

CLIENT ALERT

November 15, 2016

Comments on the Draft National Gas Policy

The Ministry of Petroleum Resources recently issued, for consultation, a draft of the new national gas policy. Given the severe problems that the nation has faced in providing gas to its power plants and the challenges being encountered by investors who seek gas supply for industrial use, the new gas policy is of critical importance.

It is a large document. The policy covers almost every aspect of the gas market from governance of the gas industry by the Ministry to new strategies to maximize the value Nigeria obtains from its LNG exports; from proposals to spur upstream production of gas to possible new uses for gas such as CNG and LNG trucks. It is also an uneven document. The policy proposals in areas like improving LPG penetration are quite detailed, while in some other areas, like the determination of commercial terms for PSC gas, it does little more than to recognize the need for action on the part of government.

This client alert highlights a few areas which we believe are important to many of our clients, and we hope that it will assist in evaluating the policy and deciding how to contribute to the advocacy effort to produce a policy that will significantly boost the gas industry. This client is based on comments our firm has provided to the legal and fiscal study group of the Nigerian Gas Association (NGA) to support the NGA's efforts to ensure that the policy benefits from the views of key stakeholders.

Governance

The policy, correctly, has a strong focus on improving the capacity of the Ministry of Petroleum Resources to provide leadership to the gas industry. This is very welcome as the Ministry has sometimes seemed like a bemused bystander whilst operators in the industry struggled with very serious issues. Thus, the proposals to improve the research and analytical capacity of the Ministry, to provide a user-friendly one-stop shop for investors and to institute joint forums where industry and government review and seek to resolve the problems in the gas sector are all very positive. The proof of the pudding will, however, be in the eating.

Also, the idea of a single petroleum regulatory agency is a good one. Operators currently have to contend with multiple requirements from several agencies and a single agency will help to streamline the regulatory process. However, as the policy recognizes, the new agency will require strong capacity-building.

Some of the other proposals on governance are, in our view, questionable. The proposal to appoint a National Gas Focal Point falls in that category. This individual, the policy says, will be charged with the practical implementation of the policy. This sounds like a key part of the Minister's functions, in which he or she will be supported by the proposed single petroleum regulatory agency and the various agencies in

the Ministry that will actually implement the policy. It is hard to see what additional value this focal point will bring.

Similarly, the proposal to create a “Project Desks” in the Ministry to lobby for various projects within government could bring one more layer of bureaucracy to a sector that already has too much bureaucracy. The Minister should be the ultimate champion for gas projects, lobbying for them within government, supported by the leadership of the various agencies, like the Nigerian National Petroleum Corporation (NNPC) and its subsidiaries, which are responsible for such projects.

Improved Safety Regulation

The policy states that safety regulation would be improved in the gas sector and that operators who breach regulations will face “stiff penalties”. This is one of the less developed parts of the policy and no reference is made to the existing safety compliance framework neither is there any evaluation of what needs to be improved in this framework.

The Petroleum Act, the Petroleum (Drilling and Production) Regulations, the Mineral Oil Safety Regulations and the National Oil Spill Detection and Response Agency (NOSDRA) Act, among other laws and regulations, already contain provisions on the enforcement of safety and environmental compliance in the industry. The Department of Petroleum Resources (DPR) and NOSDRA currently conduct inspections and investigations under the various existing laws and regulations, and impose penalties which, at least in the view of operators at the receiving end of such penalties, are already quite “stiff”. The policy needs to acknowledge the institutions and processes which currently exist and state what needs to be changed.

Areas to be considered for reform include having a mechanism to ensure that safety policies that apply to the industry are streamlined and regularly updated, that there is a clear demarcation of responsibility between the various agencies responsible for safety compliance in the industry, that consideration be given to more formal processes of investigation and administrative sanction and that the relationship between those processes and the nation’s existing prosecution and judicial systems is clearly defined for the guidance of regulators and operators. Operators often find themselves responding to investigations by DPR and NOSDRA at the same time and on the same set of facts. Often times these agencies purport to impose penalties which are so severe that they appear to have assumed the powers of the law courts.

Open Access, Regulated Tariffs and Limits to Cross-Ownership

The policy proposes to introduce open access to infrastructure in the gas sector, to ensure that use of such facilities is based on transparent tariffs determined on utility rates of return and to prohibit business models where the same entity holds upstream assets and also runs and controls gas processing or transportation infrastructure.

Guaranteed access to existing infrastructure on the basis of transparent pricing methodologies, subject only to capacity constraints and gas quality standards, is a goal that no one can quarrel with. Also, there is a good case for limiting participation of the same entity in gas production and transportation as the market matures. However, while in previous incarnations of these ideas, e.g. in the Downstream Gas Bill of more than a decade ago and the various drafts of the Petroleum Industry Bill, complete open access was always projected to occur after certain milestones had been achieved in the gas industry, the policy appears to suggest that open access will occur immediately or soon after the policy is adopted.

The concern with this approach is that in an environment in which Nigeria should be doing all it can to encourage new investments in gas infrastructure, immediate open access and constraints on cross-

ownership might act as disincentives to potential new investors. It is hard enough to attract investors to a market with weak effective demand without also requiring such investors to be immediately subject to complex rules on access.

The West African Gas Pipeline (WAGP) offers an alternative model. WAGP from the start was subject to tariff methodologies that improved the return for investors in the pipeline as the gas market grew. However, open access was delayed for a few years and affiliates of upstream gas producers among the investors were given exclusivity in selling gas through the pipeline for a specified period. These sweeteners helped to unlock the investment, but have since expired and WAGP is now an open access pipeline.

Another issue related to open access is ensuring that robust mechanisms exist to settle disputes whenever open access takes off. There has been a lot of frustration caused by the difficulties in resolving disputes arising from the limited access granted to other operators in owner-operated oil pipelines under crude handling agreements (CHAs). Shippers of crude oil under the CHAs have complained of high-handedness and arbitrariness on the part of owners, including in setting prices and allocating liability for line losses, and have claimed that DPR's conciliatory approach has done nothing to check abuses by owners. Owners, on the other hand, complain of their inability to sanction users who do not pay their bills or introduce crude of unacceptable quality into their pipelines because DPR requires them to carry all crude pumped into their pipelines. And these disputes have in some cases lingered for years. An open access regime in the gas industry will need to have robust dispute resolution mechanisms based on best practice around the world to avoid those kinds of problems.

Domestic Gas Pricing

The policy states that domestic gas pricing will continue to be set by government until the sector is ready for willing buyer, willing seller wholesale gas pricing. Until that milestone is achieved, domestic gas will be priced based on the Export Parity Netback Price (EPP), which is derived from gas supply agreements in use by Nigeria NLNG.

This is another part of the policy where more detailed work is required. The proposed EPP transitional pricing model raises a number of issues which need to be answered, preferably in a revised version of the policy. A revised set of regulations is mentioned in the policy, but these are key policy issues that belong in the policy document itself, which will then inform the regulations. These issues include:

- The current policy recognises 3 categories of gas buyers with 3 different pricing methodologies: power, industrial (feedstock gas) and commercial. Are the 3 categories being replaced by one single transitional price?
- There is a particular concern with small commercial entities that depend on gas supply from NGC's franchisees. Where additional pipelines are required to supply such entities, their final price has sometimes been as high as \$7/mcf. Such gas prices are not conducive to industrialization and it seems that a set of incentives are required to support manufacturers who are in that position.
- The EPP can only be calculated by those with access to the underlying contracts from which it is derived. It is, therefore, necessary to state to the general public what the price actually is, including any applicable indexes.
- The last price prescribed by the previous Minister of Petroleum Resources for the power sector is considered the prevailing price. When does the EPP replace the last prescribed price?
- The previous Minister's last pronouncement also prescribed prices for transportation. What is the current policy on pricing of transportation?

Triggers for Wholesale Market Regime

The policy sets out a number of triggers for the transition to wholesale gas pricing. They essentially have to do with increased availability of both gas and gas transportation infrastructure, most critically the OB3 pipeline which will allow the transportation of gas from the eastern part of the Niger Delta to the western part of the country. Given how long we have struggled with completing critical infrastructure, it is hard to predict when all sections of OB3 will be finally completed. It is, therefore, very likely that it will be a very long time indeed before these triggers have occurred.

Even when all the triggers have occurred, there might still be the challenge of providing gas at sufficiently attractive prices to support manufacturing. Since almost everyone agrees that the current system of government-prescribed pricing and cross-subsidies between various markets of gas has failed, consideration should be given to terminating the system in its entirety, moving to a wholly commercial market in the near future and then providing incentives, including possibly explicit subsidies, for any critical industries that cannot realistically cope with commercial prices. In our view, this is preferable to an endless transition out of a regime which has been so unsuccessful.

Domestic Gas Supply Obligation

The policy reiterates support for the imposition of domestic gas supply obligations (DSOs) on upstream producers, and states that it is “reasonable for there to be a domestic gas supply obligation imposed on producers which is sufficient to kick-start domestic market development but not so high that producers see it onerous.” What the policy does not say is whether government considers the current level of DSOs “reasonable” or “onerous” and what parameters will be used to determine DSOs going forward.

Also, given the current weaknesses in the gas to power chain, which are highlighted in section 4.3.10 of the policy, the question arises whether government should continue to impose DSOs at a time when the power sector which takes most domestic gas is incapable of paying for gas promptly and many industrial projects that have been granted gas purchase orders have not yet materialized after tying down large volumes of gas for years.

Developing Gas Resources

A number of the ideas in the policy on developing gas resources are very good. Among them is the commitment to support exploration of deep gas and reservoirs in the inland basin. It is also positive that the policy recognizes the need to provide a framework to finalize commercial terms for gas development in the PSCs and also recognizes that such a framework will need to allow for adjustment to fit particular circumstances.

Infrastructure

One of the most important issues in the delivery of infrastructure projects in the petroleum industry is the impact of the Nigerian Oil and Gas Content Implementation and Development (NOGCID) Act on project schedule and cost. The OB3 project, one of the key infrastructure projects identified in the policy, was delayed for more than 2 years because of a dispute over national content requirements for the supply of pipes. The new gas policy does not address the impact of the NOGCID Act on project delivery and measures to deal with any adverse impact. In our view, that is a significant gap.

We hope you have found these comments useful and we are available to discuss any of them in more detail.