TEMPLARS

LEGAL AND COMMERCIAL IMPLICATIONS OF THE PROPOSED PSC (AMENDMENT) BILL 2019

On 15 October 2019, the Senate passed a Bill to amend the Deep Offshore and Inland Basin Production Sharing Contract Act[1] (“**PSC Act**”). The Deep Offshore and Inland Basin Production Sharing Contract (Amendment) Bill 2019 (the “**PSC Amendment Bill”** or “**Amendment Bill”**) was ostensibly passed in the spirit of section 16 of the PSC Act and, as much as possible, to ‘*equalize*’ the State’s and investors’ interests in crude oil resources in the deep offshore and inland basin.

Section 16 of the PSC Act permits a review of the Act to ensure that the Federal Government of Nigeria (“**FGN**”) benefits should prices exceed the set threshold of US$20 per barrel, in real terms. In any event, the section also permits a review of the Act after 15 years from its commencement and thereafter, every subsequent 5 years.

Overview of PSC Amendment Bill 2019

The Amendment Bill passed by the Senate apparently seeks to achieve four primary objectives, which are to: (a) replace the existing graduated water depth based royalty regime under the PSC Act with a flat rate for all deep offshore and inland basin Contract Area, in addition to a price-based regime; (b) eliminate the crude oil price based review requirement of the extant PSC Act; (c) mandate the Minister to cause the Corporation to call for a review of the production sharing contracts every 8 years; and (d) prescribe a penalty for non-compliance with obligations under the Bill.

Of these amendments, the revised royalty regime will clearly have the most substantial market implication in the immediate term. The focus of our commentary will therefore be on that aspect of the Amendment Bill which seeks to revamp the existing royalty regime.

New Flat Royalty Rate

The Amendment Bill eliminates the previous royalty rates based on graduated scale of various water depth and replaces it with a flat rate of 10% of the chargeable volume of crude oil and condensate produced, which applies to all areas with water depth in excess of 200 meters, i.e. deep offshore, and 7.5% for the inland basin.

This implies that regardless of the water depth or the price of crude oil, all operations in the deep offshore and inland basin are now subject to a flat rate of 10% and 7.5% respectively. In addition to the newly proposed flat rate, a price based royalty regime will apply with increasing rates for various price brackets.

Price-Based Royalty Regime

Under the additional price-based regime, no added royalty is payable on the first US$20/barrel. The US$20 benchmark appears to have been derived by reference to the US$20/ barrel threshold specified under section 16 of the extant PSC Act. However, the Amendment Bill appears not to have taken cognizance of the requirement that the US$20/barrel benchmark has to be the “real term” value of US$20. In other words, the US$20/barrel benchmark specified in section 16 of the extant PSC ought to be the present

[1] Cap. D3 Laws of the Federation of Nigeria, 2004

day equivalent of the value of US$20 as at 1993.[2]

The royalty rate applicable for other price brackets include: (a) 2.5% for prices above US$20 and up to US$60/barrel; (b) 4% for prices above US$60 and up to US$100/barrel; and (c) 8% for prices above US$100 and up to US$150/barrel; and (d) 10% for prices above US$150.

Implications of the new Royalty Regime

In comparison to the previous regime, the newly introduced flat rate plus price-based royalty regime, if eventually it is enacted into law, will improve the economic benefit of PSCs to the FGN regardless of the price of crude oil in the market.

However, from the perspective of the PSC Contractors, the proposed new royalty regime will without doubt, create additional liability on their operations. Under the extant PSC Act, Contract Areas located in areas beyond 1000 meters water depth are not liable to pay any royalty at all. On the other hand, the proposed royalty regime under the Amendment Bill imposes a minimum royalty rate of 10% on all deep offshore[3] PSCs, regardless of their water depth plus, additional royalty liability where crude oil prices exceed the US$20/barrel benchmark.

For example, where crude oil prices are US$35/barrel and a Contract Area is beyond 1000 meters water depth, under the prevailing royalty regime, such Contract Area has zero royalty liability. However, under the royalty regime proposed in the Amendment Bill, the same Contract Area will be liable to pay a minimum of 10% of the chargeable volume of crude oil and condensate produced, plus 2.5% of US$15 (the premium element above the US$20/barrel benchmark) multiplied by the chargeable volume of crude oil and condensate produced.

This could potentially alter the economics of a number of the existing deep offshore PSCs.

■ *Implication for PSC Renegotiations*

The increased royalty liability arising from the Amendment Bill, if passed into law, is also likely to have significant impact on the economics of the current renegotiations of some of the 1993 PSCs which are nearing the end of their terms and subject to renewals. It is not inconceivable that IOCs would want to leverage on the increased royalties to push back on the quantum of increased share of crude oil production revenue that the Government may be aiming for, or request a higher cost cap than they were initially willing to consider.

■ *Potential for Future Disputes*

Further, whilst the revision of the royalty regime should have no impact on past disputes and obligations, it could throw up potential interpretational differences between the FGN and IOCs which could lead to new disputes. For example, purposive interpretation suggests that where crude oil price exceeds US$20/barrel the respective additional royalty rates should apply according to the specified price bracket, as opposed to applying the rate of the final price bracket to the entire premium element above US$20. To illustrate the point, if we assume that the crude oil price at a particular time is US$70, our reading of the Amendment Bill is that the royalty liability will be determined by first applying the 10% flat rate, followed by a rate of 2.5% on the amount above US$20 and up to US$60/barrel; and finally followed by a rate of 4% on the remaining amount from US$61 to the hypothetical price of

[2] The year the PSC Act was deemed to have commenced despite being enacted in 1999.

[3] Section 17 of the extant PSC Act defines deep offshore to mean any water depth beyond 200 meters.

US$70/barrel. Yet, it is not inconceivable that the FGN could take the view that the 4% which applied to the final price bracket of $61 to $70 should instead apply from the amount above US$20 and up to the hypothetical price of US$70/barrel. Indeed, such an interpretation-based dispute has been experienced under some existing royalty regimes. For instance, under the production-based royalty regime where royalty rates vary according to production brackets in a similar manner to the price bracket proposed in the Amendment Bill, the State parties (NNPC and DPR) have, in a previously contested royalty dispute, applied the rate applicable on the final production bracket on the entire production.

- ***Potential Stabilisation Trigger***

Finally, questions around potential stabilisation triggers are also likely to arise. Briefly, stabilisation clauses in investment agreements such as PSCs were designed to mitigate against political risks associated with changes in law, policy, directives, procedure etc. by the State which could have material and adverse effects on a private counterparty. Regardless of any argument around whether this amendment was foreseen / foreseeable at the time the PSCs were executed, the fact remains that there will (likely) be a change in law, a key element for triggering a claim for stabilisation. Our analysis[4] suggests that a successful claim for stabilisation would rest more on whether an analysis of the economics involved, reveals a material and adverse effect on the economic benefit or expectations of the PSC Contractors. All things considered, it will be interesting to see if the PSC Contractors are willing to take a bet on countering the effect of the potential change in law through stabilisation.

Conclusion

In conclusion, whilst the undisputable intent of the Amendment Bill is to increase Government earning, the introduction of a flat rate plus price royalty regime appears to discard the spirit behind the incentive in the first place, which was to reward Contractors for the effort of conducting petroleum operations in a difficult terrain in the deep offshore. That may well be a reality that PSC Contractors have to accept or challenge through contractual remedies available to them, including (but not limited to) a claim for stabilisation.

We will continue to monitor developments on the Amendment Bill as it moves through the legislative process and up to possible enactment by the assent of the President. We shall update our commentary on the Bill as developments unfold.

[4] For a fuller analysis on the potential issues around stabilisation kindly contact the under listed contact persons.

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