of the Government Inter-Agency Team on the previous PIB. I was consultant to this team. My work relates to being consultant to host governments on petroleum matters and I will therefore review the PIB 2012 from this perspective. Annex A contains a detailed analysis of the Bill. Annex B contains a fiscal evaluation of government revenues as a result of the PIB 2012.

<u>Institutions (Part II)</u>

The PIB 2012 creates two regulatory entities. The Upstream Petroleum Inspectorate incorporates responsibilities with respect to technical and commercial matters related to the upstream. The Downstream Petroleum Regulatory Agency combines technical and commercial responsibilities with respect to the downstream. The entities are organized as a body corporate. This ensures that the entities can attract qualified professionals and operate efficiently. The powers and functions provided in the PIB 2012 would permit the two entities to be effective regulators because both technical and commercial functions are united in the same regulatory entity as recommended in the Government Memorandum.

The PIB 2012 creates a Petroleum Host Communities Fund. Peace and stability in the Niger Delta can be significantly enhanced if people in the region experience that they share fairly in the benefits of oil and gas production. The PHC Fund sets aside 10% of the after tax profits to achieve this goal. This amount can subsequently be credited by the companies against other payments to government, so they will not be out of pocket. The revenues from the onshore and shallow water are to be distributed to the communities. However, rather than distributing revenues directly from the operators to the communities, as was proposed in the Government Memorandum, the Bill is vague as to how this benefit will be distributed and leaves this to future regulation. This could result in political interference and non-transparency.

Another concern of the PHC Fund would be that the amount of the 10% after tax profit would strongly fluctuate with oil price movements and this will make it difficult for the communities to plan their affairs. It was for this reason that the Government Memorandum provided for stable payments. Also 10% of the deep water after tax profits will be transferred directly to the petroleum producing littoral States without any transparency as to how these funds will be used.

It is a desirable goal to create an effective and profitable NNPC along the lines of, for instance, Petrobras. This can be best achieved by incorporating NNPC under the Companies and Allied Matters Act and subsequently privatizing NNPC partially.
Such steps could ensure that the company is managed like any other major international petroleum company with minimum political interference. Both the House Bill 159 and the Government Memorandum contained this concept.

The PIB 2012, however, diverts from this objective by first breaking up NNPC in three entities, and subsequently privatizing only two entities. This leaves major government assets and revenue streams in a Management Company, which will likely continue to be subject to heavy political interference.

<u>Upstream (Part III)</u>

The PIB 2012 dealing has excellent upstream provisions related to transparency and non-confidentiality. This is a very good step forward for Nigeria. From a legislative point of view these provisions are among the most advanced in the world and make Nigeria a leader in Africa in this respect.

Generally, the provisions related to the upstream license and lease award process, work programs, relinquishments, development plan approval, unitisation and production adhere to best international practice.

A very negative provision is that the President has the power to grant licenses and leases without competitive process or any other process. This leaves the door wide open to political favoritism and corruption in a manner that has been practiced in Nigeria in the past. It should be noted that, for instance, the Presidents of the United States or South Africa would not have such powers.

<u>Downstream (Part IV and V)</u>
The PIB 2012 has adequate downstream provisions related to tariff methodology and network codes, license conditions for pipelines, pipeline networks, gas suppliers and gas distributors, as well as oil product consumer protection mechanisms.
In general, Part V enshrines the desirable goal of creating a fully competitive gas market in Nigeria.

However, a negative feature is that access to the domestic market for smaller gas producers is severely hampered by lack of open access and tariff provisions for gas processing plants and upstream pipelines. This will make the objective of a competitive gas market difficult to achieve and leaves the domestic market at the mercy of the major petroleum companies.

In this context it is of concern that the domestic supply obligation section has been much reduced in strength with ample possibilities to avoid penalties in case of non-compliance. Nigerian gas consumers would be better protected if the PIB 2012 would provide for a more defined initial domestic gas pricing framework. Such framework should offer high enough gas prices to ensure a rapid development of supplies for the domestic market.

The domestic gas price should be in the $ 2.50 to $ 4.00 per MMBtu range at the points where gas is in marketable condition for transport to final customers. This range is consistent with domestic market prices in other major gas producing countries in Africa and Asia.

<u>Indigenous companies, health, safety and environment (Part VI and VII)</u>
Part VI and VII remain largely unchanged from House Bill 159. An interesting addition is that companies will not be responsible for environmental damage caused by sabotage.
Part VI does not include the softening proposed by the Inter-Agency Team of the conditions of the provisions of the counter-productive *Nigerian Oil and gas Content Act, 2010.* This Act seriously impedes further oil and gas developments in Nigeria even if there would be adequate provisions in the PIB.

<u>Petroleum Revenues (Section 197 and part VIII)</u>
Section 197 provides the Minister of Petroleum with draconian powers to determine rentals and royalties by regulation. It cannot be recommended to leave such an important revenue source for Nigeria to political manipulation after the Bill has passed. With respect to royalties defined under the regulations in the Petroleum Act is it understood that these regulations remain in force until replaced by new regulations. However, it seems that the royalties under the Deep Offshore and Inland Basin Production Sharing Act will be terminated as soon as the PIB is passed.

Regardless of the new royalty regulations, the imprecise definition of measurement point in the Bill leaves the door wide open for the current practice of stealing oil. Also, the Bill provides possibilities for significant transfer pricing for export gas.

The PIB 2012 maintains the concept of creating a fully consolidated Companies Income Tax plus a Nigerian Hydrocarbon Tax. This is a modern concept which in principle could result in attractive petroleum revenues for Nigeria, while encouraging significant investment. For the onshore it is proposed to lower the combined tax rate from 85% to 80%. However, the uplift of 5% would be replaced by a production allowance largely as originally proposed by the Inter-Agency Team. For the deep water the proposed combined tax rate remains 50%. Also the current uplifts of 50% in deep water would be replaced by the production allowances.

The Bill does not refer to production sharing contracts, but it seems understood from the Bill that the current “tax oil” concept would be replaced in existing PSCs with the new tax provisions. This means that the tax will be determined after deduction of the profit oil payments.

Table II in the Fourth Schedule contains either an error or a large give away of the Nigerian Hydrocarbon Tax through excessive capital allowances. Also the production allowances which were meant to encourage new production are now granted on existing production without the need for additional investment.

Yet, these allowances are not made available with respect to leases companies which are in joint ventures with NNPC. This is unreasonable.

The current onshore and shallow water terms are too tough to encourage strong investment in new production. The production allowances were meant to stimulate investment in all new production.

Penalties for not paying Nigerian Hydrocarbon Tax are severely reduced in the PIB 2012.

In summary, the petroleum revenue provisions of the PIB 2012 may result in significant revenue losses on existing production without encouraging investment in new production. Annex B illustrates that depending on the interpretation of the various clauses of the PIB 2012, revenue losses with respect to existing production from onshore and shallow water may be 22% for leases in which NNPC does not participate and 6% for leases in which NNPC participates. For deep water PSCs the revenue losses with respect to existing production could be as much as 50% depending on the interpretation of the various clauses of the PIB 2012.

The PIB 2012 should therefore be revised by clarifying and amending the tax provisions and by including royalty provisions in a manner that would strongly encourage investment in production from new mining leases and other new production. A clear an unambiguous fiscal system should be established that will lead to higher levels of oil and gas production.

At current price levels the government take for oil for <u>new</u> leases in the onshore, shallow water and deep water should be from 60% for high cost small fields to 75% for low cost large fields (assuming the government take is calculated without including the NNPC participation in the calculation). At higher price levels the government take should increase with price. The government take should be lower for gas.

<u>Repeals, transitional and savings provisions (Part IX)</u>

The PIB 2012 does not repeal a number of Acts which were repealed under the Government Memorandum and the House Bill 159. A legal analysis is required of the various implications.

Part IX also includes what was considered Part X under the House Bill 159 related to interpretation and citation. The definitions of upstream and downstream are confusing and unclear. There is a variety of errors in cross referencing and definitions are included which are not used in the PIB.

2. Annex A. Detailed Review of the Bill

2.1. Part I – Objectives

This Part is an appropriately structured introduction setting out the general objectives.

2.2. Part II – Institutions

A. The Minister

The provisions of this Part contain improved provisions with respect to the right of pre-emption and the power to make regulations, compared to the Government Memorandum and House Bill 159. **Systematic input of all stake-holders in the development of regulations is an important issue contained in the PIB 2012.**

B. Petroleum Technical Bureau

The Petroleum Technical Bureau is a relatively modest unit in the Ministry to give some technical advice where required.

The powers are not comparable with the National Petroleum Directorate which was proposed in the Government Memorandum or the National Petroleum Commission proposed in House Bill 159. The proposals for the Directorate and Commission envisaged that a strong coordinating role was required for the management and guidance of the Nigerian petroleum industry.

The lack of such an effective coordinating entity may result in lack of clear direction in the development of the petroleum sector.

C. Upstream Petroleum Inspectorate

The Inspectorate has both technical and commercial functions, as can be highly recommended. Only if technical and commercial issues are considered simultaneously will the appropriate decisions be made about development plans for oil and gas fields or for other infrastructure projects. An important provision is that the Inspectorate has the power to regulate third party access to facilities, which would include oil pipelines to refineries or export terminals and gas pipelines to gas processing plants.

In principle, this will create the possibility for the smaller companies to gain access to the transportation systems in order to market and export their oil and gas. Yet, this possibility is not backed up by corresponding provisions in Part III of the Bill; which is a considerable concern. The Inspectorate is also in charge of ensuring the payment of royalties, rentals and fees. This is normal power for such an entity. The Inspectorate will also liaise with the Service on cost deductions, which is welcome assistance to the FIRS.

However, there is no coordination with the FIRS on determining oil and gas prices for royalties and tax purposes. This is an unfortunate gap in the functions, since as will be discussed under Part VIII, the matter of transfer pricing is a serious concern.

D. Downstream Petroleum Regulatory Agency

The Agency has both technical and commercial functions as can be recommended. The Agency seems to have full and adequate powers to deal with the downstream sector.

An interesting issue is that there is no mention of refining or refining operations in the PIB 2012 other than in Section 220 (2)(b) of the PIB 2012 which mentions that regulations may be made for these operations.

Given the fact that precisely the matter of construction and operation of new refineries is a major issue in Nigeria, this seems a major omission. The PIB 2012 does not provide any guidance or framework for the Agency as to how to deal with refineries.

E. Petroleum Technology Development Fund

The Development Fund provisions are largely unchanged from earlier proposals.

F. Petroleum Equalisation Fund

The Equalisation Fund provisions are largely unchanged from earlier proposals. This Fund will be required as long as the petroleum products market is not completely deregulated.

G. Petroleum Host Communities Fund

There is a strong sense in the Niger Delta communities that the people living in this area are not benefitting directly from the oil and gas wealth of the area, despite the activities of the Niger Delta Development Commission.

It was therefore that the Government Memorandum included a detailed and transparent financial distribution system in order to ensure that the communities would benefit directly from the petroleum activities. Financial transfers would go directly from the petroleum companies to the communities based on pre-determined fees without interference from government. This would ensure that the communities would actually get the funds.

The PHC Fund leaves matter wide open. It allocates 10% of the after tax profits of the onshore and shallow water operations to the communities and the littoral States. The manner in which revenues will be distributed will be regulated by the Minister. This opens the door in principle to significant political interference and possible non-transparency.

Also it can be expected that the after tax profits will fluctuate considerably with the oil price movements. This will expose the communities to widely fluctuating income streams which will be very difficult to effectively absorb. It was for this reason that the Government Memorandum included stable payments directly related to the value of the assets located in or near the communities.

The 10% payment can subsequently be credited against any payments to government. Since this could be both against royalties and tax and because there is no coordination on this matter between the Inspectorate and FIRS, this could lead to “double dipping”.

Also it states that the PHC Fund will be used for economic and social infrastructure. This means that the PHC Fund may simply replace existing government programs for investment in infrastructure, rather than being a net gain to the communities.

Also 10% of the deep water profits will be transferred directly to the Fund for the petroleum producing littoral States without any transparency as to how these funds will be used.

H. Breakup of NNPC

General Comments

NNPC is to be broken up in three separate companies:
- The National Petroleum Assets Management Corporation
- The National Oil Company, and
- The National Gas Company Plc.

The two companies and a Management Company under the Corporation would be incorporated under the Companies and Allied Matters Act.

The Corporation would receive the NNPC interests in the current unincorporated joint ventures. The National Oil Company and National Gas Company Plc would split the remaining assets. Both the National Oil Company and the National Gas Company Plc will be partially privatized.
The apparent goal is to create Nigerian companies similar to, for instance, Petronas or Petrobras. It is puzzling to understand how this is going to be achieved by breaking up NNPC in three parts. Also splitting activities in oil and gas would not lead to a strong national company. Neither Petronas or Petrobras was broken up in a similar manner in the past. Petronas and Petrobras have extensive operations in both oil and gas.

The key to a successful National Oil Company is to incorporate NNPC as a whole under the Companies and Allied Matters Act and then partially privatize it. This was contemplated in both the Government Memorandum and the House Bill 159. Such a partial privatization, similar to Petrobras or Statoil, would create an entity which is being managed with all the features of a private profit oriented company and with, hopefully, a minimum of political interference.

Privatizing only pieces of NNPC and leaving significant assets in a 100% government owned company is going to be a confusing strategy. Deciding which assets go to which company and splitting up NNPC will be a complicated process. Why going through such a complex process if the goal of efficient NNPC can be achieved much simpler? It may be that there remains a strong desire for political interference with NNPC matters.

Specific Comments

Sections 129(3), 157(3) and 168(2). Most favored company clauses. The tax provision under these subsections would leave the door wide open for very significant tax losses for Nigeria.

2.3. Part III – Upstream Petroleum

Subsection 172(3) Unnecessary restrictions on exploration. Petroleum exploration licenses do not give any right to petroleum and are non-exclusive. The main purpose is to collect information. It is an unnecessary obstacle to restrict such information collection to open acreage. It will make the evaluation of such acreage more difficult, if results cannot be tied in to data from existing wells and fields on existing prospecting licenses and leases. This in turn will hamper the bid process for such open acreage.

Section 174. Transparency and non-confidentiality maintained. A very good provision of the PIB 2012 is that the provisions related to transparency and non-confidentiality have been maintained as per the Government Memorandum. This is a very good step forward for Nigeria. From a legislative point of view these provisions are now among the most advanced in the world and will make Nigeria a leader in Africa in this respect.

Sections 178 and 179. Bank guarantee removed. In general, the detailed work commitment provisions and development plan approval process of the Government Memorandum were maintained. However, the obligation to provide a bank guarantee for the work to be committed was removed. This seriously weakens the ability of the Inspectorate to enforce a work commitment and a development plan.

Section 181(6). The reference to a competitive bid process is in error, since the license area from which further lease parcels will be selected already belongs to the licensee.

Section 190 (6). Public bid opening removed. The provision that bids have to be opened in public was removed.

Section 191. President has the power to grant licenses and leases. A very negative provision of the PIB 2012 is that the President has the power to grant licenses and leases without competitive process or any other process. This leaves the door wide open to political favoritism and corruption in a manner that has been practiced in Nigeria in the past. It should be noted that the President of the United States or of South Africa do not have similar powers.

Section 193(3)(c). Return of acreage severely diminished. The inclusion of paragraph (c) of subsection (3) as drafted defeats the entire purpose of section 193. Currently, companies are “sitting on” large oil mining leases which contain in addition to the discovered fields significant unexplored acreage. The concept of section 193 was to enforce either the drilling of unexplored acreage or to have companies drop this acreage so it can be subject to a bidding round for other interested companies. By making the relinquishment date the end of the oil mining lease period, this whole concept is no longer of use and the purpose of most the section 193 been made useless.

Section 197. Royalties, fees and rentals to be defined. The PIB 2012 leaves the entire determination of royalties to the Minister under regulations. Since royalties are not provided for in the Act and since the Acts containing royalty provisions will be repealed under the PIB 2012, royalties will be set in the future based on regulations. Determining royalties through regulations rather than in the PIB itself will lead to constant pressure on the Minister in the future to lower royalties for a wide variety of reasons. Also it can certainly not be recommended that such an important revenue source is determined after the Bill has passed and the matter of royalty levels can become a matter of political manipulation.

Section 200 (4)(a). Cross reference to subsection (1) is in error and should be subsection (3).

2.4. Part IV – Downstream Licensing

General Comments

Part IV is a very broad procedural Part, which permits licensing with any type of conditions attached for any downstream project. Part IV also permits any type of corresponding regulations to be made. In general the procedures are simpler than proposed in the Government Memorandum. This is an advantage.

However, it is unclear what process the Agency would follow to approve and grant a license for a project or what type of license is required for what type of activity.

For instance, if an investor would want to invest in a gas project involving a gas pipelines from several gas fields, a gas processing facility and gas pipelines to one or more power plants, what would such an investor do? How would such a project be approved? There is no clear policy structure in Part IV, despite the detailed procedural provisions.

2.5. Part V – Downstream Petroleum

Section 222. Open access severely limited. The open access provisions only apply to current downstream facilities, apparently not future facilities. Also open access does not apply to gas processing facilities. At the same time the PIB 2012 does not contain an open access provision for pipelines prior to the measurement point and therefore part of the upstream operations. As a result small producers will have very severe difficulties getting access to transportation and processing facilities.

Section 224 (1). No tariffs for gas processing. The PIB 2012 does not include the power to set tariffs for gas processing. **This makes it very difficult to set the fair market value for natural gas for royalty and Nigerian Hydrocarbon Tax purposes, since gas processing costs would typically be a deduction for determining the value of gas at the measurement point.** In particular for LNG exports, gas typically has to be processed first before being delivered to an LNG facility for liquefaction. This means where petroleum companies own both gas production and gas processing facilities, excessive gas processing fees could reduce significantly the value of the produced gas and therefore reduce royalties and taxes.

Section 224 (4). Contract tariffs adopted. The addition of this subsection will make it possible to adopt contracted prices as tariffs. Again this opens the door widely to the reduction of the value of oil and gas at the measurement point and could create a significant obstacle for smaller companies to enter the Nigerian market.

Section 232. Arm's length relationship between producer and pipeline transporter removed. The concept that a pipeline transporter should have an arm's length relationship with producers was removed in the PIB 2012.

Section 256. Transitional gas pricing. The PIB 2012 sets out the possibility for transitional gas pricing arrangements. This provides a more flexible approach then the initial price regulation contemplated in the Government Memorandum.

Section 261. Public service levy. This section creates the possibility for a public service levy.

Section 269. Domestic supply obligation made less specific. The domestic supply obligation is made less specific and initial gas market prices are not set in the PIB 2012. These provisions have now been replaced by the new section 256. Also the concept of the domestic gas aggregator was removed. This is a positive step. The domestic gas aggregator was in fact an oligopolistic structure which could have hampered the development of competitive gas markets. This means that the introduction of gas for domestic consumption in Nigeria will now largely depend on the pricing structure developed under section 256. However, it is likely that it will take considerable time for a fully competitive market to emerge. For this reason Nigerian consumers would be better protected if the PIB 2012 contained as a minimum an initial defined gas pricing system.

Section 271. Franchise areas set for gas processing. This section permits the development of gas processing franchise areas. Yet, as was indicated earlier, there are no open access provisions for gas processing. Also gas processing tariffs are not set. The creation of gas processing franchise areas, without open access and tariff provisions may result in significant misuse of this monopoly power. It would prevent smaller producers to enter the gas market on the basis of the construction of their own gas processing facilities.

Section 272 (1)(b(ii). Penalties for failure to supply the domestic market made very weak. The PIB 2012 no longer includes strong and specific penalties for failing to supply the domestic market. In fact a paragraph is now included that states that as long as the supplier has *made reasonable commercial endeavors to make gas available*, penalties will not apply. This paragraph will get everyone of the hook.

Sections 275 – 282. Effective provisions to prevent routine gas flaring. The PIB 2012 now includes effective provisions to prevent routine gas flaring.

2.6. Part VI – Indigenous Petroleum Companies

The provisions of this Part with respect to indigenous petroleum companies have remained similar compared to the Government Memorandum.

2.7. Part VII – Health, Safety and Environment

The provisions of this Part have remained similar to the Government Memorandum, with the exception of subsection 293(2).

293(2). Companies not responsible for environmental damage as a result of sabotage. The PIB 2012 now includes a provision whereby companies will not be responsible for environmental damage in the case of acts of sabotage or tampering with equipment.

298. Penalties and sanctions. A new good section was added which permits the Inspectorate and Agency make companies liable to sanctions and to levy penalties.

2.8. Part VIII – Provisions On Taxation in the Petroleum Industry

General Comments

Contrary to the Government Memorandum and the House Bill 159, Part VIII no longer contains provisions related to rentals, royalties and production sharing. Part III now include broad powers to determine rentals and royalties through regulations. Since no mention is made with respect to production sharing provisions it is understood that these provisions in contracts will remain unaltered. Also fiscal revenue management provisions were deleted.

Stealing of oil. The lack of new royalty provisions has a significant implication with respect to the measurement of petroleum production. Under the Government Memorandum it was proposed to adopt the international practice of measuring oil and gas production at the measurement point in the field, directly where oil and gas leaves the field area. This was in contrast to the existing practice of measuring at a point downstream where oil or gas is delivered or sold. The reason for the tougher measurement point provisions in the Government Memorandum was to stop the practice of stealing or diverting oil or gas before it is measured. The PIB 2012 will continue the existing practices. This means that it will remain possible to steal or divert oil or gas before it is measured. This will continue to result in losses to the Nigerian economy and will continue to benefit those involved in these practices.

Relative revenue loss in case of price increases. Another significant loss to Nigeria is the fact that both the Government Memorandum and House Bill 159 contained royalty provisions related to the increases in oil and gas prices. A special additional royalty was clicking in under high oil or gas prices. For instance, if as a result of significant political turmoil in the world, oil prices would increase to $ 200 per barrel, under the previous proposals Nigeria would receive an extra royalty on oil.

If LNG export contracts would be concluded which under certain conditions of the world gas market would result in netbacks of $ 10 per MMBtu or more Nigeria would automatically receive extra royalties on gas.

Under the PIB 2012 such extra royalties do not exist and therefore oil and gas companies may earn a wind fall if oil and gas prices would increase to high levels. It will now depend on regulations whether such features will be re-introduced.

The deletion of the price progressive royalties contradicts the stated objective of the Bill in Section 1(d) which specifically calls for the creation of a progressive fiscal system.

LNG export pricing. Under current attractive export conditions to Japan and East Asia, the price of LNG at the export point in Nigeria would be relatively high. The Government Memorandum included detailed provisions to ensure that Nigeria would receive fair market value for LNG at the export point. These provisions have been deleted from the PIB 2012. The Bill now therefore leaves the door wide open for significant transfer pricing of gas, resulting in potentially very large losses to the Nigerian petroleum revenues.

Very favorable 1993 PSCs maintained, while 2005 PSCs are not improved for investors. The terms and conditions of the 1993 series of deep water PSCs were excessively favorable for investors. These terms are now being maintained under PIB 2012. From an international perspective the terms of the 2000 series of deep water PSCs were acceptable and no change in overall burden on existing production is required. The terms for the 2005 series of deep water PSCs are too tough to stimulate active investment and therefore better terms should be established for such PSCs.

Electronic Management Information Systems deleted. The Government Memorandum provided for the requirement for companies to establish electronic management information systems containing all fiscal and non-fiscal data to which government official involved in revenue collection, auditing and supervision could link up to in real time. This would have significantly improved the transparency of the revenue collection and would have improved the ability of the Ministry of Finance to carry out revenue collection forecasting. The PIB 2012 deletes this requirement.

Specific comments on the Nigerian Hydrocarbon Tax.

Following are some specific comments on the Nigerian Hydrocarbon Tax (NHT).
Section 304 (1) (a). Door wide open for transfer pricing. This subsection establishes that the NHT will be determined based on the proceeds from sales of oil, gas, condensates or bitumen. This leaves the door open in principle for transfer pricing by exporting crude oil and artificially low prices. Subsequently, Section 315 builds in some protection for the valuation of crude oil and condensates, although rather weakly, since the selling price has to have a *reasonable* relationship with the official selling price, rather than being equal to the official selling price. No such protection is built in for LNG exports. Therefore, the PIB 2012 leaves the door wide open for export of natural gas at artificially low prices.

Section 305 (1)(g). Favorable interest deductions. This subsection essentially permits any deductions for interest on loans as long as it is incurred for upstream capital expenditures. There is no mention of any requirement for fair market rates of interest on an arm's length basis.

Section 312 (2) Fourth Schedule Table 1 – Not necessary. The Fourth Schedule eliminates the Petroleum Investment Allowance. Nevertheless Table I is maintained. This Table should have been deleted, since maintaining it may create tax implementation problems as a result of the confusion it is creating.

Section 312 (2) Fourth Schedule Table II – Excessive Allowances will reduce the Nigerian Hydrocarbon Tax to zero. The Fourth Schedule was retained with some improvements from the PPT Act. Nevertheless, Table II was changed dramatically. Under the PPT Act companies were permitted allowances equal to 98% of the value of the capital assets, based on a 20% straight line for 5 years. This was a regular and normal procedure. Table II of the PIB 2012 extends the allowances indefinitely for year 6 and after. This means that, for instance, the total allowances on an asset with a 20 year life would be 346% of the initial value of the asset. With such enormous allowances it is likely that the Nigerian Hydrocarbon Tax will in effect be reduced to zero. These allowances are not constrained by provision 6(2) of the Fourth Schedule which requires to retain one percent of the asset in the books for accounting purposes (not for tax purposes). The specific mention of "year 6 and after" clearly establishes this. **This change is either an error in the Table or a very large give away of government revenues.**

Section 312 (2) Fifth Schedule – Give away on production allowances for existing fields. The Fifth Schedule seems to adopt the production allowances approximately as provided for under the

Government Memorandum or House Bill 159. Nevertheless, there is an important difference with respect to the application. Under the Government Memorandum the production allowances only applied to petroleum mining leases which started production **after** the enactment of the Act. The purpose was to encourage new production. The production allowances were meant to **replace** the existing investment tax allowances. This was, for instance, clearly provided for under Subsection 353(8) of the Government Memorandum. This specific subsection was removed from the Fifth Schedule (in fact, interestingly the numbering was not even adjusted – subsection 9 is missing in PIB 2012).

This means that the production allowances now apply to all leases. Producers of existing production will now be able to "double dip" and claim the production allowances, in addition to the investment tax allowances already claimed prior to the promulgation of the Act.

Section 312 (2) Fifth Schedule (3) - This section provides for an allowance for tax purposes of the lower of $ 1 per MMBtu and 100% of the value of dry gas. Yet, all costs still remain deductible. This means by definition that the Nigerian Hydrocarbon Tax on dry gas under a gas price of $ 1 per MMBtu or less will always be strongly negative, which means result in a significant tax loss. This is not a sensible tax practice.

Section 312 (2) Fifth Schedule (1) i) – Confusion on Production Sharing Contracts. A general production allowance applies to companies with production sharing contracts with NNPC ***which are not benefitting from Investment Tax Credit or Investment Tax Allowance.*** It seems contrary to legal principles that companies would continue to benefit from the Investment Tax Credit and Investment Tax Allowance when the PPT Act has been repealed.

Section 312 (2) Fifth Schedule (1) ii) – Joint Venture companies with NNPC not entitled to the production allowance. It seems puzzling that companies in joint venture with NNPC would not be able to benefit from the production allowances for new petroleum mining leases. This is contrary to the concept established in the Government Memorandum that new field production should be encouraged in Nigeria, regardless of who investments in such new fields.

Roles of National Oil Company and Government Agencies as well as some other provisions deleted. Under the Government Memorandum significant responsibilities were assigned to the National Oil Company and Government Agencies to provide background information to the Service in order to make the tax assessment of the Service more effective. These provisions have been deleted from PIB 2012. Furthermore, some other provisions which enhance the power of the Service to effectively collect tax, such as the power to distrain, were deleted.

Section 344. Penalty for failure to pay tax reduced to insignificant amounts. The penalty for failure to pay tax was 200 percent of the tax not paid plus interest under the PPT Act and subsequent Government Memorandum. This has been reduced to an insignificant amount of 10 percent plus interest. Based on such low penalty amounts it seems that it could be advantageous to simply not pay tax, since the rate of return on the tax amount not paid and retained may be higher than the penalty plus interest. In other words it pays not to pay tax.

Specific comments on the Companies Income Tax.

Section on Companies Income Tax not numbered. Part B of Part VIII relating to the Companies Income Tax follows Section 353, but is not numbered. The Subsections are numbered.
Subsection (1). Nigerian Hydrocarbon tax not deductible. Subsection 1 maintains the provisions of the Government Memorandum and House Bill 159 which made the Nigerian Hydrocarbon Tax not deductible for Companies Income Tax purposes. This provisions strengthens the government revenues from the two taxes.

Subsection (8)(a). Extension of Section 39 benefits for LNG projects is reasonable. Under the Government Memorandum the benefits under Section 39 for LNG were limited to companies committing to LNG project prior to December 31, 2011. Subsection (8) does not provide such restriction. Given the delay in the PIB and the increased competitiveness of the world LNG markets, this adjustment is reasonable.

Subsection (8)(b). “Extraction” is imprecise. The word “extraction” is imprecise and could lead to confusion with “exploitation”. It would be better to use the word “processing”.

Subsection (9). Incentives for upstream operations not necessary and could create significant tax losses on oil revenues. It is not necessary to provide tax incentive for upstream producers which produce gas for the domestic market. Most gas sold in the domestic market by upstream producers will be associated gas which is produced together with crude oil or condensates. Providing significant corporate income tax incentives for the production of crude oil and condensates for companies that deliver gas only to the domestic market could result in very significant corporate income tax losses.

2.9. Part IX – Repeals, Transitional and Savings Provisions.

This part now also includes what used to be Part X under the House Bill 159 and the Government Memorandum related to interpretation.

Section 354. PIB 2012 does not repeal a number of Acts. The list of Acts repealed under the PIB 2012 is shorter than under the House Bill 159 and the Government Memorandum. A legal analysis is required to determine the implications of this.

Section 362. Interpretation. The definitions of upstream and downstream are rather confusing. Upstream now includes pipelines from the fields to refineries or export points. These are typically not considered part of the upstream. The large upstream transportation systems are not regulated under Part III. No open access or tariff provisions apply to these systems.
In principle the Inspectorate has the power to impose such provisions, but without guidance in the Act, this may be a difficult concept to implement. As a result it may be difficult for small companies to have access to these systems.

The Interpretation section contains various errors and concepts are defined which are not used in the Bill. For instance “production allowances” refer to Schedule Three rather than to Schedule Five. The concept of a “Domestic Gas Aggregator” is not used in the Bill.

3. Annex B. Fiscal Analysis of the Bill

Following is an economic analysis for:

- Onshore and shallow water leases, and
- Deep water PSCs

The analysis is done for the leases and production sharing contracts under existing production.

3.1. Government Take analysis

Onshore

For the onshore it is assumed that the royalties will remain unchanged. Of course, if royalties would be lowered, the revenue losses to Nigeria would be higher than estimated in this Annex B.
The onshore evaluation is based on two cases:

- Case # 1 assumes that the Fourth Schedule is indeed in error,
- Case # 2 assumes that the Fourth Schedule is indeed meant as a perpetual uplift for the investor.

Furthermore, the case with and without NNPC participation are being evaluated for existing production.

Chart 1 illustrates the case of leases in which NNPC does not participate. As can be seen from chart the Case # 2 interpretation would result in rather significant government revenue losses. For the average field size the losses would be as much as 22%. However, it should be noted that in reality the losses would be more since most companies will be able to double dip. They may have been able to take the 5% uplift already and with the introduction of the PIB 2012 they would be able to take the production allowances also.

Chart 1. Government Take of Nigerian PIB for onshore leases in which NNPC does not participate

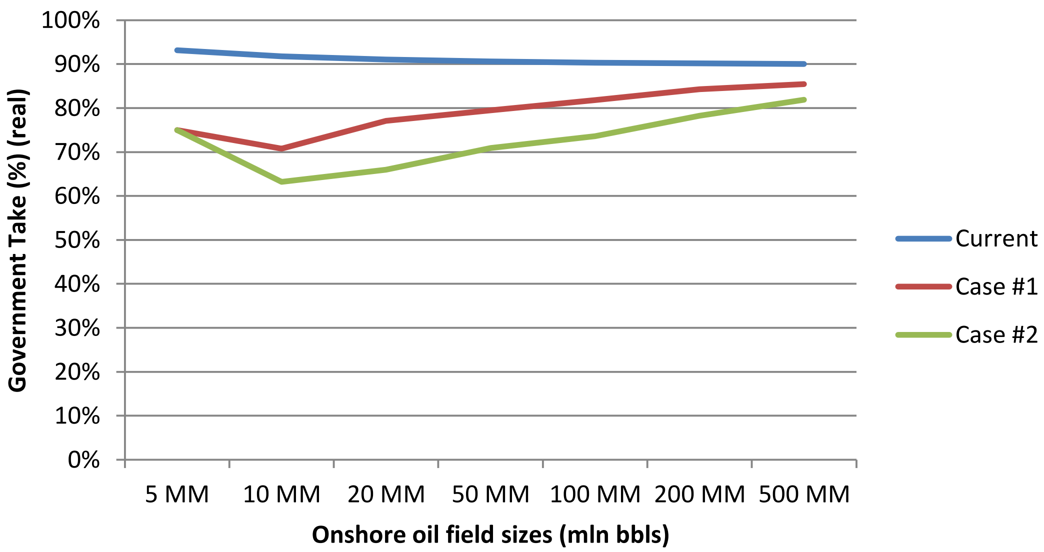
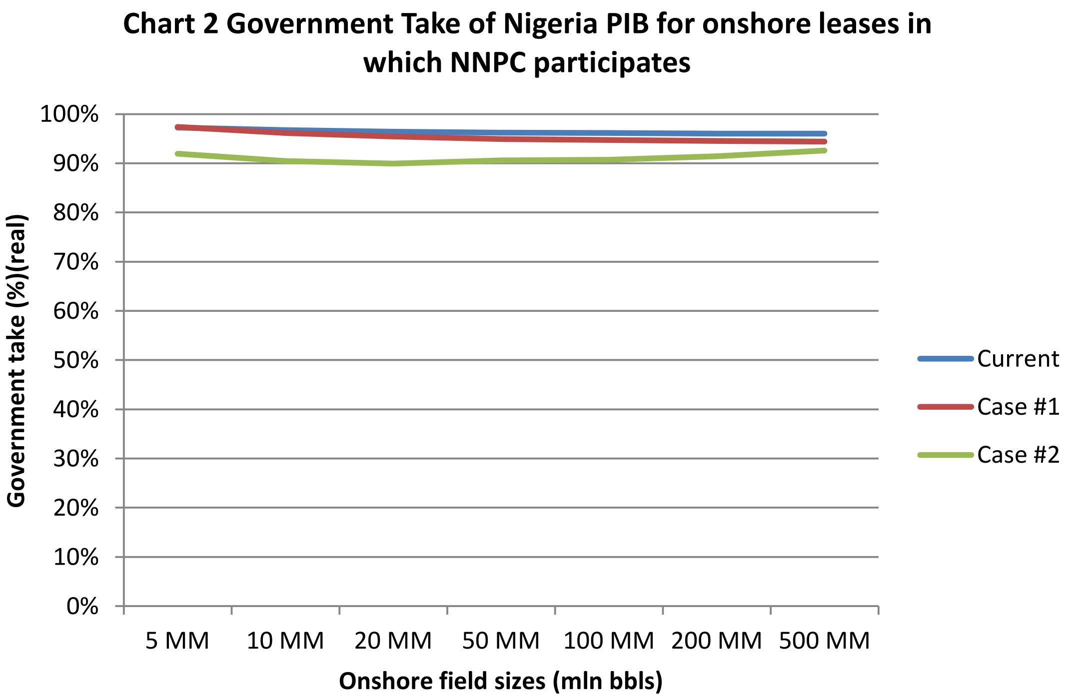


Chart 2 illustrates the case of leases in which NNPC would participate. Such leases would not be subject to production allowances. Therefore under Case #1 there would be no significant change in economics. However, also in this case if the Fourth Schedule indeed represents an uplift, the losses would be 6% for the average field size. Again actual losses may be more where companies double dip by having already taken the 5% uplift and would now be able to take the "perpetual uplift".



A loss of revenues on existing production is not in the interest of Nigeria. It should be noted that production from new mining leases should be stimulated with better terms since a higher level of production would be beneficial for Nigeria.

Shallow Water

The results for shallow water will be very similar to the onshore results. Only the royalties are somewhat less.

Deep Water

For the deep water the year 2000 style PSCs is taken as the "Current Terms". These are the PSCs which are competitive from an international perspective.

Many issues would affect the revenues in the PIB 2012. Following are the cases as a result of interpretation issues with PIB 2012. Starting with Case # 2 it is assumed that the effects of each next case are cumulative.

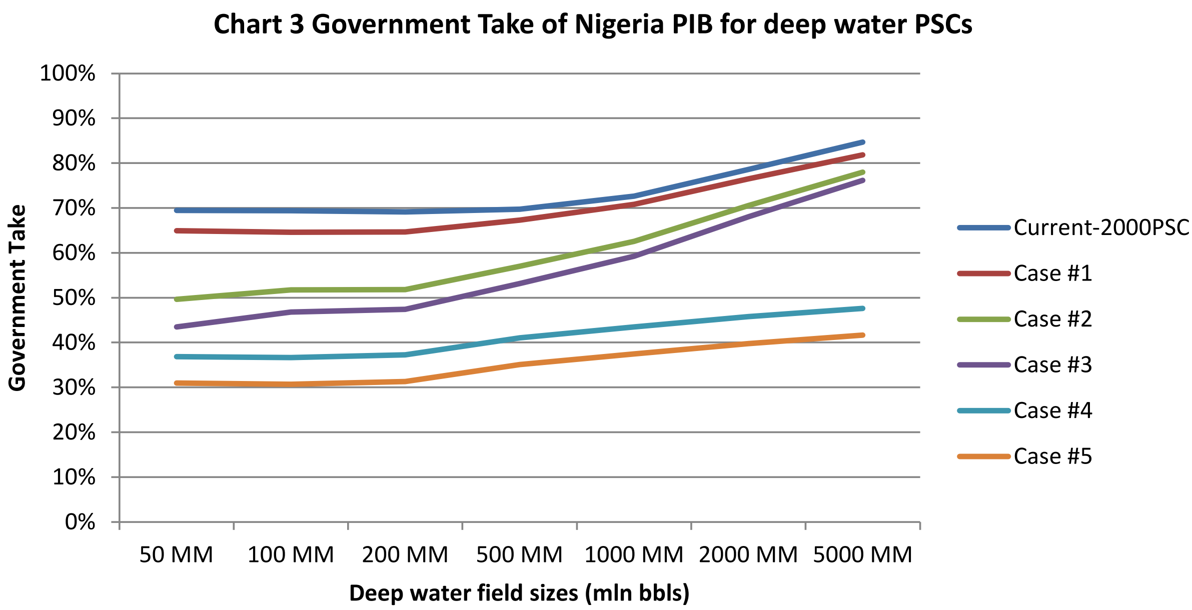
The cases are:

- Case # 1 assumes that the Fourth Schedule is an error
- Case # 2 assumes that the Fourth Schedule is indeed meant to be a perpetual uplift.
- Case # 3 assumes that with the repeal of the "Deep Offshore and Inland Basin Production Sharing Act" will indeed result in the loss of royalties
- Case # 4 assumes that NNPC will be privatized and that no arrangements will be made to transfer the production sharing profit oil revenues to Nigeria from NNPC to Nigeria. In other words it is assumed that the privatized NNPC can retain these profit oil shares and will pay corporate income tax and hydrocarbon tax on its income. It should be noted that the dividend

policy would not be determined by a Board in which private investors participate. It is assumed that dividends will be retained. If Nigeria is to achieve the goal of a "Petrobras style" national oil company, profits would have to be re-invested rather than paid as dividends for a very long period.

- Case # 5 assumes that the Coastal States will receive 10% of the profits and that these amounts will be credited against the revenues to the Federal Government.

As can be seen the revenue losses to Nigeria based on the cumulative results of Cases # 2, # 3, # 4 and # 5 is 50% for the average field size and more for the PSCs with larger fields.



Again it should be noted that actual revenue losses may be more where companies will be able to double dip by having been able to take thee 50% uplifts prior to the promulgation of the PIB 2012 and subsequently still receive the production allowances and the perpetual uplift.

Also for the deep water PSCs a loss of revenues from existing production is not in the interest of Nigeria. Only production from new mining leases should be stimulated with more favorable terms. Also the terms of the 1993 series of PSCs should be improved for government, while the 2005 series of PSCs should be improved for investors.

3.2. Profitability analysis

The following Charts 4, 5 and 6 provide the IRR analysis of the same cases as for the government take analysis.

Chart 4 and 5 illustrates how current terms for the onshore create uneconomic conditions for small fields which are more costly than $ 20 per barrel (capital and operating costs).

Chart 4 illustrates how the proposed production allowances would create a significant improvement in economics. Therefore, this system is an important and required stimulus for new production from small high cost onshore fields. The excessive depreciation provisions would make the IRR somewhat more attractive. However, since the benefit is late in the life of the field, the gain in IRR is modest.

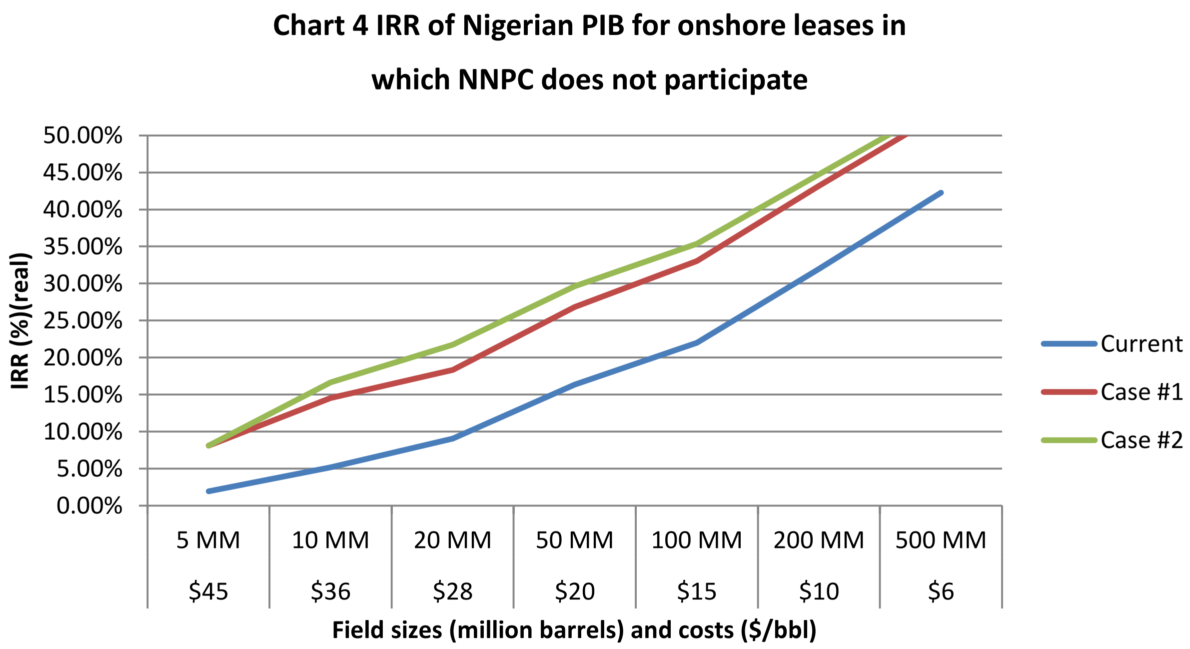


Chart 5 illustrates how not applying the production allowances to joint ventures with NNPC would leave the small high cost fields in these leases uneconomic and therefore undeveloped.

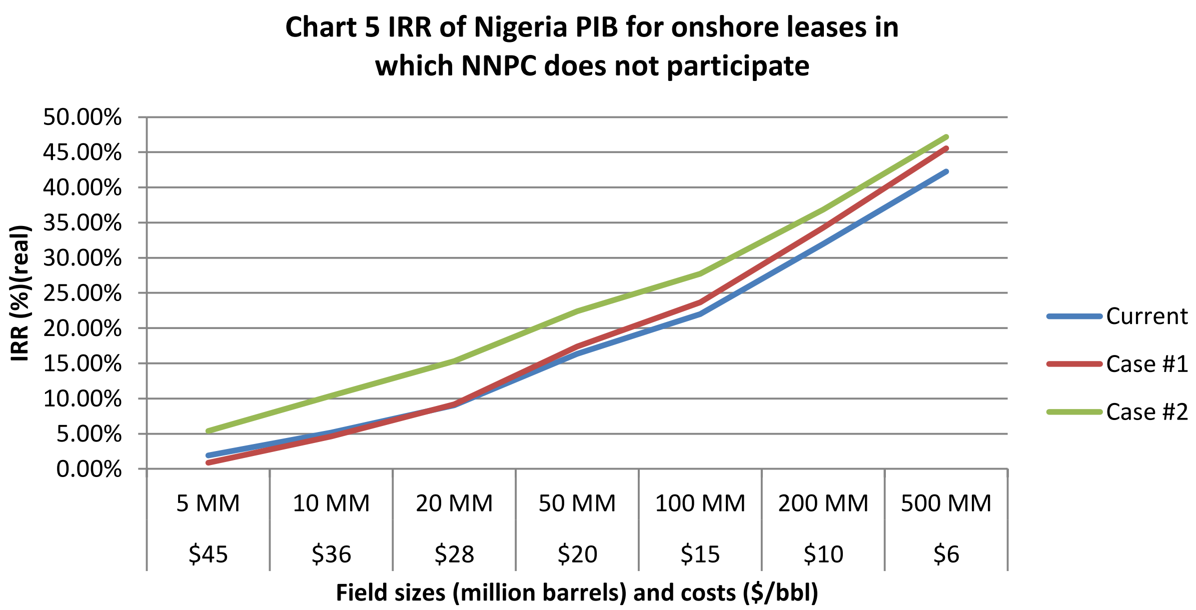


Chart 6 illustrates how under current terms of the year 2000 series of PSCs small oil fields are uneconomic as a first field in the contract area if costs are higher than about $ 23 per barrel (capital and operating costs). The production allowances (Case # 1) and lower taxes would significantly improve the economics. Fields costing $ 31 per barrel are economic under these terms. This would be a welcome and adequate stimulus if applied to new production.

As can be expected economics improve further with cases # 2, # 3, and # 4. Case # 4 and # 5 would result in the same economics because the profit share to the coastal states would be creditable against other payments to government.

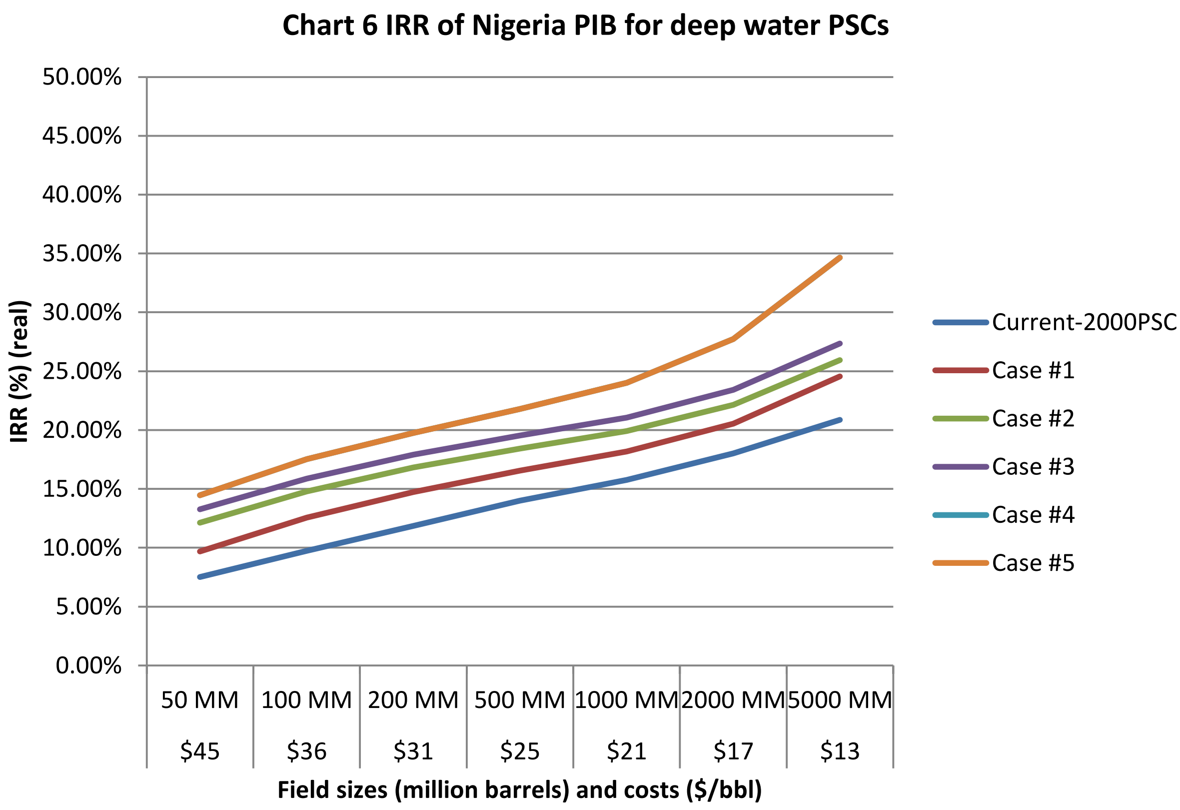


Chart 6 IRR of Nigeria PIB for deep water PSCs
50.00%
45.00%
40.00%
35.00%
30.00%
25.00%
20.00%
15.00%
10.00%
5.00%
0.00%
IRR (%) (real)
50 MM $45
100 MM $36
200 MM $31
500 MM $25
1000 MM $21
2000 MM $17
5000 MM $13
Field sizes (million barrels) and costs ($/bbl)
Current-2000PSC
Case #1
Case #2
Case #3
Case #4
Case #5

About Van Meurs Energy

Van Meurs Energy is the trade name for Van Meurs Corporation, Van Meurs y Asociados, and Van Meurs Consultores. Van Meurs Energy is one of the leading consulting firms focused on oil and gas fiscal policy matters. We have provided these services to more than 90 governments over the lasts 47 years

Van Meurs Energy provides services in the upstream oil and gas industry with respect to consulting, training and expert witness in arbitration. We provide access to databases, fiscal ranking service and a world fiscal model, expert reports and publications and evaluate the impact of climate change and renewals on the petroleum industry.

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