NEWSLETTER MAY 2011

Marginal Fields in Nigeria: An overview of the Enabling provisions and Fiscal Regime.

Content:

Introduction

It is estimated that the Petroleum Industry accounts for 90% of the total government revenue (approximately 20% of the Gross Domestic Product) in Nigeria.[1] This explains the Federal Government of Nigeria's policy objective to expand its reserves to 40 billion barrels by 2011 using the most resourceful and financially viable method.[2] One major approach towards achieving this set objective is the development of Marginal Fields Development Programme (MFDP).

The MFDP amongst other objectives seeks to discourage continuous holding of undeveloped fields by International Oil Companies (IOCs), reduce the rates of abandonment of depleting fields and assure the Government's take in acreages which would otherwise have become unproductive. Furthermore, the MFDP is recognized as a means of encouraging Indigenous Oil and Gas Companies (IOGCs) to develop the required technical and managerial competence required to handle challenges in the Sector.

Marginal Fields has been defined as "oil production fields which form part of a country's oil reserves that have been left undeveloped or unattended due to a consideration of facts ranging from the

[1] United States Energy Information Administration, *Nigeria*, available at http://www.afbis.com/Nigeria/vision.ht>

[2] Oroma O.J: *What are the Legal and Contractual Implications of the 40% Cap on Foreign Equity Participation in Nigerian Marginal Fields?* Available at www.dundee.ac.uk/cepmlp/gateway/files.php

economic non-viability of such fields to the high costs of developing these fields."[3] Its importance to the Nigerian economy cannot be over emphasized and the fact that Marginal Fields help empower IOGCs which in effect is a means of controlling capital flight from the operations of IOCs cannot be neglected.

This newsletter presents an overview of the regulatory regime of Marginal Fields in Nigeria focusing on the provisions of Petroleum Amendment Act 1996. In addition, the newsletter compares the Nigerian fiscal regime on Marginal Fields with the regulation of the United Kingdom (UK) Continental Shelf.

Marginal Fields in Nigeria

The Petroleum (Amendment) Act of 1996 (the "Act") was the first legislation to address the absence of a policy on the acquisition of Marginal Fields in Nigeria by interested investors. Paragraph 16A of the Act provides for the farm-out of marginal fields.

In July 2001, the Office of the Presidential Adviser on Petroleum and Energy released a "*Guideline on farm-out and operation of Marginal Fields*" (the "Guideline"), which constitutes the protocol for the government regulator, *farmors* and *farmees* in marginal fields operations.

[3] Okagbue, N.S., Olabampe, A: "*Legal Framework for the Acquisition of Marginal Fields in Nigeria.*" *available at* heinonlinebackup.com/hol-cgi-bin/get_pdf.cgi?handle=hein.journals/

Highlights of the Act and Guideline

The Act and the Guideline amongst other provisions, provides for the voluntary and compulsory farm-out of Marginal Fields subject to the consent of the President. The major highlights are further discussed below.

Definition of Marginal Field

The Act defines Marginal Fields as "such Fields as the President may, from time to time, identify as Marginal Fields."[4] This definition, apart from being ambiguous, gives the President wide discretion over what Fields qualify as Marginal Fields.

Furthermore the Guideline defines Marginal Fields as "any Field that has reserves reported annually to the Department of Petroleum Resources (DPR) and has remained un-produced for a period of over 10 years." In addition, it stipulates the characteristics required for a Field to be marginal as follows:

1. Fields not considered by license holders for development because of assumed marginal economics under prevailing fiscal terms;
2. Fields which have had at least one exploratory well drilled on the structure and have been reported as oil and gas discoveries for more than 10 years;
3. Fields with crude oil characteristics different from current streams which

[4] Paragraph 16A

cannot be produced through conventional methods or current technology;
4. Fields with high gas and low oil reserves;
5. Fields that have been abandoned by the leaseholders for upwards of 3 years for economic reasons; and
6. Fields which the present leaseholders may consider farming out due to portfolio rationalization.

Operation of Marginal Fields

The Guideline provides that only IOGCs are allowed to apply for or operate Marginal Fields. However, these IOGCs are permitted to have foreign technical partners with equity participation not exceeding 40%.

This attempt by the Government to promote participation of IOGCs in the oil industry is commendable. However, the upstream sector is extremely capital intensive, and requires sound technological expertise which most IOGCs lack. More importantly, the terrain of Marginal Fields is very risky and uncertain and it is undisputable that special drilling technology, equipment, and expertise are essential to make its development lucrative.

In 2003 for instance, the Nigerian Government handed over the operations of 24 Marginal Fields to 31 Nigerian IOGCs[5] and not many of these companies have made appreciable progress with their concessions.[6]

In as much as foreign partnership is permitted, the magnitude of resources required to be committed by the foreign technical partners to the working of the programme, will dissuade many of them from accepting only 40% equity share, and consequently refrain from participating in the programme. Thus the Marginal Fields so allocated to the indigenous firms may remain undeveloped.

Voluntary and compulsory Farm out of Marginal Fields

Under the Act, the holder of an Oil Mining Licence (OML) may, with the consent of and on such terms and conditions as may be approved by the President, farm-out any Marginal Field which lies within the leased area.[7] The President may also cause the farm-out of a Marginal Field if such Field has been left unattended for a period of not less than 10 years from the date it was first discovered. The Act defines farm-out as "an agreement between the holder of an OML and a third party which permits the third party to explore, prospect, win, work and carry away any petroleum encountered in a specified area during the validity of the lease".

[5] Feso B: *Nigerian Marginal Fields: Navigating through Financial Storms* available at http://www.themixoilandwater.com/2011/05/nigerian-marginal-fields-navigating.html

[6] Ibid

[7] Paragraph 16A (1) of the Act

This definition is with a proviso to the effect that the President shall not give his consent to a farm out or cause the farm out of a Marginal Field unless he is satisfied –
(a) that it is in the public interest to do so, and in the case of a non producing Field, that the Marginal Field has been left unattended for an unreasonable time (usually more than 10 years) ; and
(b) that the parties to the farm-out are in all respects acceptable to the Federal Government of Nigeria.

The Act failed to define what constitutes "public interest," thus causing one to wonder when exactly it will be in the interest of the public for the President to withhold consent with respect to the farm out of a Marginal Field. Again the discretion granted to the President is very wide as he can withhold consent unreasonably and justify it on the grounds of public interest.

Furthermore, the proviso that the President can withhold consent in the case of an unproducing Field where such Field has been left unattended for an unreasonable time not less than 10 years does nothing for the Nigerian Economy. The definition of unreasonable time is ambiguous; it is clear that unreasonable time cannot be less than 10yrs but it can well be more than 10yrs all at the discretion of the President.

In addition, the Act failed to specify the criteria for determining (b) above, i.e. the parties that would be acceptable to the Federal Government of Nigeria.

Nature of title under Marginal Fields

The nature of title with regards to Marginal Fields is somewhat similar to the traditional notions of a Lease and Sub-lease. Firstly, on one hand is a lease between the Government as the lessor and the OML holder as the lessee and on the other hand is a sub-lease between the OML holder (the "farmor") as sub-lessor and a Marginal Field holder (the "farmee") as sub-lessee.

Secondly, paragraph 21 of the Guideline provides that "the Field(s) shall revert to the Marginal Field pool of the Farmor, 24 calendar months after the end of production operation on the Field." This is similar to what obtains in Leases, where the right of possession at the end of the term of years reverts to the Lessor after the term of years for which the lease was granted.

However, the reversionary interest principle obtainable under a Lease is not applicable to Marginal Fields. This is due to paragraph 19.0 of the Guideline which provides that "if at the end of 24 months of consent to the farm-out agreement, a Farmee shows verifiable evidence of efforts made to progress the work on the Fields according to approved plan and the DPR is satisfied, the farm-out shall be renewed for the remainder life span of the Field."

The above provision implies the possibility of renewing a farm-out ad-infinitum which is against the inherent reversionary principle governing the validity of a lease.

Furthermore, paragraph 20 of the Guideline provides that "the Farmee has all the rights of the OML leaseholder in respect of the farm-out area." Also the "Farmee has the right and obligation to deal directly with the DPR and other administrative authorities as the new leaseholder; and all rights, interests, obligations and liabilities of the Farmor in respect of the farm-out area containing the Fields automatically transfer to the Farmee and the Farmor is relieved of the same as from the date of the execution of the Farm-out Agreement."

Paragraph 20 suggests that a Marginal Field is treated as separate and distinct from an OML. The Farmee more or less can be said to be conferred with a legal title which is distinct from that of the Farmor. Furthermore, the consent of the President to a farm - out agreement between an OML holder and the Marginal Field Operator under the Act also supports this conferment of legal title.

It has been argued that because of certain clauses in farm-out agreements, a Farmee is a Sub-lessee, thus, the Farmor by implication is the legal owner of the Marginal Field and not the Farmee. However, this argument seems to be defeated wholly by the fact that Marginal Fields are not solely governed by the agreement of contracting parties but also regulated by the provisions of legislation, the guidelines and the practice and directives of the DPR in connection with the guidelines.

The Fiscal Regime of Marginal Fields in Nigeria

Nigeria's fiscal regimes, consisting of Joint Ventures (JVs), Production Sharing Agreements (PSAs) and Service Contracts are derived from the Petroleum Profits Tax Act of 1959, its several amendments and contracts between the Nigerian National Petroleum Corporation (NNPC) and operating companies.[8] Of the regimes, PSAs, and the consequent Production Sharing Contracts (PSCs) are applicable to marginal concessions.[9] The PSCs are composed of instruments such as; bonuses, rentals, royalty and Petroleum Profit Tax (PPT), with the application of ring fencing and cost recovery, in addition to investment allowances and obligations imposed on operators.

The Fiscal Regime of the United Kingdom Continental Shelf (UKCS)

The key enactment establishing the UKCS fiscal regime is the Oil Taxation Act 1975. The regime was formulated with the government objective of "securing a fairer share of profits for the nation and ensuring a suitable return for oil companies on their capital investment."[10] From inception the regime consisted of three main instruments, making it a royalty/tax system, namely:

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[8]Akhigbe, I: *How Attractive is the Nigerian Fiscal Regime, which is intended to promote Investment in Marginal Fields?* Available at http://www.dundee.ac.uk/cepmlp/car/html.

[9] Ibid

[10] Nakhle, C: *Opinions on the UK North Sea Petroleum Fiscal Regime: Preferences Revealed.* 5 I.E.L.T.R., 101, (2005) p 101

Royalty, Petroleum Revenue Tax (PRT) and Corporation Tax (CT).

Comparative analysis of the Fiscal Regimes: Nigeria and United Kingdom

An analysis of the Marginal Field's fiscal regimes in the UK and Nigeria is given consideration with reference to their neutrality, stability, risk and profit sharing on the backdrop of an evaluation of their attractiveness.

Neutrality

The Nigerian system whereby royalty instrument is retained by the PSC demonstrates non-neutrality when compared to that of the UK.[11] Non-neutral fiscal tools act as disincentives to investments as they negatively distort the relatively unfavorable project revenue profile of Marginal Field development projects.[12] The most significant effect of their influence is the delay to the relevant project's payback.

The UK achieved complete neutrality since January 2003 with the abolition of royalty payments. This is due to its existing fiscal tools (PRT and CT) being solely focused on profit for their assessment.

[11] Akhigbe I: Ibid
[12] Ibid

Stability

A review of the UK regime shows it's been adapted in response to economic influences and not arbitrarily.[13] The UK government promises to continue this trend, anticipating a need for future adaptation to include Field maturity concerns.

However, stabilisation clauses are absent from the standard Nigerian Marginal PSC just as is the case for the UKCS regime.[14] The MFDP has been pursued at a time of high oil prices. Accordingly, any declaration regarding the government's propensity to promote stability for their development is speculative at best.

Risk sharing

Both the Nigerian PSC and the UKCS regime offer a capital cost uplift allowance in conjunction with accelerated depreciation.[15] In isolation, these factors delay taxation, but the inclusion of royalty payments and bonuses may eclipse their impact. The UKCS regime is however more generous in terms of risk sharing than that of Nigeria's PSC as the UKCS's regime uplift of 75% is greater than that of the Nigerian PSC in addition to its exclusion of bonuses.[16] Furthermore, the narrow ring fence applied in Nigerian regime constrains any opportunity to offset costs, hindering an opportunity for risk sharing.

[13] Ibid
[14] Ibid
[15] Ibid
[16] Ibid

Profit share

It is difficult to determine which regime is more equitable in terms of profit sharing. The Nigerian government exacts a greater fraction of the mineral rent when compared to that of the UK.[17] However, due to the significantly lower costs associated with Nigerian crude, its government take may be more equitable in absolute terms.[18] On the other hand, the UKCS regime indicates a fourfold increase in UKCS costs in comparison, supporting arguments of larger rents from the Nigerian concession.

Recent developments in the operation of Marginal Fields in Nigeria

It is expected that with the passage of the Petroleum Industry Bill (PIB), the Marginal Field farm-in will be converted to outright acreage holdings. The PIB proposes that the IOCs give up areas currently being operated by Marginal Field operators as opposed to the current operation where the IOCs receive some form of royalty from the IOGCs.

This proposition by the PIB is a welcome development as it would allow the Marginal Field operators acquire their own acreage and become masters over their own Fields under favourable royalty and tax provisions.[19] The existing contracts with the IOCs were granted without implementing a modern acreage management which typically includes strong relinquishment practices, with particular reference to the 'drill or drop' system.[20] Consequently, the IOCs are 'sitting on' acreage, which by implication means no access to acreage for new investors.

Furthermore, it is anticipated that the PIB will give Nigerian IOGCs a competitive advantage in that they will be required to pay lower royalty (lower production in Marginal Fields), as well as benefiting from the 2010 landmark deregulation & indigenization of the industry.

Conclusion

With the huge reservoir of Marginal Fields in Nigeria,[21] it is undisputable that the exploitation of Marginal Fields would increase Nigeria's revenue as well as oil production. However, it is imperative that the Nigerian Government weighs its indigenization policies against the lack of financial and technological capabilities facing Nigerian IOGCs. Thus Nigerian IOGCs are encouraged to seek foreign technical partnerships to meet capacity and funding challenges.

Furthermore, the IOGCs should be poised to leverage opportunities presented by the

[17] Ibid
[18] Ibid
[19] Feso B, *ibid*

[20] This means that companies either carry out significant work on a new block or return the acreage to Government.
[21] Which is currently put at over 2.3 billion barrels of Stock Tank Oil Initially in Place (STOIP), spread over 183 Marginal Fields.

rapidly evolving legal framework of the upstream sector once the PIB is passed into law and IOCs are pressured to “give up” [Marginal Fields] or lose them.

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