

THE NATIONAL GAS POLICY

EXAMINING THE SIX CRITICAL SUCCESS FACTORS

"Gas, the Beautiful Bride of Hydrocarbon" – Anonymous

The recently approved National Gas Policy (the "Policy") by the Nigerian Federal Government ("FGN") has thrown up mixed reactions from participants in the Nigerian oil and gas industry (the "Industry"). Whilesome believe that the Policy will move the Nigerian economy from oil to gas, others are cautiously optimistic on the Policy and have identified that certain issues such as gas pricing, infrastructure and appropriate gas flaring penalties, if not properly addressed, may inhibit the success of the Policy.

In this briefing, we have identified six critical factors that will affect the success or otherwise of the Policy. These include:

- a. Gas Pricing
- b. Passage of Gas Legislation
- c. Sufficient Gas-centric Incentives
- d. Investor friendly Gas Development Agreements
- e. Compliance with Gas Development Agreements
- f. Policy Reliability

Gas Pricing

The current market conditions on the pricing of gas supplied to the domestic market is not competitive as pricing of gas under domestic gas obligations imposed on suppliers is based on an Aggregate

Domestic Gas Price prescribed by the Department of Gas ("DoG"). These prices are not determined on a willing buyer-willing seller basis and have not encouraged deliberate gas development for the domestic market by producers. The current market conditions on the pricing of gas supplied to the domestic market is not competitive as pricing of gas under domestic gas obligations imposed on suppliers is based on an Aggregate Domestic Gas Price prescribed by the Department of Gas ("DoG"). These prices are not determined on a willing buyer-willing seller basis and have not encouraged deliberate gas development for the domestic market by producers.

The Policy maintains a dichotomy between the wholesale gas price for the domestic market and pricing for LNG export. The Policy recognizes that the current regulated pricing regime for the domestic market is a transitional measure to market-led pricing.

During the transitional period, the wholesale gas price for the domestic market will remain subject to the Export Parity Netback Gas Price. In order to arrive at the production price to be applied to the domestic market, the cost of regasification, shipping and liquefaction will be deducted from the average export market price. It must be mentioned that during the transitional period, parties may engage in transactions on a willing buyer-willing seller basis once they have met their Domestic Supply Obligations .

The triggers for a market-led pricing include (1) pricing reference point(s) (2) large volumes (3) many buyers and (4) many sellers. Specifically, the Policy says a wholesale market will be determined by the following:

- a. When the Obiafu – Obrikom – Oben (“OB₃”) pipeline, which will act as a connection system between the eastern and western parts of Nigeria, is completed.
- b. Where sufficient gas volumes of 2bcf/d passes through the completed OB₃;
- c. When Oben gas plant develops as a physical gas hub with sufficient volumes and hub pricing can replace regulated pricing;
- d. Where there are sufficient numbers of wholesale traders (sellers) and consumers (buyers);

Looking at the above-mentioned triggers for the wholesale gas market, the question that comes to mind is, can Nigeria have an unregulated wholesale gas market in the short term? The response to this may be partially positive. Positivity is expressed based on the fact that the OB₃ pipeline is at about 80% completion and expected to be operational very soon with a capacity of 2bcf/d.

The trigger of sufficient gas volumes of 2bcf/d assumes that OB₃ will always have sufficient gas volumes from producers at all times which may not necessarily be the case considering the peculiarity of the Industry as it relates to security and sabotage of both oil and gas pipelines. Also, 2bcf/d is above current domestic supply of about 1.3bcf/d, therefore production needs to be ramped up to ensure at least 2bcf/d is supplied to OB₃. With the current plan to increase domestic gas supply to 5bcf/d by 2020, a 2bcf/d target for OB₃ may not be too ambitious.

In our considered view, the first two triggers for a market-led gas market may be achievable in the short term of 3 – 5 years, however, the last 2 triggers appear unclear. For example, there seems to be no clarity as to what will constitute sufficient volumes for Oben as the Policy is silent on this. Also, what will amount to sufficient number of wholesale traders and consumers leaves room for conjecture and may give government the latitude to delay in declaring a wholesale gas market. Closely linked to the issue of number of wholesale traders and consumers is the issue of sufficient incentives to the market to encourage more players in the development, trade and consumption of gas. This point shall be discussed further under the “Gas-centric Incentives” header.

The Policy also proposes an LNG Export Tolling Price whereby owners of LNG liquefaction facilities will be paid a tolling fee by Government for liquefying, shipping and regasification of Government’s equity gas. Also, the Policy proposes Infrastructure Tariffs, which will be introduced for monopoly infrastructure within the gas industry. Monopoly infrastructure will include LNG liquefaction, gas processing, gas storage, transportation and distribution. The Policy does not state whether government will be paying Infrastructure Tariffs in addition to the LNG Export Tolling Price. However, it is expected that the Infrastructure Tariffs should be separate from the LNG Export Tolling Price.

Passage of Gas Legislation

The Policy recognizes that gas is a hydrocarbon that needs to be legislated upon in its own right and proposes that a new legislation shall be passed to focus on the following amongst other things:

- Midstream and downstream segments of the gas market
- Separation of gas infrastructure ownership, operations and trading
- Pricing
- Licensing
- Fiscals

Whilst gas legislation is absolutely necessary, the extent of political will for the passage of this legislation may be of concern. This is so considering the fact that successive governments have been unable to pass the substance of the initially conceptualized Petroleum Industry Bill into law, save for its governance component (Click here for our article on the Petroleum Industry Governance Bill currently before the lower chamber of the Nigerian Federal Legislature). Also, the average timing for legislative process in Nigeria takes between 18 and 24 months. If this is taken into perspective, it is doubtful that the proposed gas legislation can become law before the end of the current administration in May 2019.

Sufficient Gas-centric Incentives |

The Policy aims to provide certain incentives for gas development. For example, the fiscal framework of the Policy recognizes that gas pricing should be market based and not fixed by the State. Also the FGN intends to relax royalty and tax rates for gas, and incentivize entry into the midstream. In addition, favourable production allowances and hydrocarbon taxes will be introduced for PSCs in the event of gas production.

The principles of the fiscal framework under the Policy are to the effect that there shall be non-consolidation/non-recovery of gas costs from oil income. The aim of the separation of gas costs from oil income is to remove the cross subsidy of oil to the gas sector to ensure that gas costs are attributed to gas projects alone. That said, the proposal of non-consolidation/non-recovery of gas cost from oil income needs to be carefully considered. Currently under section 11(1)(2)(c) of the Petroleum Profits Tax Act ("PPTA") incentives for the utilization of associated gas is subject to the maintenance of separate records of expenses incurred in the utilization of associated gas from costs incurred in oil operations. The PPTA further recognizes that there is the possibility of not being able to separate gas and oil expenses and under such instance; such expenses shall be allowable against oil income.

While the Policy largely mirrors the provisions of section 11(2)(c) of the PPTA with regards to attribution of gas costs as separate from oil, the Policy does not speak to how costs, which cannot be clearly separated as gas costs are to be treated. Would those costs continue to be regarded as costs attributable to oil field development and allowable against oil income?

Our response is yes, in the circumstance that, in the absence of any overriding legislative provision, the express provisions of section 11(2)(c) of the PPTA remains law.

As part of the incentives for gas development, we are of the view that gas income should be subject to income tax only to the exclusion of hydrocarbon tax. Whilst gas production and distribution are expressly listed as activities, which qualify for pioneer status, other midstream activities such as development of gas infrastructure should be expressly listed as part of the activities that will enjoy pioneer status for new entrants. Another incentive, which needs to be considered, is reduced import duties for gas equipment and other midstream equipment. We believe all these measures should stimulate the desired level of investment in the gas sector.

Investor friendly Gas Development Agreements

Production Sharing Contracts (“PSC”) between the Nigerian National Oil Corporation (“NNPC”) and exploration and production companies (“EPCs”) typically concentrate on the development and production of oil with little mention of natural gas. Typical PSC provisions provide that the NNPC and PSC Contractors shall enter into supplemental agreements for the development of natural gas upon discovery of commercially viable quantity of natural gas.

Unfortunately since the popularity of PSCs in the Industry from the 90’s, supplemental agreements for the development of natural gas have not been executed. The absence of clarity of terms for gas commercialization means that significant discovered gas resources remain undeveloped in Nigeria’s PSC assets especially in offshore basins.

In furtherance of the Policy, we are aware that the Ministry of Petroleum Resources (“MPR”) is currently working on a draft Gas Development Agreement (“GDA”) and its release to the Industry is imminent. We note that an essential element of the Policy is to ensure that the GDA terms are to ensure development of gas resources for the benefit of the nation. It is necessary to point out that while this is done, the FGN should ensure that Industry players are widely and sufficiently consulted to ensure the GDA terms are workable from an investor’s perspective.

Also the GDA terms should ensure that PSC contractors are sufficiently incentivized to engage in gas development. Where this is done the gas potential of the nation may be unlocked.

Compliance with GDAs |

Contractual disputes between the NNPC and EPCs have historically been a challenge. It is no longer news that PSC contractors have been engaged in various disputes with the NNPC. For example, in recent times JV Partners have alleged NNPC's non-compliance with Repayment Agreements signed in 2016 on the settlement of NNPC's outstanding cash call obligations.

In order to encourage investments into the gas sector, contractual breaches, whether alleged or real, should be minimized by NNPC and the FGN. Absolute compliance with executed GDAs should be a must, if investors' confidence is to be inspired. Contractual non-compliance discourages investments, which will not be in the best interest of the Policy and ultimately Nigeria.

Bottom Line: Policy Reliability |

Reliability and stability is a key success factor, which can make or mar the success of the Policy. The FGN and its relevant ministries, departments and agencies, including the MPR, DoG and NNPC, should ensure that the Policy is not changed at will – do not change the rules of the game midway. Much as risks are to be managed, the absence of stability or confidence in a system, only increases the cost of participation. Financiers may not readily lend, and they would, then at higher premiums, to investors who choose to play in an unstable system. The Policy should be the guiding principle for the development of any gas legislation and any executive or administrative action on gas development and business in Nigeria. Needless to restate, but then, for emphasis, the enormous capital outlay required requires that investors to be reasonably guaranteed that the Policy is reliable and stable. This is necessary for investment decisions and protection.

For further information on the foregoing, please contact Oyeyemi Oke (oyeyemi.oke@ao2law.com) with the subject: **"The National Gas Policy - Examining the six critical success factors"**



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Oyeyemi Oke leads the Energy, Finance and Projects group of the firm. He is dual qualified as a lawyer and chartered accountant, and holds a Masters of Law from the University of KwaZulu-Natal in South Africa. Oyeyemi graduated with second class upper division from the Nigerian Law School and the Lagos State University, where he made distinctions in Company Law, Land Law and Public International Law.

Oyeyemi has about a decade of experience and has worked in the legal services division of an indigenous oil and gas company, where he advised on various energy, finance, mergers, acquisition and tax related issues.

Prior to joining AO2 Law, Oyeyemi was Senior Associate at Templars where he specialized in Energy, Projects, Finance and Tax practice areas.

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