

“BOOM OR BUST - The PIB and Gas Sector Liberalisation in Nigeria”

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1.0 INTRODUCTION

Nigeria has been struggling to develop its domestic gas market and to maintain its position as a major player in the global gas business over the past decade. Anyone familiar with the process will appreciate that the strategies adopted by the four administrations over this period have been more or less the same – essentially a pseudo - liberalist policy masked under appellations such as: “*Nigerian Natural Gas Strategy*”, “*National Gas Masterplan*”, “*Nigerian Gas Revolution*”.

2.0. OUR ENQUIRY

The issue for enquiry in this paper is whether the attempt by the Government to reform the gas sector through the Petroleum Industry Bill (PIB) will ensure the liberalization of the gas sector in Nigeria and, ultimately, Nigeria’s industrialization. This paper will take a view of global developments and, ascertain the relevance, responsiveness and appropriateness of the PIB’s provisions for the development of Nigeria’s gas resources vis – a vis Nigeria’s development needs. The ultimate question is how transformational will the PIB be for our gas sector, and ultimately, for the Nigerian economy?

3.0 PIB OBJECTIVES

The broad objectives of the PIB are set out in the first section of the Bill. The specific objectives of most relevance to our discussion this afternoon are the following:

- “optimize domestic gas supply for the power and industrial sectors” (S.1(c))
- “establish a progressive fiscal framework that encourages further investment in the petroleum industry” (S.1(d))
- “deregulate and liberalise the downstream petroleum sector” (S.1(f))
- “create efficient and effective regulatory agencies” (S.1(g)).

Let us now examine how or whether these objectives stack up.

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i. Optimization of domestic gas supply for the power and industrial sectors

The Gas sector in Nigeria holds out significant economic potential to Nigeria. The reserve base is world class whilst demand is growing rapidly.

In response to growing demand for gas from the power and industrial sectors, the Government introduced a *Domestic Gas Supply Obligation* on holders of gas reserves and facilitated the process for the establishment of a Domestic Gas Aggregator. These initiatives are preserved in the PIB – and that is a plus for the future direction of the sector.

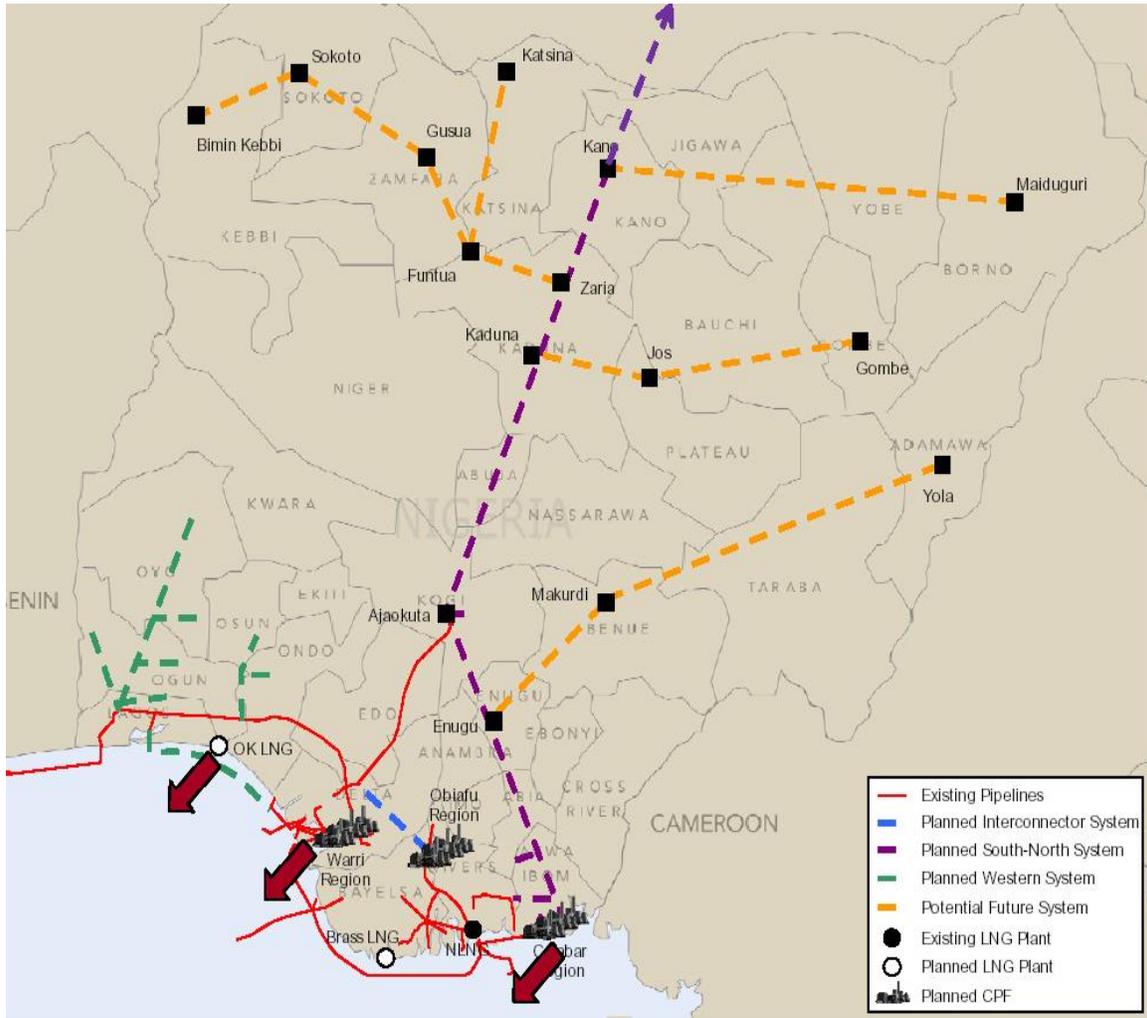
Undoubtedly, the development of gas infrastructure will help accelerate Nigeria's elusive and much desired industrial development and economic growth. Acknowledging the inadequacy of the existing gas processing, transmission and distribution infrastructure to support the current demand, Nigeria has adopted a national **Gas Infrastructure Blueprint** (see Diagram on page 3) that seeks to address the need for rapid deployment of gas infrastructure to the main cities.

ii. Would the fiscal framework encourage further investment in the gas sector?

It has been argued that new gas infrastructure should be developed with public funds where such projects are not bankable for the private sector, yet are of strategic value to the development of the network. On the strength of this argument, the treasury should fund every piece of infrastructure going forward since virtually every new infrastructure is strategic and unbankable given the fact that the market is at its very early phase. In my humble view, there are more innovative ways to achieve rapid infrastructure roll out but the PIB does not provide a robust response to this possibility nor to the urgency of the country's needs for energy security as it does not adequately incentivize private sector investment in infrastructure. Rather, it embeds orthodoxy, which is the current fiscal framework for downstream gas projects (Nigeria's outdated Industrial Policy, the Companies Income Tax, and Education Tax, essentially).

The diagram below shows several proposed pipelines for the transportation of gas to some population load centers in economically disadvantaged states of Nigeria. These are multiple projects which require a significant amount of funding presumably by the Federal Government. However, the opportunity cost for the funding by the Government of the development of these proposed pipelines and associated infrastructure is the loss of critically required funding in other social sectors such as the health and education sectors that are less amenable to private sector capital. Surely, a fiscal break for private sector investors in such infrastructure and related anchor downstream projects (think power stations, fertiliser and petrochemical projects) will be a better solution. Such projects are “pioneer” project within the

contemplation of Nigeria’s existing national industrial policy, albeit in this case, they should enjoy a better fiscal break than what currently exists under the current framework. These are the sort of issues that one would have expected the fiscal provisions of the PIB to resolve.



iii. How does the PIB help achieve deregulation and liberalization of the downstream gas sector?

a. Central to the programme of reform should be a fundamental shift in the role of the Government as an enabler, rather than a leader of the sector. Currently, through various entities, the Government plays multiple roles - as policy-maker, planner, investor and regulator. The PIB promises that the role of the Government should be to create an attractive environment for the rapid development and expansion of the downstream gas sector through private sector involvement. However, it fails miserably on this score. It actually seeks to embed the currently outmoded “statist”

structure of multiple roles for government investment in the sector. We should realize by now that a continued policy of Government sponsored monopolies is inconsistent with the desire for significant private sector involvement in the gas sector.

In spite of very clumsy drafting, one can see that Nigerian Gas Company Limited, the operator of the gas network and NNPC's subsidiary, will mutate into Nigerian Gas Company PLC, a super Government – owned gas company. It is proposed that 49% of its shares will be divested to the public by listing on the Nigerian Stock Exchange (NSE) within 6 years of its incorporation. The question arising is: must government continue to control this company? Surely, we all know that deregulation or liberalization of a sector does not occur when Government remains in its commanding heights. On this score, the PIB provisions are internally inconsistent with its stated policy objectives.

b. The PIB introduces several tools for the regulation of the gas sector:

- A licencing regime
- Competition regulation
- Third Party Access Rules
- A Network Code
- Connection Agreements
- Market rules
- Pricing principles

These are the typical tools and instruments that one should expect in a sector moving towards liberalization. However, whether these regulatory tools will be effective in the spectre of a sector under the overwhelming control of the Government (Q: can Government regulate itself?) remains to be seen.

iv. Does the PIB create efficient and effective regulatory agencies for the gas sector?

a. The model of sector oversight proposed by the PIB does not in fact promise independent regulation of the gas sector. Sections 6 (1) (g) and (h) preserves the old model of sector regulation – the Minister continues to grant licences upon the advise of the Downstream Petroleum Regulatory Agency (Agency). To make matters worse, members of the board of the Agency do not have protection (security) of tenure that those on the board of the Nigerian Electricity Regulatory Commission (NERC) have. To all intents and purposes, the board members have a “grace and favour” appointment i.e. at the pleasure of the President. This further undermines their independence. To the extent that the Agency cannot take decisions independent of the Minister, or operate under a regulatory structure similar to that which exists in the electricity sector, where the Minister for Power is in charge of policy and NERC

independently regulates that sector, then we should expect regular political interference in gas regulation, which will ultimately result in inconsistent regulation between the power and electricity sectors.

b. The regulatory model proposed for the gas sector has two separate commercial and technical regulators for the upstream and the downstream. This is in an era when the whole polity is concerned about the size of Nigeria's bureaucracy. But on a more technical note, one regulator with 2 divisions (upstream and downstream gas) or structured along specialized activities (Technical and Commercial Divisions) would be more "*effective and efficient*" for sector regulation *a la* the efficiency desideratum in S.1 of the Bill.

On another technical note, and this is my experience: it is always difficult to identify a fine line between the upstream and the downstream, less so between the respective technical and commercial teams. The industry should therefore expect a new era of regulatory conflicts between the upstream and the downstream.

In addition to that, there is a substantial regulatory issue, which is that one of the hallmarks of effective regulation is for a regulator to be able to have unfettered access to information within the regulatory space. That information is extremely useful for the policy people and will ultimately help in sector direction. The PIB unfortunately creates two regulators in a network bound sector. This can only lead to asymmetrical information being considered by both and acted upon in a dynamic chain. As such, we should expect gaps in regulation and the regulatory ball to be regularly dropped between both regulators. And of course, gaming by operators will occur.

The long and short of this is that the energy chain is one interrelated chain and the separation of regulatory agencies does not help create "*efficiency and effectiveness*". Hence, expect efficiency losses and inconsistent regulation from this regulatory split.

To illustrate, a number of incumbent players in the sector currently operate both in the upstream and the downstream. The sector is however moving rapidly towards the midstream, and we will, in short order, witness a fair level of integration of entities from wellhead through gas utilization, especially in power generation. The promoters of these entities will leverage on assets in both segments to achieve efficiency gains for their affiliates through cross – subsidization, management integration and other similar commercial efficiency/value optimisation strategies. One questions the vision of the draughtsmen of the PIB on this issue – how have they positioned the regulator to capture these plays or games, moreso in an era of two separate regulators within the gas chain?

Functionally separate markets for gas sales, transmission and distribution with each function performed by separate business entities tends to encourage the

acceleration of natural gas supplies and investment in infrastructure. This is why in most developed jurisdictions, the licensing regime requires the separation of monopoly and commercial interests within the same organisation, at least in management terms, and sometimes in legal terms. This is to prevent the risk, whether real or perceived, that the operator of monopoly services, such as Network Operation or Distribution, will discriminate in favour of its own commercial interests to the detriment of others and the market ultimately. Curiously, the PIB does not explicitly provide for the management of this possibility. This is a significant omission, and it is an issue which is better handled now rather than when the regulatory structure is set and the key players embedded in the system. The only hope, of containing abuse of powers through cross – interests would be recourse to the general competition powers of the Agency to handle such issues in future. It will be interesting to see how these matters will be resolved at that time.

4.0 GLOBAL TRENDS – a global dash for gas

Gas is a globally utilized commodity and it would be useful at this juncture, to undertake a quick competitive review of the global landscape to better appreciate how Nigeria’s gas sits in the global arena, moreso as global trends are beginning to coincide with large structural domestic issues in Nigeria.

United States of America - The US is experiencing an unexpected boom in oil and gas production. U.S. oil production rose at its highest annual rate ever in 2012 to levels not seen in decades. As a result of innovations in hydraulic fracturing and lateral drilling, natural gas production and inventories are at all-time highs.

The US is now positioned to become a substantial global exporter of gas and gas products. On the back of some of the lowest cost natural gas, a slew of greenfield and brownfield projects are under development in the US by industries such as petrochemical, plastics and fertilizer makers who rely on natural gas both as a raw material and an energy source. \$65 billion has been announced for the construction of new plants related to cheaper natural gas and up to \$15 billion in expansion plans have been announced by Gulf Coast chemical makers whilst some players are shipping mothballed plants abroad back to the US. Other energy intensive industries such as automotive, metals and mining, cement, transportation sectors are not left out from this bonanza.

Other regions and countries also have significant gas reserves:

- **East Africa** has become an Eldorado for the world’s biggest oil and gas companies². The new oil and gas discoveries in Kenya, Malawi, Mozambique, Tanzania, Madagascar, Uganda are regarded as “gargantuan”. In

² Statoil, ExxonMobil, Shell, Tullow Oil, Ophir, Total, CNOOC, Anardako and ENI.

Mozambique and Tanzania especially, up to 100 tcf of gas has been discovered in the past couple of years – and there are prospects for more giant discoveries. These huge discoveries plus favourable geographic locations and less complicated bureaucracies have positioned these countries for significant gas exports into the Asian markets.

- **China** has the world's largest reserves of nonconventional gas—double the estimated US reserves.
- If we thought that the shale gas revolution is a game changer, we should consider the successful test recently conducted by **Japan** for the extraction of natural gas from methane hydrates 1,000 meters below the surface and 50 miles off its shores. With no energy resource of its own, Japan is determined to commence production of methane gas by 2019. Picture a significant shrinkage in the Asian gas market and its impact on the global energy industry should this ever occur – as it is likely to at some point in the future given the significance of this resource to Japanese national interest. Given the existence of over 100,000 tcf of methane hydrates worldwide (Source: US Geological Survey), this is a potentially massive energy resource which far exceeds the US's 2,074 tcf of shale gas. By comparison, Nigeria's known gas resources are 187 tcf.

If one were to supplant the abundant shale gas with abundant conventional gas supply sources within countries such as Australia, Qatar, Saudi Arabia, Angola, the world seems to be awash with a potential over supply of gas. What all this means is that Nigeria is no longer the only game in town, and days when it had free reign into LNG markets in Europe, the US and Asia are effectively gone, with just about a small window of opportunity left for its gas in Asia.

5.0 WHERE ARE THE MARKETS - A Quick Global Market Survey

Nigeria's traditional natural gas markets [Spain, Portugal, France, USA] are drying up. Energy policy reform and economic crises in Europe has weakened Nigeria's position in the European gas market whilst a natural gas revolution promises soon to make the US a net-exporter of energy.

Let's add to that picture: the discovery of abundant gas resources all over the African coastline, including the well reported case of Mozambique, means that global investors now have more options open to them for where to invest in gas projects such as fertilisers, methanol and petrochemicals. This must mean that Nigeria's policy objective of earning as much from gas exports as it does from oil within a decade of the commencement of sector reforms is no longer attainable in the light of its constrained traditional markets and competition from other new players for market share.

With a shrinking European market, our last export frontier therefore seems to be Asia which is projected to experience rapid growth in energy demand in its juicy markets such as India, Japan, South Korea and China. However, Nigeria will have to contest for access to these markets with major gas suppliers such as the US, Australia, Qatar, Saudi Arabia and East African countries such as Angola, Kenya, Malawi, Tanzania and emergent Mozambique.

Australia, with its gigantic LNG projects is best positioned to supply into this market. But then, so is Saudi Arabia and Qatar. Mozambique and Angola are also better geographically positioned than Nigeria. As for the US, it has repurposed its foreign and trade policies as a matter of strategic national interest, towards Asia. A slew of on – coming free trade agreements with the Asia - Pacific region and Europe would boost U.S. exports including natural gas exports into those markets. These developments do not portend well for Nigeria's gas export opportunities. My guess is that Nigeria will just be about lucky to get the 7th train of the Nigerian LNG and the Brass LNG project off the ground and the country might as well kiss LNG exports good-bye after these projects.

6.0 WHERE DO WE GO FROM HERE?

The global trends are occurring at a critical juncture in Nigeria's political history and these trends raise a further question as to whether or not the PIB has positioned Nigeria to weather the approaching storms.

The current administration inherited the gas sector reform initiatives from its two predecessors. As earlier mentioned, not much has changed between the various administrations of the past 12 years since the policies were initially formulated. There was in fact a sweet spot of 5 years (2005 – 2010) when several global developers of gas-based industries were literally begging to invest in Nigeria's gas due to the high gas prices in Europe, Asia and Americas. That opportunity is literally evaporating before our eyes.

However, the major shifts in the geopolitics of the gas sector and the socio - political economy of Nigeria calls for a radical rethink on gas policy. The drivers for this are clear:- a massive youth bulge which could either be leveraged on to pivot the country for unprecedented growth (**boom**) or topple the country towards irredeemable collapse (**bust**), depending on policy decisions taken or the lack thereof. The employment rate is so low that it creates an atmosphere of insecurity for all; meanwhile there is an abysmal infrastructural deficit in the country that is as much a problem and an opportunity for economic growth; and as far as manufacturing goes, Nigeria has effectively de - industrialized. Nigeria's natural gas, the most abundant of all its resources, has a critical role to play in reversing this gloomy picture. But Nigeria has to be very smart and must act very quickly too.

Another important and relevant dynamic is the apparent aversion of the IOCs for the midstream in Nigeria or even the downstream for that matter, a game that is natural to them and which they play so well in other countries. The unprecedented flight (to safety?) out of Nigeria by Nexen, BG, Conoco Phillips, Shell out of Nigeria or away from onshore assets and the rumoured prospective exit of Petrobras could either be a signal that all is not well in Nigeria (a vote of no confidence?) or a confirmation that there are better plays for investment beyond Nigeria? Is this a case of rats heading for the hills before an earthquake? And how come Nigerian players appear unperturbed by the unprecedented divestment by global upstream players from the country and the non – entry of a single global midstream player in the midstream. Is there something Nigeria should be worried about and should also be doing to attract first-rate players back into the mix?

7.0. RECOMMENDATIONS

In the light of the socio – economic issues plaguing the country, and the need to effectively challenge our competitors for investors in infrastructure and gas based industries, the following recommendations should be considered:

- The policy focus should shift towards accelerated investment in the upstream and gas infrastructure.
- Let the sector be private sector driven. The Government cannot afford to fund the development of gas infrastructure at the pace that Nigeria’s socio – economic developmental requirements. The gas sector is most amenable to private sector capital if the right conditions are put in place. Rather than embed Government as a commercial participant in the sector, consideration should be given to private sector leadership.
- Undertake genuine liberalization of the sector – introduce independent regulation. Investors do place a premium on a solid regulatory code. Nigeria must strive for it.
- Take another look at the fiscal provisions - Our main competition, the USA, has the second highest corporate taxes in the world at 35%. However, state or local tax incentives help offset this. Nigeria should consider a counterweight to this and all options must be on the table. Amongst other possibilities, fiscal inducements should be considered as a strategy for retaining investor appetite in Nigerian gas. This is not novel: afterall the fiscal regime for gas utilization has proven to be the most effective driver for gas project development in Nigeria, particularly major export projects. Potential tax revenues will be lost, but consider that these might never be earned in the first place if the proper conditions are not in place in the currently tight

competitive space for investors. Beyond that, the multiplier effects and positive security/peace dividend to the country will far outweigh these initial fiscal deferments. Nigeria needs to be smart.

There is a good argument against the current fiscal regime for the upstream which allows for the consolidation of capital costs of downstream projects against upstream taxes. However, Nigeria does need a progressive upstream tax regime that still incentivizes investment during a soft global market whilst rewarding the Government when the market strengthens whilst also providing some stimulus in the mid stream and downstream to attract urgently required investment in the domestic market.

The current orthodoxy around government take from gas projects is in my humble opinion outmoded given the recent tectonic shifts in global energy. In fairness to the framers of the PIB and everyone who worked in the backroom of gas sector reform in the early years, we were then at the beginning of a supercycle and every country with significant hydrocarbons was considering a renegotiation of their bargain with investors. Several governments around the world introduced variants of windfall taxes for this purpose. In Nigeria's case, it correctly concluded at that time after a deep level of analysis of fiscal regimes around the world, that the conditions were ripe for a renegotiation of take, hence its proposals made for increased take initially through the proposed Natural Gas Fiscal Reform Bill and subsequently, in the PIB.

That might have been the correct position then; however, so much has and is beginning to happen both in Nigeria itself and in the global energy order that Nigeria is no longer in a position to insist on the fiscal terms proposed in the PIB for the sector – that is if we expect to experience major investment to a level that will stem economic decline and adverse security issues that might follow continued economic decline. My core message today, is that the end of the supercycle for countries such as Nigeria is in clear sight and it must immediately take the radical steps that it must to prepare for the difficult days ahead.

The National Industrial Policy initially framed in 1975 proposed up to 5 years as a tax holiday for “pioneer industries”. That policy was introduced almost 40 years ago and like the Petroleum Act, which the PIB is seeking to repeal and replace for reasons of obsolescence, I am of the view that the Companies Income Tax which adopts the tax holiday proposals in the National Industrial Policy is no longer relevant for the direction Nigeria needs to go with respect to the rapid development of its midstream and downstream gas industries. The PIB also adopts the orthodoxy of a 5 year tax holiday for midstream and downstream gas projects; however, if we need to, as we must in fact do, rapidly arrest the economic blight in northern Nigeria, we must have gas

transported up there pretty damn quick. The economics of doing that for gas producers, gas processors and gas transporters will almost certainly be shaky, but I have no doubt that a seven (7) year tax holiday will do the trick. Hence, in contrast to the PIB terms, I am proposing a fiscal stimulus for the midstream and downstream gas sector, including for projects or companies that directly take gas from the transportation and distribution network.

7.0 CONCLUSION

In conclusion, the current draft of the PIB does not present a competitive framework for massive investment in Nigeria's gas sector. Neither does it assure a liberal regulatory regime. However, It is never too late to amend its potentially ineffectual regulatory and fiscal provisions. This will help reposition Nigeria as an effective competitor in the global gas business as well as leveraging on its gas abundance to usher in an unprecedented period of economic growth.

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