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UNDERSTANDING THE FUNDAMENTALS OF TAKING SECURITY OVER OIL AND GAS RIGHTS UNDER THE PIA 2021



1. Introduction

The oil and gas industry accounts for a significant part of Nigeria's foreign exchange earnings, revenue and economic growth. This accounts for the Nigerian government's interest in this sector. The industry is notable for the huge costs involved in financing operations and activities. In the usual course of operations, operators' businesses could be exposed to various regulatory, operational and market risks, which could have a significant impact on existing financing obligations to their lenders. These risks also impact the sustainability of oil and gas companies and their businesses, which could significantly affect their ability to service their debt obligations to financing counterparties. To protect themselves against such risks, lenders would often take security interests over the oil and gas assets, rights, and interests of borrowing oil and gas companies.

It is against this background that we will examine in this article, the types of security interests that could be taken by lenders over oil and gas rights, the nature of such rights and the perfection of the security interests under Nigerian law. The article will also provide insight for lenders and other stakeholders interested in the Nigerian oil and gas industry to enable them to make informed decisions when granting loans and taking security interests over oil and gas rights.

2. Oil and Gas Rights under the Petroleum Industry Act 2021

The Petroleum Industry Act 2021 (the "PIA") is now the primary law regulating the Nigerian oil and gas sector. The PIA applies to holders of licences or leases (a) who have entered into a conversion contract with the Nigerian government; (b) whose licence, lease or permit granted under the repealed Petroleum Act, 2004 has expired and is then renewed under the PIA; or (c) whose licence was granted under the PIA. The PIA splits oil and gas operations into upstream, midstream and downstream activities. It established the Nigerian Upstream Petroleum Regulatory Commission (the "Commission") to regulate the activities in the upstream sector and the Nigerian Midstream and Downstream Petroleum Regulatory Authority (the "Authority") to regulate activities in the downstream and midstream sectors.

2.1 The Commission

The Commission is responsible for the technical and commercial regulation of upstream petroleum operations while licences and leases in the upstream sector are granted by the Minister in charge of petroleum resources on the recommendation of the Commission¹. All activities carried out under the various licences are subject to monitoring and administration by the Commission in accordance with regulations prescribed by the PIA. Specifically, the PIA provides for the following categories of licences related to upstream petroleum operations:

¹ Petroleum Industry Act, Section 3(1) (g)

(a) Petroleum Exploration Licence

The Petroleum Exploration Licence (“PEL”) is granted to qualified applicants to carry out petroleum exploration operations on a non-exclusive basis within the area provided for in the licence². A PEL only permits exploration activities and does not include any rights to extract, transport, export or otherwise treat petroleum discovered, within the licensed area³.

(b) Petroleum Prospecting Licence

The Petroleum Prospecting Licence (“PPL”) provides the holder with exclusive drilling rights for exploration and appraisal wells, as well as non-exclusive rights for petroleum exploration operations, within the licensed area. In addition, a PPL grants a holder the right to extract and dispose of crude oil or natural gas obtained during drilling, subject to complying with the obligations imposed by the PIA⁴. The scope of a PPL is broader than that of the PEL as a PPL allows the holder to conduct exploration activities as well as dispose of the extracts of the exploration.

(c) Petroleum Mining Lease

On its part, the Petroleum Mining Lease (“PML”) is granted to qualified applicants to win, work, carry away and dispose of crude oil condensates and natural gas exclusively⁵ derived from the licensed area. A PML grants the holder an exclusive right to carry out the development and production of petroleum with respect to the area covered by the lease⁶ and the non-exclusive right to carry out petroleum exploration operations. A PML will be granted to the holder of a PPL for each commercial discovery of crude oil or natural gas or both, subject to the conditions imposed under the PIA.⁷

2.2 The Authority⁸

The Authority, on its part, has the responsibility for the technical and commercial regulation of operations in the midstream and downstream sectors of the petroleum industry.⁹ The Authority’s functions include granting, issuing, modifying, extending, renewing, reviewing, suspending, cancelling, reissuing or terminating licences, permits and authorisations for midstream and downstream petroleum operations pursuant to the PIA.¹⁰

² Ibid, 70 (1) (a)

³ Ibid, 71 (3)

⁴ Ibid, Section 70(1) (b)

⁵ Ibid, Section 70 (1) (c)

⁶ Ibid, Section 82 (1)

⁷ Ibid, Section 81 (1)

⁸ Ibid, Section 29

⁹ Ibid, Section 31

¹⁰ Ibid, Section 32(i)

The PIA empowers the Authority to make regulations and issue guidelines for the grant or renewal of licences and permits for midstream and downstream petroleum activities. Some of the licences for Midstream operations include gas processing licence, bulk gas storage licence, gas transportation pipeline licence, gas transportation networks operator licence etc. On the other hand, the licences granted for downstream operations include retail gas supply licence, gas distribution licence, domestic gas aggregation licence, licence for the distribution of petroleum products etc.

3. Taking Security over Oil and Gas Rights in Nigeria

Security interests over oil and gas rights may take several forms, such as assignment, mortgage, pledge, charge or hypothecation. Some of these security interests allow the lender, upon enforcement of the security, to take possession of, or sell/transfer, the oil and gas rights in the event of a default by the holder/borrower. The nature of the oil and gas rights on which security will be taken would depend on the sector in which the holder operates. We will now consider the relevant rights in each of the sectors.

3.1 Security over Upstream Oil & Gas Licence/Lease

The PIA expressly permits the creation of security over the whole or part of oil and gas rights or interests in a licence or lease granted under the PIA. This is pursuant to section 95(5) of the PIA which provides that a holder of a licence or lease (that is, PEL, PPL or PML) may, by way of security, wholly or partly assign, pledge, mortgage, charge or hypothecate its interests under the applicable licence, lease, or grant a security interest in respect of the interest, subject to obtaining the consent of the Commission. The express mention of a charge in the subsection means that, even though the creation of a charge will not result in the transfer of the relevant licence or lease to the security holder, the consent of the Commission will still be required to create the charge. This deviates from the position under the repealed Petroleum Act, 2004 which provided that the prior written consent of the Minister in charge of petroleum is required for the assignment of a licence or lease or any right, power or interest therein or thereunder.

3.2 Security over Midstream and Downstream Oil & Gas Licence/Permit

The holder of a licence or permit in the midstream and downstream sector may assign or transfer its licence or permit or any right arising from the licence or permit to any other person subject to the prior written consent of the Authority. Upon an application for consent, the Authority will communicate its approval or refusal of the assignment or transfer within the time prescribed by regulation. Where the Authority does not approve or refuse an application and fails to communicate its decision to an applicant for the assignment or transfer of a licence or permit within the prescribed time, the application will be deemed approved. What this means, in our view, is that the assignment by way of security of a licence or permit relating to the downstream or midstream sectors requires the consent of the Authority. Unlike in the case of PEL, PPL or PML, the creation of a charge over a licence or permit relating to the downstream or midstream sector does not require the consent of the Authority. This is because a charge would not transfer the licence or permit. If the charge is enforced, which will

result in the transfer of the licence or permit to a third party, the consent of the Authority will be required. While these are our views based on our interpretation of the relevant sections of the PIA, the Authority will need to issue regulations to clarify these points.

3.3 Analysis of the various Security Interests

We will analyse in this part, the different options and nature of security that can be taken in relation to oil and gas rights and interests.

(a) Assignment

This involves the assignment by way of security of rights and interests of the borrower/security provider under a PPL or PML directly to the lender/security trustee. This will be done pursuant to an all-assets debenture or a deed of assignment. An assignment could be in respect of oil and gas rights, receivables or rights under oil and gas contracts, profits flowing from a joint venture arrangement, production sharing contract, etc.

(b) Pledge

A pledge is usually created by depositing the object of the security with the lender (or its nominee) for the debt owed and, in the case of a PPL or PML, the licensing documents. This will be on the condition that the pledged documents evidencing the oil and gas rights will be returned to the borrower upon the full discharge of the debt obligations. The essential element of a pledge is possession which may be actual or constructive. A pledge does not transfer title to the lender. The lender, however, retains the right to sell the interest under the title where the borrower fails to discharge its debt obligations. Notwithstanding that the PIA recognises a pledge as a form of security in respect of PPL and PML, the pledge of oil and gas rights is, however, not a common form of security for oil and gas financing. This is because of the difficulty of enforcement. The possession of the title documents alone is not sufficient authority for a secured lender to transfer the rights to a third party.

(c) Charge

A charge (whether fixed or floating) created over oil and gas rights does not transfer the title to such rights to the lender or security trustee. It, however, creates a proprietary interest over the rights and gives the lender/security trustee the right to take possession of, and take benefit of the interest in the rights where the borrower defaults on the repayment obligations. The charge can be by way of a floating charge or a fixed charge. The fixed charge fastens to an asset that is identifiable and attaches immediately upon creation. The identity of the property does not change (though it may be extended) during the subsistence of the fixed charge. A floating charge, on the other hand, is

flexible and does not immediately attach to the charged assets until crystallisation. The charged asset may change over time during the subsistence of the floating charge. A floating charge floats over the assets or undertakings of the borrower until the event indicated in the security documents occurs, which causes the floating charge to crystallise and become a fixed charge. A charge can be created over a PPL or PML and the consent of the Commission is required to be obtained as a condition for the creation of the charge.

(d) Mortgage

Where an interest in an oil and gas right is mortgaged, the ownership of the interest under the right is transferred to the lender/security trustee on the express or implied condition that the interest will be re-transferred (equity of redemption) to the borrower upon the full discharge of the secured obligations. Given that a mortgage transfers title from the borrower to the lender/security trustee, if the debt obligations are not discharged, the lender/security trustee will not re-convey the title to the defaulting borrower, and the equity of redemption will not actualise. In relation to a PML, in addition to obtaining the consent of the Commission, all other perfection steps will need to be taken to perfect a mortgage over a PML.

(d) Hypothecation

Hypothecation involves the use of oil and gas rights as security while retaining possession and utility of such rights. This form of security is similar to a charge. Upon default of the borrower, the right is transferred to the lender as the beneficial owner. Under the hypothecation agreement, the borrower retains possession and utility of the oil and gas rights which ensures that the borrower/security provider may continue to generate revenue from the use of the rights with no risk of immediate attachment. The borrower's possession of the oil and gas rights gives more flexibility to manage and utilise these rights in a manner that benefits their operations. This arrangement makes hypothecation a more favourable form of security on the part of the borrower and not on the part of the lenders because of concerns regarding ease of enforcement.

4. Taking Security in Practice

In practice, when taking security over oil and gas rights and interests, lenders would generally agree to create the security by way of a floating charge (in some cases both fixed and floating charge) in an all-asset debenture, security deed or deed of charge depending on the transaction structure. This is because the floating charge is an equitable interest that hovers over the asset and will not attach to the asset immediately. The use of a floating charge also allows the holder of the licence to continue to deal with it in the ordinary course of business without the interference of the lender. The floating charge will only crystallise to a fixed charge upon the occurrence of certain prescribed crystallisation events, usually events of defaults.

In addition to the above, the lender would take an assignment (by way of security) of rights and interest of the rights holder in the project documents such as the Production Sharing Contract/ Joint Operating Agreement, Crude Handling Agreement, etc.

5. Perfection Requirements

5.1 Consent

(a) The PIA: Upstream

The PIA provides that the consent of the Commission must be obtained where a holder of a PEL, PPL or PML wishes to wholly or partly assign, pledge, mortgage, charge by way of security or hypothecate its interests under the applicable licence or lease or grant a security interest in respect of the interest¹¹. The Commission shall within 60 days of the receipt of the request for consent, act on the request, provided that consent shall not be unreasonably withheld by the Commission¹².

Specifically in relation to a PML, a PML creates an interest in land. Under the Land Use Act, the alienation (including mortgage) of an interest in land requires the prior consent of the Governor of the State in which the land is located to be obtained. In view of this, a lender should ensure that the prior consent of the Governor of the State in which the land is located is obtained for the mortgage of a PML by the holder.

(b) The PIA: Midstream and Downstream

A holder of a midstream or downstream licence or permit cannot, by way of security, assign or transfer its licence or permit or any right arising from the licence or permit without the prior written consent of the Authority. Failure to do so is a ground for revocation of the applicable licence¹³. Creation of a charge over such a licence or permit will, however, not require the consent of the Authority.

5.2 Stamping

All the security documents for the creation of security over oil and gas rights and interests must be stamped in accordance with the Stamp Duties Act¹⁴ (as amended). The Act requires that instruments executed in Nigeria or relating to anything done or to be done in Nigeria must be stamped in order for the documents to, among other things, be admissible in evidence and enforceable before any court of law or arbitrator

¹¹ Ibid, Section 95(5)

¹² Ibid, Section 95(6)

¹³ Ibid, Section 120(1) (f)

¹⁴ Cap. S8 L.F.N 2004

in Nigeria¹⁵. Failure to stamp such documents will, however, not render it or the security interest created void or invalid, the relevant document will just not be admissible in evidence until the applicable stamp duty is paid and the documents stamped by the Commissioner for Stamp Duties. In addition, unstamped security documents will not be accepted for registration by the Corporate Affairs Commission (“CAC”) and non-registration of the documents with the CAC would render the security void against the liquidator and other creditors of the borrower.

Stamp duties on security documents will be determined ad valorem at the rate 0.375% of the amount secured. The documents are required to be stamped within 30 days of execution if executed in Nigeria or within 30 days from the date on the original or a copy of the security document being received in Nigeria.

5.3 Registration

(a) National Collateral Registry

The Secured Transaction in Movable Assets Act, 2017 applies to all security interests in movable assets created by an agreement that secures payment or the performance of an obligation. It requires that security interests in movable assets be registered at the National Collateral Registry (“NCR”) to be perfected. The movable assets covered are both tangible and intangible properties other than real property. Accordingly, the security documents creating security over the licence/permit will need to be registered at the NCR. Based on our experience, registration of the security documents at the NCR costs N1,000. Priority between relevant perfected security interests in the same collateral is determined by the order of registration at the NCR.

(b) Corporate Affairs Commission

Where the security is created by way of a charge (which includes a mortgage), the security documents creating the charge must be registered with the CAC within 90 days from the date of creation to complete the perfection requirements. The document creating a charge will not be registered by the CAC after 90 days from the date of creation unless accompanied by an order of the Federal High Court extending the time for registration. Registration of a charge with the CAC will constitute notice to third parties of the transfer of the oil and gas rights under a licence or lease. Failure to register a charge with the CAC will render the charge void against the liquidator and other creditors of the borrower.

(c) Land Registry

In relation to a PML, the instrument creating a charge or mortgage over a PML will also need to be registered at the relevant land registry in the state to which

¹⁵ Ibid, Section 22(4)

the PML relates. A mortgage is registrable at the land registry because it transfers interest in the land covered by the PML. In the case of a charge, even though it does not immediately transfer title to land, it creates an interest in land. It is, therefore, important to register the charge over a PML at the land registry to give notice to third parties of the existence of the charge.

5.4. Notice of Assignment

Following the execution of the assignment agreement or any security document assigning the interest in the asset or project documents relating to the exploration and exploitation of oil and gas rights, the borrower will need to give notice of the security interest to the other holders of the asset and counterparties to the project documents. The counterparties will, in some cases, be asked to issue an acknowledgement of receipt of the notice of assignment and state their readiness to comply with the directives therein. The notice of assignment, however, suffices for the creation of an assignment by way of security and binds such counterparties to the lenders/security trustee.

6. Conclusion

In conclusion, the PIA 2021 has introduced a more structured approach to the creation of security interests over oil and gas rights. It has also replaced the previous requirement to obtain Ministerial consent with that of the Commission and Authority as applicable. This should make the process of obtaining consent faster and it is a positive step towards creating a reliable investment environment. It has also addressed ambiguities provided by numerous guidelines on the position of the law on obtaining consent in connection with creating security. Oil and gas rights provide a valuable source of security for lenders, we believe that lenders and stakeholders will hopefully find these changes helpful in the course of security oil and gas financing.

One downside of the changes is that, unlike in the past, the creation of charges over oil and gas rights and interests now requires the consent of the Commission. Given that the Commission will charge fees to provide its consent, that would increase the cost of taking security. We hope that the Commission will not charge excessive fees and will provide regulatory guidance on this point.

*This update has been provided by **Yinka Edu, Joseph Eimunjeze, Abolanle Ayoola and Ifunanya Chinwuba** of the Banking & Finance team at Udo Udoma & Belo-Osagie. For more information about our Banking & Finance practice group offerings, please visit our website at www.uubo.org or email us at uubo@uubo.org.*