GREY MATTER

ENERGY	STABILIZATION CLAUSES IN PRODUCTION SHARING CONTRACTS – HOW RELEVANT IN THE LIGHT OF AMENDMENTS TO THE DEEP OFFSHORE AND INLAND BASIN (PRODUCTION SHARING CONTRACT) ACT?

Whilst presenting the 2020 budget to the National Assembly on October 8, 2019, President Muhammadu Buhari (**the** "**President**") noted that the amendment of the Deep Offshore and Inland Basin (Production Sharing Contract) Cap D3 LFN 2004 Act ("**the Act**") was necessary and could yield up to Five Hundred Million United States Dollars (US$500,000,000) in additional revenue for the Federal Government of Nigeria ("**FGN**").

Undoubtedly, as contemplated by Section 16 of the Act, the Act ***is subject to a review: (i) whenever the price of crude oil exceeds US$20 per barrel,*** ***and (ii) after a period of fifteen (15) years from the date of its commencement and every five (5) years immediately thereafter.***

However, this review was never conducted despite the fact that the price of crude oil had since exceeded Twenty United States Dollars (US$20) per barrel and of course a period of fifteen (15) years had since elapsed following the commencement of the Act. Given these factors, and the desire of the FGN to increase its revenue, the FGN triggered a review of the said Act.

Subsequently, following an unprecedented and rather astonishingly speedy passage of the Deep Offshore and Inland Basin Production Sharing Contracts (Amendment) Bill (the "**Bill**") 2019, by the Senate and House of Representatives, the President assented to the Bill and it became law on November 4, 2019.

Relevant Implications of the Amendment Act:

i. A New Approach to Determining Royalty

Indubitably, a significant outcome of the coming into force of the Deep Offshore and Inland Basin (Production Sharing Contract) Act Cap D3 LFN 2004 (Amendment) Act 2019 (the "**Amendment Act**") is the potential increase in revenue accruable to the FGN from the Production Sharing Contracts ("**PSCs**"). This is premised on the introduction of ***a new method of determining royalty by price in addition to the determination of royalty on a field basis***.

Whilst the Act previously provided for a graduated royalty payment based on the water depth of the oil fields, the Amendment Act imposes a royalty of ten percent (10%) on all fields with water depths exceeding 200 meters ("**Deep Offshore**"), while a royalty of seven point five percent (7.5%) is applicable to oil production from fields in the frontier or inland basin. Furthermore, in addition to the predetermined royalty payable on a field by field basis, Section 2 of the Amendment Act (a new Section 5(2) of the Act) introduces the payment of ***royalty by price*** to ensure that changes in the prices of crude oil, condensates and natural gas are reflected in royalty payments to the FGN.

The imposition of a fixed royalty rate of ten percent (10%) on all Deep Offshore fields is expected to result in an immediate increase in royalty payable by the majority of operators of Deed Offshore fields, as about eighty percent (80%) of the PSCs in Nigeria relate to fields with water depth of one thousand (1000) meters and beyond.

Relatedly, by virtue of the Section 2 of the Amendment Act (new Section 5(4) of the Act), any increase in crude oil price above Twenty United States Dollars (US$20) and up to One Hundred and Fifty United States Dollars (US$150) will attract an added royalty payment at a rate between two point five percent (2.5%) and ten percent (10%).

ii. Uncertainty of Royalty Payment Obligations in the Event of a Price Change

Pursuant to the new Section 5(2) of the Act, where there is any increase in the price of crude oil, condensates and natural gas that exceeds Twenty United States Dollars (US$20) per barrel ("**Price Change**"), royalty rates shall be determined in line with the formula stipulated in the new Section 5(4) of the Act as follows:

- A Price Change above Twenty United States Dollars (US$20) and up to Sixty United States Dollars (US$60) attracts a royalty payment of two point five percent (2.5%);
- A Price Change above Sixty United States Dollars (US$60) and up to One Hundred United States Dollars (US$100) attracts a royalty payment of four percent (4%);
- A Price Change above One Hundred United States Dollars (US$100) and up to One Hundred and Fifty United States Dollars (US$150) attracts a royalty payment of Royalty of eight percent (8%); and

- A Price Change above One Hundred and Fifty United States Dollars (US$150) attracts a royalty payment of ten percent (10%).

Whilst the rates applicable in the event of a Price Change have been stipulated in the Act, it appears there may be some ambiguity regarding the manner in which the rates will be applied. For example, where there is a Price Change above Twenty United States Dollars (US$20) but less than Sixty United States Dollars (US$60), it is not clear whether the two point five percent (2.5%) royalty rates will be applied to the entire Price Change or it will be applied to the difference between the Price Change and Twenty United States Dollars (US$20).

iii. An Immediate Need to Review and Re-Negotiate Production Sharing Contracts ("PSCs")

As aforesaid, the FGN is anticipating a significant improvement in its revenue situation as a result of the coming into force of the Amendment Act and the new royalty provisions contained therein. However, the projected immediate increase in FGN's revenue may be hindered by the specific provisions contained in the relevant Stabilization Clauses (if any) as preserved under the PSCs.

Generally, Stabilization Clauses are used to mitigate political risk and to preserve the fiscal regime in international oil contracts. In many developing countries, International Oil Companies ("**IOCs**") rely on the negotiation and inclusion of Stabilization Clauses in PSCs entered into with host nations (who typically lack the required capital to fund exploration and production activities in Deep Offshore fields, and thus rely on the IOCs to bear the cost and risks associated with such exploration and production activities). Simply, a Stabilization Clause ensures that parties to the PSC are restored to equilibrium in the event of ***a change in legislation or regulations***, which ***alter existing fiscal terms*** or ***materially affect the commercial benefit*** afforded the contractor under the agreement.

In light of the provisions of the Amendment Act, which has indisputably altered the fiscal regime applicable to operations in the deep offshore, it is now imperative for NNPC and its contractor parties (mostly IOCs), who have executed PSCs that contain Stabilization Clauses with comparable language like that mentioned above, to immediately review the terms and conditions of their individual PSCs, in order to determine the amendments that will be made to the PSC in order to align same with the new fiscal terms contained in the Amendment Act.

We note that the enforcement of the new fiscal regime imposed by the Amendment Act ***will occasion an increase in costs and may impact on the benefits derived by the IOCs from the PSCs as presently drafted.*** Consequently, the IOCs may seek to rely on relevant provisions of the Stabilization Clause in the PSCs, ***which require that the IOCs be made whole in the event of any change in legislation that erodes economic benefits of the IOCs***.

Indeed, the fiscal regime applicable to most PSCs have been grandfathered, such that Parties to the relevant PSCs are able to use their best efforts to agree modifications to these PSCs, ***as will compensate for the effect of any changes*** resulting from the enactment of or change in the laws or regulations, any rules, procedure, guidelines, instructions, directives, or policies, pertaining to the PSC, which occurs subsequent to the Effective Date of the relevant PSC and which materially and adversely affects the rights and obligations or the economic benefits of the IOC,. *Where **Parties fail to agree on such modifications within a period following the date on which the change in question took effect, the matter shall thereafter be referred at the option of either Party to arbitration***.

The implication of the Stabilization Clause highlighted above is that the specific provisions of the relevant PSC will now need to re-negotiated and modified so as to restore as near as practicable the commercial benefits of the IOCs under the specific PSC. Further, such modification must be negotiated and agreed within a time certain to forestall a recourse to arbitration.

In view of the foregoing, it is imperative for the impacted PSCs to be immediately reviewed to ascertain the extent to which the Amendment Act has materially affected the commercial benefits preserved thereunder and to amend the PSCs to reflect the required modifications.

Conclusion

The expedited amendment of the Act reflects the intention of the FGN to generate additional revenue from PSCs and derive more revenue in the event of a Price Change. However, the need to increase the FGN's revenue must be balanced with the similarly obvious need to uphold the sanctity of contracts in order to ensure the Nigerian oil and gas industry remains attractive to investors. This is particularly important in recognition of the growing regional competition to attract investment into Deep Offshore oil operations.

Depending on the specific language of the Stabilization Clause, the Amendment Act will, undeniably have triggered the Stabilization Clauses contained in some, if not all, of the existing PSCs. Thus, the NNPC and the IOCs will, most likely commence an immediate review of the PSCs to align the terms and conditions of same, with the new fiscal terms.

- **For further information or specific clarifications, please reach out to the key contacts below.**

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