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DOMESTIC CRUDE SUPPLY OBLIGATIONS: BOON OR BANE FOR NIGERIA'S PETROLEUM INDUSTRY?

INTRODUCTION

On 29th July 2024, the Federal Executive Council ("FEC") directed the Nigerian National Petroleum Company Limited ("NNPCL") to commence sale of crude oil to domestic or local refineries in Nigerian Naira in place of the largely prevalent practice of sale in United States Dollars (the "Directive").[1] The Directive as approved FEC, would commence on 1st October 2024, starting with crude oil sales to the Dangote Refinery. This Directive which is poised towards stabilizing prices of petroleum products in the country and perhaps ease the pressure on the Nigerian Naira with respect to sourcing of foreign currency, came in response to concerns raised by the management of the 650,000 barrel per day (BPD) capacity Dangote Refinery which commenced operations early this year.

The management of the Dangote Refinery raised concerns about its inability to purchase crude oil for its operations from domestic producers, inclusive of International Oil Companies (IOCs). Sequel to that, the Dangote Refinery called on the Nigerian Upstream Petroleum Regulatory Commission (the "Commission") to intervene by ensuring that the provisions of the Petroleum Industry Act 2021 (the "PIA") are fully complied with by crude oil producers in the country. This call by the Dangote Refinery for the intervention of the Commission, is premised on the claim by the Dangote Refinery that its efforts to purchase crude oil from local producers had resulted in an additional premium of up \$3 to \$4 per barrel[2] above the international benchmark rate for the purchase of crude oil from international producers outside Nigeria. This is despite the fact that the purchase of crude from such international producers will entail additional costs for freight, insurance and other associated costs.

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[1] FEC approves sale of crude oil to Dangote refinery in Naira (thecable.ng).
It is necessary to mention that AO2LAW has been involved in transactions in which sale of crude oil to local refineries has been denominated in Naira on a "willing buyer-willing seller basis".
[2] https://nairametrics.com/2024/08/09/we-are-still-unable-to-get-full-supply-of-crude-oil-from-domestic-producers-dangote-group/.

Expectedly, the Directive has sparked a wave of discussions within the petroleum industry. Many stakeholders have raised concerns about the ripple effects of the Directive on subsisting contracts, future contracts and overall market dynamics.

This briefing note aims to bring clarity to these concerns from both a legal and commercial perspective, while examining the legal framework that governs the Domestic Crude Supply Obligations ("DCSO") of crude oil in Nigeria.

LEGAL & REGULATORY FRAMEWORK FOR DOMESTIC CRUDE SUPPLY OBLIGATIONS IN NIGERIA

Crude oil is one of Nigeria's biggest export products which generates about 80% of the country's revenue and considerably impacts the nation's gross domestic product.[3] The Nigerian petroleum industry is primarily regulated by the PIA, which came into force with the purpose of clearing the path for the growth and development of the Nigerian petroleum industry. With regard to the domestic supply of crude, Section 109 of the PIA clearly outlines the framework for the DCSO mandate while the Production Curtailment and Domestic Crude Oil Supply Obligation Regulations 2023 (the "Regulation") issued by the Commission pursuant to the PIA,[4] provides the practical guidelines for the implementation of the DCSO mandate in Nigeria.

DCSO is a regulatory requirement imposed by a government on petroleum producing companies to allocate a certain portion of its crude oil production for domestic consumption, which is aimed at ensuring that the local market has sufficient supply to meet its energy needs, particularly for refining into petroleum products like gasoline, diesel, and kerosene, which are essential for the country's economy. Section 318 of the PIA defines DCSO as:

> *"The obligations of an upstream crude oil producer to dedicate a specific volume of crude oil towards the domestic refineries as stipulated in section 109 of this Act"*.

The practice of DCSO is implemented in various forms across the globe by oil producing countries to ensure that their domestic markets are adequately supplied with crude oil.[5] This

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[3] The GDP Report for Q4 2023 by the Nigerian Bureau of Statistics reported that Crude oil exports contributed up to 4.70% to Nigeria's GDP.

[4] Section 109 (2) Petroleum Industry Act 2021.

[5] See for instance, Article 78 of the Republic of Angola Petroleum Activities Law 10/04 of 12 November 2004, which mandates the National Concessionaire and its associates upon notice from the Government of Angola, to supply an entity appointed by the Government with a quantity of petroleum aimed at satisfying the domestic consumption requirements of the Republic of Angola.

practice is particularly important for countries that are both major oil producers and have significant domestic energy demands such as Nigeria.

As we have highlighted, the crux of the DCSO mandate in Nigeria is as encapsulated in Section 109 of the PIA which essentially aims to ensure the adequate supply of crude oil and condensates to the domestic market. It is to be pointed out however, that the PIA envisages that the implementation of the DCSO mandate as between petroleum producers and local refiners of crude must be on a willing buyer - willing seller basis,[6] predicated on commercially negotiated terms without coercion or imposed conditions from the government, except: (i) there are unreasonable obligations demanded of the refiner;[7] or (ii) the failure to enter the contract under voluntary market condition is due to a default of the refiner in the judgment of the Commission.[8]

This market-centric approach adopted by the PIA as it relates to the DCSO, is to achieve two main objectives namely: (i) to ensure that the price of crude oil in the local market is largely determined by market forces as opposed to pre-determined or fixed prices by the regulators; and (ii) to ensure that the price of crude oil in the local market is, by and large, reflective of the international benchmark price for crude oil while easing pressure on the Nigerian Naira with respect to the demand for foreign exchange.

The Commission is authorized to issue guidelines and enforce penalties for domestic supply obligations, while the Nigerian Midstream and Downstream Petroleum Regulatory Authority (the "Authority") is responsible for regular reporting of the needs of refineries in terms of shortage, crude oil requirements or inadequate supply of crude oil, to the Commission. The PIA stipulates that crude oil is to be sold to operational licensed refineries in Nigeria. The PIA also envisaged that the provision of payment guarantees by refineries who intend to purchase crude from petroleum producers is a key commercial instrument to safeguard payment of products delivery, with transactions conducted optionally in US dollars or Naira as maybe agreed by parties. However, by the Directive, FEC has now mandated that the payment for the sale of crude oil by NNPCL to domestic or local refiners shall now be in Naira.

The practice of DCSO in Nigeria does not limit the quantity of crude oil or hinder petroleum producers from exporting same to other countries as long as they comply with their obligation to supply the imposed quantity to domestic refineries. The Regulation empowered the Commission to require fulfilment of DCSO as a condition for granting export permits. To this end, the Regulation provides that: (a) all export permit applications must be reviewed and endorsed by Commission; (b) approval of export permits will consider the production quota assigned by Commission relative to the lessee's DCSO; and (c) Commission will not approve any export permits or export quantity that would breach a DCSO.[9]

[6] Section 109 (1) Petroleum Industry Act 2021.
[7] Article 12 (4) the Production Curtailment and Domestic Crude Oil Supply Obligation Regulations 2023.
[8] Article 12 (5) of the Production Curtailment and Domestic Crude Oil Supply Obligation Regulations 2023.
[9] Article 9(2) of the Production Curtailment and Domestic Crude Oil Supply Obligation Regulations 2023.

APPRAISING THE DCSO REGIME IN NIGERIA

As contemplated under the Regulation, when the Authority informs the Commission of crude oil supply shortages or inadequate refinery conditions, the Authority shall provide a written confirmation detailing: (i) the refineries affected by the shortage;(ii) the volume of such shortage or inadequate supply condition;(iii) the reason behind such shortage;(iv) the specification of the crude oil; and (v) any other relevant information. Following this, the Commission shall issue a Request for Quotations ("RFQ") to all petroleum producers for quotations to supply the required volume. The RFQ will specify the volume, location, crude oil grade, price, and response time. Upon receiving responses, the Commission will provide this information to the affected refineries to facilitate contracts on a willing buyer and willing seller basis, giving the refineries the opportunity to interface with the petroleum producers on price and other commercial points. The Commission may intervene if unreasonable demands are made on the refineries by the petroleum producers by imposing an obligation on the petroleum producer to supply the necessary volumes required, with the Authority being notified of such intervention.[10]

When imposing DCSO on petroleum producers, Regulation 13 of the Regulation provides that the Commission will consider/select petroleum producers based on the proximity and accessibility of their production to the refinery's location, as well as whether the crude specification meets the refinery's grade requirements. In the event that multiple upstream producers meet these criteria, the Commission will allocate volumes to each producer proportionally, taking into account their existing contracts with refineries, total production, existing export commitments, and production quotas. In carrying out such obligations, petroleum producers are required to sell the allocated crude oil volumes to the designated refinery and no other. Under the Regulation, the parties have the option to trade in US Dollars or in the local currency Naira, as mutually agreed by the parties. However, this option has now been affected by the FEC Directive to NNPCL. It is worth noting that any petroleum producer who fails to comply with the DCSO regulations, including not entering a contract for delivery of DCSO volumes or failing to deliver such volumes, will be subject to an administrative fee of 15% of the fiscal price of the non-delivered DCSO. This fee will be payable to the Commission unless the producer can demonstrate that the non-compliance was due to a force majeure event, default by the refiner (buyer), or other reasons deemed acceptable by the Commission.[11]

In the event that a refiner fails to lift the petroleum product within the scheduled delivery window, resulting in production curtailment, the Commission shall suspend the refiner from receiving future allocations of DCSO for a period determined by the Commission. This suspension will also apply if the refiner defaults on payment for allocated crude. Additionally, the refiner shall

[10] Articles 12 (4) & (6) of the Production Curtailment and Domestic Crude Oil Supply Obligation Regulations 2023.

[11] Article 18 (2) of the Production Curtailment and Domestic Crude Oil Supply Obligation Regulations 2023.

be liable to pay penalties equivalent to the delayed royalties from the deferred volume, along with any other penalties specified in the sales agreement between the parties.[12]

Similarly, if the refiner fails to offtake the allocated DCSO (except in cases of force majeure), take-or-pay obligations shall apply to the barging, pipeline, or truck service delivery of the DCSO. In the case of marine delivery, the defaulting refiner shall incur liquidated damages if the petroleum producer is forced to sell the allocated crude as distressed cargo.[13]

CHALLENGES ASSOCIATED WITH IMPLEMENTING THE DCSO REGIME

While the implementation or practice of DCSO is intended to enhance local refining capacity, reduce fuel imports, and stabilize the domestic energy market, petroleum producers face significant challenges in complying with these mandates. These challenges are typically technical, logistical, regulatory and economic[14] in nature.

Technical Challenges

From a technical perspective, the state of Nigeria's refineries presents a formidable challenge. The country's refineries (particularly, the government-owned refineries) are largely outdated, and inoperative due to years of neglect, inadequate maintenance, and technical inefficiencies. As a result, even when crude is supplied domestically as mandated, the refineries are often unable to process it efficiently or at full capacity, with the exception of privately owned refineries who may be able to offtake such crude albeit at significantly less volumes. This inefficiency reduces the overall incentive for petroleum producers to comply with the DCSO since the crude oil may not be effectively utilized, leading to a scenario where producers feel they are supplying a resource that is underused or wasted.

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[12] Paragraphs 5.3 and 5.4 of the Guideline for Operationalization of Domestic Crude Supply Obligations 2024.
[13] Paragraph 5.5, ibid.
[14] The economic challenges associated with implementing the DCSO Regime are discussed in detail under the "Implications of the FEC Directive" subheading in this briefing note.

Infrastructure and Logistic Challenges

Logistics also play a significant role in hampering compliance with DCSO. Nigeria's oil transportation infrastructure is notoriously inadequate, with a significant portion of the pipelines and other delivery systems being vulnerable to vandalism, theft, and sabotage.[15] The lack of a reliable and secure supply chain for transporting crude from the fields to the delivery points agreed by parties adds another layer of complexity to compliance. Petroleum producers must invest in costly security measures and sometimes face delays in delivery, which can disrupt operations and lead to financial losses. Moreover, the congested and underdeveloped transportation networks often lead to bottlenecks, further complicating the logistics of meeting the DCSO mandate.

Regulatory Concerns

The regulatory environment in Nigeria introduces an added layer of complexity. The frequent changes in government policies, coupled with a lack of clear and consistent enforcement mechanisms, creates uncertainty for petroleum producers. The ambiguity in policy implementation, including the criteria for meeting DCSO and the penalty for non-compliance are potential sources of disputes between the government and oil companies. This uncertainty can result in companies hesitating to invest fully in the necessary infrastructure and processes to meet these obligations.

Addressing the foregoing challenges requires a comprehensive approach, including upgrading refinery infrastructures, improving transportation logistics, and creating a more stable and predictable regulatory framework. Only then can the objectives of DCSO be fully realized, contributing to Nigeria's energy security and economic stability.

IMPLICATIONS OF FEC'S DIRECTIVE

The FEC directive to NNPCL mandating the sale of crude oil in Naira to domestic refineries marks a significant shift in Nigeria's oil and gas sector, with wide-ranging implications for international investors, existing contracts, and future agreements. This move, which departs from the previous regulatory practice as backed by the Regulation, of allowing transactions in either United States Dollars or Naira, introduces new dynamics that could reshape the investment landscape in the country.

For international investors, the Directive introduces an element of currency risk that was previously mitigated by the option to transact in United States Dollars. The Naira has been historically volatile, often subject to fluctuations driven by economic policies, foreign exchange reserves, and global oil prices. With the Directive, international investors must now navigate the risks associated with exchange rate volatility, which could erode their returns when

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[15] https://www.vanguardngr.com/2024/08/pipeline-vandalism-oil-theft-others-reduce-nigerias-output-by-27.4m to-1.4m bpd in 10yrs/.

repatriating profits. This increased currency risk could make Nigerian crude less attractive to foreign investors, potentially leading to a decline in foreign direct investment in the petroleum sector. Moreover, investors may demand higher returns to compensate for the additional risk, thereby raising the cost of capital for petroleum projects in Nigeria.

For future contracts, the Directive will likely influence how agreements are structured, with an increased emphasis on currency provisions for domestically traded crude with refineries. Parties to crude oil sales agreements will need to consider hedging mechanisms to protect against currency depreciation and ensure that contracts are robust enough to accommodate currency fluctuations.

Be that as it may, the Directive offers the opportunity to strengthen the Naira by increasing demand for the local currency, which can help stabilize its value and reduce reliance on foreign currencies like the United States Dollars. It could also foster the growth of domestic refineries by making it easier for them to purchase crude oil without the need for foreign exchange. This could engender increased local refining capacity, reduced importation of refined petroleum products, and increased supply of petroleum products within the country at lower prices as the issues associated with the dependence on foreign currencies would have been eliminated, thus strengthening the country's drive for energy security.

CONCLUSION

The Directive marks a significant shift in Nigeria's energy sector. While intended to strengthen domestic control and economic stability, it has sparked mixed reactions among industry stakeholders. The existing statutes, such as the PIA and Regulations, set clear guidelines for domestic crude oil supply, balancing market regulation with fair trade practices.

However, the anticipated effects of the Directive on the Nigerian petroleum industry call for circumspection in its implementation. Potential conflicts with existing contracts and relations with petroleum producers are real concerns that must be managed carefully. As Nigeria navigates these changes, it will be crucial for the government, regulators, and industry players to collaborate effectively, ensuring that the objectives of the new policy are met without undermining the broader stability and growth of the country's petroleum sector.

Please do not treat the foregoing as legal advice as it only represents the public commentary views of the authors. All enquiries on this should please be directed at the key contacts