Implications of Nigeria’s Draft Petroleum Fiscal Policy

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Further to our issue of Deloitte Tax Alert - ‘Ministry of Petroleum Resources Releases Draft National Petroleum Fiscal Policy’, we have analyzed the provisions of the proposed Petroleum Fiscal Policy and highlighted the implications thereon for stakeholders, especially businesses.

Recent moves by the current government has rekindled the possibility in the short term of establishing a sustainable oil and gas industry, with a vibrant regulatory and socio-economic environment, as predicted in the Petroleum Industry Bill (PIB) which is yet to see the light of day. The hope waned as PIB faced unending legislative passage process.
The renewed effort by the Ministry of Petroleum Resources (MPR) at reforming the oil and gas industry has largely been as follows:

- Launching of a roadmap tagged “7 Big Wins” for the petroleum industry back in 2016 aimed at addressing specific issues of policy and regulation, business environment, investment, security, transparency and efficiency in the oil and gas sector.

- Renaming the PIB to “Petroleum Industry Reform Bill (PIRB)” and breaking this up into two to address one of the major challenges (bulkiness) bedeviling legislative passage of the PIB. The two are now:
  
  i. “Petroleum Industry Governance and Institution Framework Bill (PIGIFB) which deals with the governance/institutional aspects and

  ii. “National Petroleum Fiscal Policy” (NPFP) which deals with the fiscal aspects of the industry exclusively and will later form the basis of a subsequent bill

The highlights of the NPFP are summarized below:

All the activities in the oil and gas value chain are covered

The Policy covers all sectors of the petroleum industry - upstream, midstream and downstream, and includes oil and gas products.

However, unlike the PIB, it does not make provision for taxation of Bitumen. This may mean that Bitumen is to be covered exclusively under Companies Income Tax (CIT).

Nigerian Hydrocarbon Tax (NHT)

Just as it was with the fiscal provision contained in PIB, the income of oil exploration and production (E&P) companies will be chargeable to Nigerian Hydrocarbon Tax (NHT) at graduating rates. However, the NHT rates have been favourably revised in the Policy as follows:

- 40% from 50% for onshore operations;
- 30% from 50% for shallow water operations; and
- 20% from 25% for deep water operations.

Bitumen is now 0% NHT from 25% under PIB.

E&P companies to also pay CIT in addition to NHT

As it was with PIB, companies operating in the upstream sector will be subject to CIT at 30% on taxable profits. Thus, the aggregate tax rate considering both NHT and CIT adds up to 70% when compared to 80% per PIB and 85% per petroleum profit tax (PPT). This is more favourable and may encourage upstream operators’ activities.

Reduction of tax deductible items

The Policy proposes a reduction in tax deductible items which may counteract the perceived benefits of a reduced tax rate applying to upstream operators. Deductibility of interest expenses, investment tax allowance and investment tax credits are not provided for under the Policy. Therefore, the proposed tax structure may result in companies paying a higher tax than expected.

No provision for preferential tax rates

Unlike the Petroleum Profit Tax Act (PPTA), which allows E&P operators who are yet to fully expense their pre-production expenditure to be taxed at 65.75% for the first 5 years of commencement of commercial sales of crude oil, the Policy does not provide for such lower or preferential tax rate. This suggests that the tax burden may be relatively higher for upstream companies.

Gas operations is also subject to NHT in addition to CIT

Gas activities is taxed at graduated NHT rates as follows:

- Onshore – 20%
- Shallow water – 15%
- Deep offshore – 10%

Based on the above, aggregate tax (NHT + CIT) is 50%, 45% and 40% for onshore, shallow water and deep offshore respectively. This rate appears less favourable compared to the extant regime.

Recoverability of costs incurred overseas is limited to maximum of 80%

This provision is aimed at discouraging the current practice of companies investing more overseas and encourage companies to invest more in Nigeria, in the spirit of local content policy for Nigerian inclusive economic growth.

Payment of royalty is now to be on the same basis as taxes

There is an increased drive to make royalty a major source of government take in the oil and gas industry.
industry. To achieve this, the Policy proposes the payment of royalty on the same bases as taxes. Hence, the practice of paying royalty based on acreage depth will be replaced with royalty payments based on volume and price of crude oil. This will nearly eliminate the payment of a minor fraction of revenue as royalty by companies operating deep offshore.

Volume and price based royalty payments will be made on a monthly basis based on monthly production rather than quarterly. Also, royalties can be paid in kind (with oil and gas products) or in cash, albeit with prior notice especially for gas royalties in kind. Further, the royalties will be computed as follows:

a. **Volume based royalty**

The Policy provides for royalty based on oil production on graduated scales of 5%, 15% and 20% for onshore and shallow water operations and 5%, 7.5%, 12.5% and 15% for deep water and frontier operations as follows;

- 5% minimum royalty for oil and gas production below 10,000 barrels per day (bpd) for onshore, below 20,000bpd for shallow water and below 50,000bpd for deep water and frontier
- 15% maximum royalty for production above 100 million standard cubic feet per day (mmmscf) for onshore, below 200mmmscf for shallow water and below 500mmmscf for deep water and frontier
- 20% maximum royalty for production above 150,000bpd for deep water and frontier

b. **Value based royalty**

- 0% royalty for crude oil price below $50 per barrel
- A 0.2% increase for every $1 crude oil price increase above $50 per barrel
- 25% maximum royalty rate for prices above $170 per barrel

**Increased capital gains tax rate**

The proposed new legislation also seeks to increase the capital gains tax (CGT) in respect of asset based transactions from 10% to 30%. Based on the propositions in the Policy, the increased CGT rate would only apply to qualifying asset based transactions in the petroleum industry. However, in order to achieve this, amendments may need be made to the Capital Gains Tax Act which is the principal act. The PIRB is however silent on this. The bureaucratic delays that accompany the legislative passage of amendments could effectively pose a challenge to this proposal.

**Amendments to the legislation**

In a bid to ensure fiscal neutrality of each segment of the value chain, the policy proposes:

a. **Removal of associated gas fiscal (AGFA) incentive**: The incentive for investment in downstream gas utilization (sections 11 and 12 of the PPTA) where oil and gas companies relieve both capital and operating expenditures against oil income is no longer applicable. With this proposition, gas operations will be treated similarly to oil operations with their expenses relieved directly from gas revenue, and will be treated as a standalone operation subject to NHT.

b. **Amendment of section 39 of CITA**: to include midstream oil utilization as an addition to gas utilization projects. This move would enable midstream operators (including LPG projects and LPG infrastructure) enjoy gas utilization incentives.
Incentives for low cost and small field operators

The Policy proposes a system of incentive bonus for efficient low cost and small operators.

As part of the proposal, a flat rate of 5% royalty will be chargeable on small field operators. It also proposes significant production allowances under the NHT that will reduce the tax rate for small fields to 0%. However, it did not define low cost and small field operators and this may leave room for ambiguity. Also, the policy did not clarify the definition of “significant allowances”.

Introduction of production allowances as a preferred fiscal instrument over cost based incentives

The Policy seeks to give credence to production allowance as the preferred fiscal tool to improve the oil and gas sector. By basing petroleum allowance on production rather than cost, the government is seemingly aimed at compelling upstream operators to run cost efficient operations and focus more on improving oil and gas yield. Petroleum allowances will be limited by cumulative production and terrain as follows:

- **Onshore:** Onshore operators with cumulative production not exceeding 10 million barrels can claim the lower of; 30% of value of oil production or $20 per barrel of oil production as production allowance. For onshore cumulative production ranging between 10 million barrels to 75 million barrels, production allowance can be claimed as the lower of; 30% of value of Oil production or $10 per barrel of oil production.

- **Shallow water:** Shallow water operators with cumulative production not exceeding 20 million barrels can claim the lower of; 30% of oil production value or $20 per barrel of oil production as production allowance. For shallow water cumulative production ranging between 20 million barrels to 150 million barrels, production allowance can be claimed as the lower of; 30% of oil production value or $10 per barrel of oil production.

- **Deepwater:** Deepwater operators with cumulative production not exceeding 500 million barrels can claim the lower of; 30% of oil production value or $7 per barrel of oil production, as production allowance.

The Policy also provides for production allowance for gas and condensates at similarly unique graduating rates.

Removal of deductibility of acquisition costs under qualifying capital expenditure

The Policy proposes non-deductibility of acquisition costs. As a justification for this proposal, the policy drafters explained that deductibility of acquisition costs, combined with low capital gains tax, tax holidays and pioneer status granted to some oil and gas companies following the recent divestment by some IOCs, has resulted in reduction in government take which should not continue.

This proposal may not be well received by certain stakeholders.

Tax holiday/carry forward of tax losses

Although the Policy expressed concern about government revenue leakages as a result of the above incentives, it did not categorically recommend their discontinuation. It will be better for the policy to be explicit on the Government’s position on these incentives going forward.

Other fiscal reforms

Other fiscal reforms proposed by the Policy include:

- Removal of gas flare penalties from qualifying deductions. This implies that gas flare penalties will not be allowed as deduction from revenue in determining the total profit.
- Improved fiscal terms for midstream oil and gas investments. For instance midstream projects such as crude oil and product transportation systems and refineries will now benefit from similar terms obtainable under Section 39 of CITA. This would ensure that processing of hydrocarbons and other extraction activities enjoy the same fiscal benefits and are kept distinct from the upstream activities.
Conclusion

It is evident that this Policy aims to increase take by the Nigerian government from the oil and gas industry especially the deep offshore while ensuring that incessant abuse of incentives is curbed and small players are given an enabling environment to thrive, albeit in the short term.

Nevertheless, the Nigerian government needs to strike a balance between the country’s drive for increased oil revenue in the short term, and the long term guarantee of revenue from the major players in the industry through taxation. We can only hope for the quick passage of the relevant legislation that will provide legal teeth to the thrusts of this current policy for the benefit of the industry.

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This is by no means an exhaustive documentation of the proposed Policy. Readers are enjoined to read the Policy proposal in full and take independent advice thereon.

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