Critical Considerations for the

Implementation of Domestic Crude Supply Obligations

under the PIA

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Introduction

Energy security is one of the key concerns of nations around the world. Underpinning this concept are four factors, namely, the availability of energy sources, energy affordability, energy accessibility and energy acceptability. Threats to the energy security of a nation are taken seriously as they may lead to political and economic instability. Countries around the world utilise various approaches to tackle and reduce their energy vulnerabilities. These approaches include the reliance on a mix of energy sources (fossil fuel, renewable energy, nuclear power), implementation of energy conservation measures, the building of strategic reserves for fossil fuel, increased hunt for domestic energy sources, innovations around mass transit and the utilisation of energy treaties.

Countries that are rich in energy resources also face energy security challenges. In Nigeria, energy vulnerability is demonstrated by its mono-product economy, where every economic activity revolves around oil and gas.

Thus, energy insecurity in Nigeria has manifested through inadequate and inefficient utilisation of oil and gas to meet domestic energy needs. This has resulted in constant queues at filling stations, inadequate and epileptic power supply, large-scale use of fuelwood with its attendant effect of deforestation and desertification, and the heavy reliance, in rural areas, on traditional sources of energy (human and animal power).

Under the National Energy Policy of 2003, a myriad of solutions and initiatives were proffered to tackle energy security. One such initiative is using the government's power of pre-emption to make petroleum products available and affordable in the country through the encouragement of local refining of products. This policy was implemented under the erstwhile petroleum law, the Petroleum Act, to enable domestic gas utilisation through the enactment of the domestic gas supply and pricing regulations.

Domestic Crude Oil Supply Obligations Regime under the PIA

The PIA has extensive provisions for the implementation of the government's pre-emptive rights over petroleum and petroleum products. It provides, amongst others, for the power of pre-emption over petroleum to be exercised to enable the supply of crude oil to refineries in Nigeria (see Section 109 of the PIA).

Under the PIA, the crude supply to a refinery in Nigeria is to be done on a willing buyer and willing seller basis, as expected of any commercial enterprise. In December 2023, the Commission released the domestic crude refining requirement of operating refineries in Nigeria together with the H1 2024 production forecast of oil producers in Nigeria. These are important data that will enable refineries and petroleum producers engage the crude supply contracting process.

However, the need for the imposition of domestic crude oil supply obligation (DCSO) arises when refineries in Nigeria suffer feedstock shortages. This may be due to –

1. a lack of supply contract,
2. insufficient contracted quantities,
3. unreasonable contractual terms, and
4. inadequate supply conditions.

When any of the conditions above arise, and upon a report made by the Nigerian Midstream and Downstream Petroleum Authority (the Authority) to the Nigerian Upstream Petroleum Regulatory Commission (Commission) of inadequate supply of crude to refineries that are operating, the Commission is required to impose DCSO on petroleum producers. Before DCSO is imposed, the Commission has indicated via the Production Curtailment and Domestic Crude Oil Supply Regulations (PC&DCSR) 2023, that the imposition of DCSO would not be automatic upon a report of shortage by the Authority.

First, the Commission will issue a request for quotation (RFQ) to all petroleum producers for the supply of the required volumes to meet the crude supply gap of the refineries. If a response is received from a producer, the Commission will facilitate the execution of a contract (on a willing buyer, willing seller basis) between such producer and the affected refinery to deal with the crude supply shortage. If the RFQ process does not resolve the supply shortage, the Commission will proceed to impose DCSO on petroleum producers.

The DCSO regime creates the following challenges and opportunities for both the Commission and petroleum producers.

Existing Obligations:

Regulatory compliance is a critical aspect for startups, and it is important to adhere to the legal requirements and standards set by governing bodies. Exploration and production activities consist of several carefully plannedactivities and processes, most of which are governed by contracts with third parties with strict timelines and volume commitments. One such activity is the sale of crude. The sale of crude istypically concluded before production, with producers committing to the sale of the entire volume produced for a term of years, which term is renewable. Thus, a DCSO can be disruptive and may potentially lead to contractual penalties for the oil producer. It is necessary for the Commission, where the need for DCSO has crystallised, to carefully balance the existing contractual obligations of the oil producer and the need for an immediate supply of crude to local refineries.

Prepayment and other financing obligations:

Many producers finance their field development plans with loans raised from third parties, such as banks or oil traders, using reserved-based lending or prepayment financing structures. The key security for these financings is the assignment of the crude produced and the proceeds of the sale of crude (after statutory deductions). The imposition of DCSO may easily trigger a default and lead to dire consequences for the oil producer. It will, therefore, be necessary for the commission to consider the financing obligations of the oil producer when making the decision to impose DCSO.

Existing Domestic Supply

There are instances where crude from petroleum producers is already contracted to supply domestic refineries. This may be done through direct contracts between refineries and petroleum producers. Sometimes, the crude sold by oil producers to traders is, in turn, supplied by the traders to domestic refineries. It will be necessary to have clarity on whether such direct or indirect supply will exclude the petroleum producer concerned from DCSO imposition.

Impracticalities of lifting small cargoes:

Where DCSO becomes necessary, and there are severalpetroleum producers that meet the criteria to supply a particular refinery, the Commission is required to allocate DCSO volumes to each qualifying petroleum producer pro-rata based on their existing obligations, the performance of their wells and their production quota. A problem that may arise based on such pro-rata allocation is that the volumes allocated to some petroleum producers may be so low that it will become impractical for the refinery to offtake such volumes. The Commission may need to encourage DCSO obligors to utilise swap contracts to deal with such development.

Facilitation by Commission:

The PC&DCSR provides for the Commission to facilitate the contracting for crude supply between domestic refineries and petroleum producers. This may create an awkward situation for parties, and depending on how the discussion develops, it may open the Commission to allegations of derailing the objective of achieving a willing seller and willing buyer contract.

Conclusion

The DCSO regime is a necessary framework for tackling the problem of energy security that Nigeria faces. However, the big challenge for its implementation is the existing crude lifting contracts of petroleum producers together with loan commitments secured by crude oil volumes. It should be noted that DCSO should only be used as a short-term emergency intervention where there are crude supply constraints. It should not replace the obligation of domestic refineries to source their feedstock supply from oil producers, both locally and internationally.

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