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Proposed fiscal regime under Petroleum Industry Bill: incentive or deterrent?

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Introduction

On November 14 2012 the House of Representatives began debating the Petroleum Industry Bill, which was first presented for consideration by the legislature on July 18 2012 (for further details please see "Commentary on the Petroleum Industry Bill 2012").

A key change proposed by the bill is the revision of the fiscal framework governing the upstream oil and gas sector, which could impact significantly on crude oil and gas business in Nigeria if the bill is passed into law. This update summarises the proposed fiscal changes.

Royalties

Royalties payable to the government in respect of crude oil and gas produced in Nigeria are imposed by the Petroleum (Drilling and Production) Regulations, which prescribe royalty rates for large oil and gas fields, and the Marginal Fields Operation (Fiscal Regime) Regulations, which prescribe royalties payable in connection with marginal oil and gas field production. At present, the royalty for crude oil production under a joint venture or sole risk is governed by a single-tier regime based on the terrain of the producing field. Crude oil production from an onshore field attracts a flat royalty rate of 20%, while royalty rates applicable to offshore production vary from 4% to 18.5% for field depths from 1 metre to 1,000 metres. Fields with a depth of more than 1,000 metres pay no royalty. The royalty for onshore gas is 5%, and 7% for offshore gas.

The bill does not specify new royalty rates for crude oil and gas production, but the minister of petroleum resources will continue to have the power to determine royalties (and fees) by issuing regulations to that effect. Information from official sources suggests that the minister is considering a new royalty regime which would replace the existing single-tier royalty regime with a two-tier regime, where the total royalty would be an aggregate of two distinct royalties: the royalty by average daily production plus the royalty by value based on price. Under the two-tier regime, production from all fields would attract royalties. The significant impact would be that producers from deep offshore fields which currently pay no royalties would become liable to pay royalties.

Taxes

The bill proposes substantial changes to the existing tax regime for crude oil and gas production.

Proposed crude oil tax and implications for crude oil producers
Under existing legislation, an oil prospecting licence or oil mining lease holder which produces crude oil from a field in an onshore, shallow water or swamp area must pay the petroleum profits tax at the following rates:

- 65.75% of net profits in its first five years of petroleum operations;
- 85% of such profits from the sixth year of operations;
- 50% for companies producing crude oil from deep offshore fields; and
- as low as 50% for companies producing from marginal fields.

Companies subject to the petroleum profits tax regime pay no other local income taxes.

The bill proposes that crude oil producers should now be required to pay the normal

companies income tax (currently 30%) as well as, rather than instead of, the petroleum profits tax, a new resource called the Nigerian hydrocarbon tax. The hydrocarbon tax will be levied at 50% of net profits for production from an onshore or shallow water field, or 25% for petroleum operations from the deep offshore, frontier acreages or the production of bitumen. The hydrocarbon tax will not be deductible for purposes of computing companies income tax, or vice versa.

The bill therefore proposes that crude oil producers should pay an aggregate petroleum tax at a rate of either 80% (ie, a 50% hydrocarbon tax plus a 30% companies income tax for production from an onshore or shallow water field) or 55% (ie, a 25% hydrocarbon tax plus a 30% companies income tax for petroleum operations from the deep offshore, frontier acreages or the production of bitumen).

For companies currently taxed at the rate of 85%, the new petroleum tax proposals will mean a slight reduction in their income tax. Conversely, operators of deep offshore fields and some marginal field operators that are currently taxed at 50%, and new producers under joint ventures or those operating on sole risk basis who are currently taxed at 65.75%, may face an increase in their income tax obligations.

Gas tax and implications for gas producers
At present, gas producers pay companies income tax at a rate of 30% and, unlike crude oil producers, do not pay a resource tax. The bill proposes that in addition to the companies income tax, gas producers should pay a hydrocarbon tax based on the terrain of the producing field. This means that gas producers may be required to pay tax on their income at a rate of 80% or 55% (ie, companies income tax plus the hydrocarbon tax), as opposed to paying only 30% companies income tax under the existing law – a potential increase of between 25% and 50% on the tax currently payable by gas producers.

When the allowable deductions are made and the production allowances for gas are applied to the taxable income of gas producers, the effective tax rate may reduce considerably, but that rate is still likely to remain significantly higher than the current 30% companies income tax rate. However, gas producers are eligible to apply for pioneer status which, if granted, entitles them to a tax holiday of up to five years. The allowable deductions and production allowances are also available for crude oil producers.

Removal of investment allowances
The bill replaces the existing investment allowances granted to operators (5% for investment in an onshore field and 10% for investment in an offshore field) with production allowances, which will apply to production under all upstream arrangements. Production allowances are the percentage of the company's taxable income from the sale of crude oil, gas, condensate or bitumen or the portion of such products produced which are exempt from taxation. The bill specifies various allowances for the production of crude oil and natural gas from onshore, shallow water and deep offshore fields.

Comment

The aim of the bill is to establish a fiscal framework that is flexible, stable, progressive and competitively attractive. It aims to increase government revenues while providing a sufficiently attractive fiscal regime that will continue to encourage investment. However, critics of the bill argue that the tax proposals are complex, and that refocusing tax incentives away from investment to production is likely to hinder investment in new exploration, particularly in risky or frontier areas.

Given the Nigerian government's goal of increasing exploitation of the country's sizeable gas resources, there is also concern that in view of the relatively low profits on gas sales and the challenges of bringing gas to market, as well as several recent discoveries of substantial gas reserves around the world, these proposals risk diverting potential investment in upstream gas to other more attractive projects, or to neighbouring countries with more favourable gas tax regimes.

When taken together with the anticipated changes to the royalty regime, the fiscal changes will increase the government's total income. This meets one of the stated objectives of the bill. However, if overall investment in the industry declines as a result, government revenue may be adversely affected.

The National Assembly is considering the bill and is due to hold public hearings on it in the coming months.

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