ENERGY & PROJECTS NEWSLETTER

OPERATIONALISING THE GUIDELINES FOR DOMESTIC CRUDE OIL SUPPLY OBLIGATIONS: A CRUCIAL STEP FOR NIGERIA'S ENERGY SECURITY

INTRODUCTION

Over the years, Nigeria's domestic refineries have grappled with chronic challenges stemming from inadequate supply of crude feedstock by lessees (holders of a Petroleum Mining Lease). This persistent shortfall has significantly constrained refining capacities, leading to an overreliance on imported petroleum products. The repercussions are multifaceted: inflated petroleum prices, heightened security and environmental risks, and a weakened energy security framework that undermines the nation's economic stability and self-reliance in energy supply.

To address these critical issues, the Petroleum Industry Act, 2021 (PIA), under Sections 8(c) and 109, outlines provisions for Domestic Crude Oil Supply Obligations. This statutory framework underpins the issuance of the Production Curtailment and Domestic Crude Oil Supply Obligations Regulations, 2023 (the "Regulations") by the Nigerian Upstream Petroleum Regulatory Commission (the "Commission"). The Regulations establish a robust legal and operational framework to streamline production management and prioritize the optimal utilisation of crude oil for both domestic supply and export. This strategic intervention seeks to rectify systemic inefficiencies, ensure a steady feedstock supply for local refineries, and bolster Nigeria's energy security by compelling compliance with domestic crude oil supply obligations. The Regulations aim to foster a more resilient petroleum value chain, reduce dependence on imports, and support the development of an energy-secure Nigeria. This marks a pivotal moment in aligning the nation's oil production practices with its broader economic and strategic imperatives.

To ensure the effective implementation of these Regulations, the Commission issued the Guidelines for the Operationalisation of the Domestic Crude Oil Supply Obligation 2024 (the Guidelines). These Guidelines were made pursuant to Section 109 of the PIA and Parts III and IV of the Regulations. They outline the framework for enforcing the Domestic Crude Oil Supply Regulations and applicable to all Nigerian crude oil lessees and licensed domestic refineries.

This Newsletter delves into the practical implications of the recently issued Guidelines, providing a comprehensive analysis of the essential measures that lessees and domestic refinery operators must adopt to align with the updated regulatory framework. It outlines actionable strategies to ensure compliance, mitigate the risk of penalties, and promote seamless operations within Nigeria's upstream oil and gas sector. By addressing these critical considerations, this Newsletter aims to empower industry stakeholders to navigate the evolving regulatory landscape effectively while fostering sustainable growth and operational efficiency.

CRUDE OIL SUPPLY ARRANGEMENT AND DELIVERY OBLIGATIONS

The recently issued Guidelines on Domestic Crude Supply Obligations aim to streamline the process of crude oil delivery between lessees and refineries, fostering transparency and efficiency in the downstream sector. A critical provision which mandates refineries to independently source and negotiate crude oil supply agreements with lessees.[1] This approach emphasizes commercial autonomy and strengthens the refinery-lessee relationship. In determining the price of crude oil, the Guidelines require both parties to consider the fiscal oil price differentials published by the Commission for the relevant month.[2] This ensures that pricing reflects prevailing market realities and adheres to fiscal benchmarks.

To ensure a timely and predictable delivery schedule, the Guidelines specify clear timelines for crude oil delivery. It provides that lessees and refiners must agree on the loading and delivery window no later than the 25th day of M-2, which is two months prior to the first day of LAYCAN.[3]

For context, LAYCAN refers to the designated period within which a vessel is expected to arrive at the loading terminal to load or receive crude oil delivery. This defined timeframe facilitates efficient scheduling, reduces the likelihood of demurrage costs, and aligns the logistics of crude oil supply with the operational plans of both lessees and refiners. However, if there is a verifiable operational constraint, the lessee is required to notify the refiner of the revised loading/delivery window not later than 21 days from the first day of LAYCAN.[4] Furthermore, it is the responsibility of the refiners to arrange and coordinate logistics to ensure that crude oil is loaded within the stipulated loading window as agreed upon in the contract. This measure is essential to prevent disruptions such as tank top scenarios or interruptions to production activities. Failure to adhere to these logistical requirements may attract penalties as outlined in the Crude Supply and Purchase Agreement.[5]

Crude oil designated for domestic consumption must be delivered directly to the designated refinery and processed locally to ensure compliance with the Production Curtailment and Domestic Crude Oil Supply Obligations Regulations, 2023.[6] The Guidelines expressly prohibits any diversion, swapping, or alternative use of crude oil without the prior written consent or approval of the Commission. Any breach of this provision may result in severe consequences, including suspension from participating in Domestic Crude Supply Obligations allocation for a duration determined by the Commission, as well as potential prosecution under relevant laws.[7]

It is pertinent to note that long-term crude supply contracts between lessees and refiners are conditional upon the refinery being fully operational and capable of receiving crude oil at the scheduled time of delivery.[8] This provision underscores the critical importance of the refinery's readiness and aligns with the regulatory emphasis on efficient and accountable resource utilization within the domestic market.

[1] Regulation 10 (1)-(4) of the Production Curtailment and Domestic Crude Oil Supply Obligations Regulations, 2023
[2] 2.3 of the Guidelines
[3] 2.4 of the Guidelines
[4] 2.5 of the Guidelines
[5] 2.6 of the Guidelines
[6] 2.7 of the Guidelines
[7] 2.8 of the Guidelines
[8] 2.9 of the Guidelines

BALANCING REGULATORY COMPLIANCE AND OPERATIONAL FEASIBILITY IN SECURING DOMESTIC CRUDE OIL SUPPLY

The Regulations are designed to address the crude oil shortages affecting Nigeria's refining sector by imposing an obligation on upstream producers to supply crude to domestic refineries. However, the implementation of the Domestic Crude Supply Obligation (DCSO) is neither automatic nor indiscriminate. Under these Regulations, lessees are not required to produce indiscriminately from their wells.

The Commission is tasked with allocating production quotas to lessees periodically, based on several factors, including the Technical Allowable Rate (TAR) for each well within a lease, the production performance of the well, and other considerations as deemed appropriate by the Commission.[9]

The assigned production quota is valid for only six months, and lessees are expressly prohibited from exceeding this quota. Additionally, the Regulations establish a clear framework for domestic crude supply, which includes the publication of domestic refining requirements and the issuance of Requests for Quotation (RFQ) to upstream producers.

Pursuant to the provisions of the Regulations, the Commission is mandated to issue a Request for Quotation (RFQ) to all producing lessees.[10] This obligation requires them to submit quotations for the supply of specified volumes of crude oil needed to address shortages or remedy inadequate supply conditions. The Guidelines further stipulate that, before issuing an RFQ in the event of a crude oil supply shortfall, the Commission must ensure that every lessee with the capacity to contribute to meeting the crude oil requirements of refineries allocates a portion of its forecasted production to prevent such shortages.[11]

To fulfill this obligation, the Commission is required to establish clear and equitable metrics to ensure a portion of the forecasted production by lessees is dedicated to domestic consumption.[12] These metrics are to be implemented on a non-discriminatory basis, thereby promoting fairness and compliance across all eligible lessees while safeguarding the continuous supply of crude oil to meet domestic refining needs.

[9] Regulation 5 of the Production Curtailment and Domestic Crude Oil Supply Obligations Regulations, 2023.
[10] Regulation 12 of the Production Production Curtailment and Domestic Crude Oil Supply Obligations Regulations, 2023.
[11] 2.10 of the Guidelines
[12] 2.11 of the Guidelines

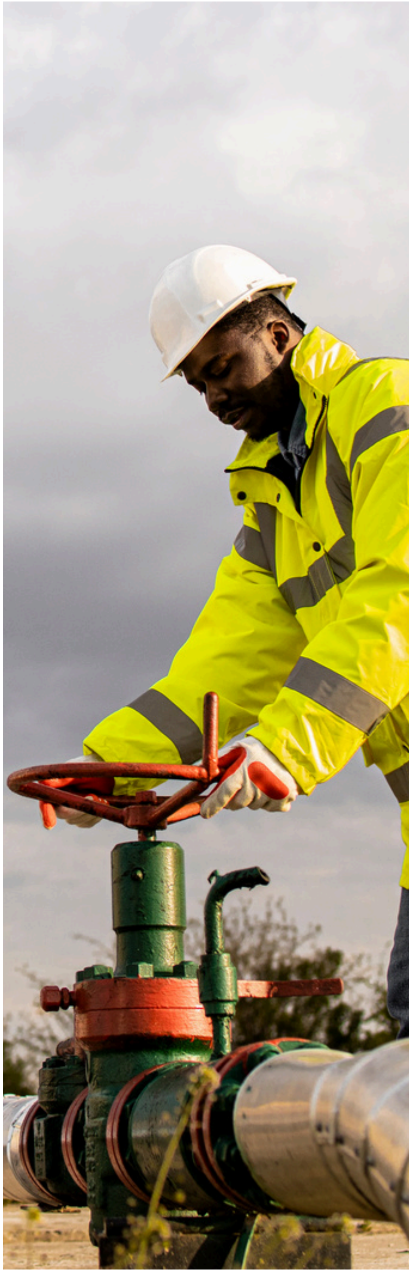
PUBLICATION OF CRUDE REFINING REQUIREMENTS

The Commission is tasked with publishing the crude refining requirements of operating refineries on its website and in three national dailies every six months.[13] This publication shall include details such as the name, location, and crude oil needs of each refinery, as well as forecasted daily crude requirements. Simultaneously, the Commission is required to provide data on the crude oil production forecasts of lessees, facilitating market-based transactions between crude oil producers and refiners.

The Guidelines equally mandate the Commission to notify both the lessees and the refiners either in writing or via publication on its website or both, the portion of the lessee's forecasted production, that shall be reserved for domestic refineries, which shall serve as the minimum value expected to be sold to domestic refineries.[14]

It should also be noted that in the event the refinery is not successful at independently sourcing future crude oil supplies from lessees or is unable to secure the minimum volume required for its forecasted period, the Refinery is required to report to the Commission before the 15th Business day of M-3, stating the grade(s) involved and the reasons for the inability to secure crude from the lessees.[15] Upon receipt of this notification, the Commission may intervene by;

a. Directing the lessee to enter into a crude purchase agreement with the refiner.
b. Facilitate negotiations on contract terms or pricing disputes
c. Direct parties to agree on a fair price based on published fiscal oil price differentials.[16]



DUTIES AND RESPONSIBILITIES OF A LESSEE UNDER THE GUIDELINES

i. Participation in Stakeholders' Meetings and Submission of Cargo Programs

Lessees are required to participate in the Domestic Crude Refining Requirement (DCRR) stakeholders' meeting, typically scheduled between the 10th and 15th business days of the second month preceding the production period (M-2). Additionally, discussions on production curtailment will take place on the 10th and 19th business days of M-2. Lessees must also ensure the timely submission of their cargo programs, including detailed allocations to domestic refineries.[17]

[13] Regulation 11 of the Production Curtailment and Domestic Crude Oil Supply Obligations Regulations, 2023.
[14] 2.13 of the Guidelines
[15] 2.16 of the Guidelines
[16] 2.17 of the Guidelines
[17] 3.1 of the Guidelines

ii. Contractual Obligations under Domestic Crude Supply Obligations.

Under the Regulations, lessees are mandated to submit their Quotation within a specified timeframe. Failure to comply with this requirement within the stipulated period attracts an administrative penalty of $10,000, payable to the Commission.[18] Additionally, lessees must ensure that all contracts entered into with refiners adhere to the requirements of the Domestic Crude Supply Obligation (DCSO). Non-compliance, unless excused by a force majeure event or expressly approved by the Commission, will result in sanctions, including administrative fines.[19]

iii. Enforcement of Penalties by Lessees

Lessees have the right to enforce penalties on defaulting refiners under the terms of the Supply and Purchase Agreement (SPA). These penalties may include the suspension of domestic crude supply allocations to refiners who fail to meet their obligations, drawing on Letters of Credit (LCs) or Bank Guarantees, which entail compensation for default and can be obtained by invoking financial instruments provided by the refiners.

Failure by refiners to lift allocated crude oil within the agreed LAYCAN has significant repercussions. This non-compliance can lead to operational disruptions, including production curtailment, as lessees may be unable to manage storage constraints or downstream commitments. In such instances, lessees are entitled to impose fines equivalent to delayed royalties and other penalties explicitly stipulated in the SPA. However, it is critical to highlight that under Section 6 of the 1999 Constitution of the Federal Republic of Nigeria (as amended), the authority to impose penalties or fines is vested exclusively in the Judiciary. Consequently, any attempt by regulatory bodies or other entities to independently impose penalties is unconstitutional. This position has been upheld in S.P.D.C.N. Ltd v. Ajuwa,[20] which reaffirms the judiciary's exclusive jurisdiction in this regard.

iv. Forecasted Production Allocation for Domestic Supply

To ensure adequate supply for domestic consumption, lessees are required to allocate a portion of their forecasted production to meet local refinery needs, in line with the Domestic Crude Supply Obligations (DCSO). As stated earlier, the Commission is to establish and implement fair metrics to determine DCSO allocations. Beyond the regulatory mandates, lessees are free to negotiate additional sales agreements with domestic refiners, enabling operational flexibility and increased market efficiency.

While the enforcement mechanisms under the SPA provide lessees with tools to address non-compliance, care must be taken to align such mechanisms with constitutional and judicial requirements. Regulatory and operational frameworks must respect the principle that penalties and fines constitute judicial prerogatives, thereby avoiding potential legal challenges or disruptions.

[18] 18(1) of the Regulations
[19] 18(2) of the Regulations
[20] (2015) 14 NWLR (Pt. 1480) 403 at 473

v. Pre-Delivery Financial Guarantees for Crude Oil Sales

In mitigating financial risks and ensuring payment security, lessees are required to secure acceptable financial instruments from refiners before crude oil delivery. These instruments are essential for enforcing contractual obligations and maintaining operational continuity. The key financial guarantees include Irrevocable Letters of Credit (LCs), which presupposes that refiners provide irrevocable LCs issued by reputable banks. These LCs must be valid for a minimum period of 90 days from the agreed LAYCAN date, ensuring sufficient time to complete delivery and payment processes.[21] LCs offer a secure payment mechanism, minimizing the risk of default by guaranteeing payment upon presentation of specified documents.

Standby Letters of Credit (SBLCs) for Long-Term Contracts are typically for refiners engaging in long-term crude supply agreements, SBLCs are acceptable as a more flexible financial instrument.[22] These SBLCs act as a financial backstop, ensuring payment in the event of non-performance by the refiner. Refiners with smaller operational capacities may provide irrevocable bank guarantees as an alternative to LCs or SBLCs. However, these guarantees must adhere to strict conditions, including:

a. Coverage equivalent to the sales value of the crude oil.
b. Incorporation of replacement policies to address potential payment defaults.[23]

The inclusion of such guarantees ensures that lessees can recover their financial exposure, even from smaller refiners.

DUTIES AND RESPONSIBILITIES OF THE REFINER UNDER DCSO

i. Financial Obligations and Payment Instruments

The Guidelines establish a clear framework for ensuring timely and secure payment for crude oil by refiners. These provisions are designed to enhance transparency, reduce payment risks, and foster smooth transactions between refiners and lessees.

Under the Guidelines, the Refiner's payment for crude oil is required to be secured through a Letter of Credit (LC). This LC may be issued by a reputable Nigerian or international bank, ensuring the financial instrument meets global standards for reliability. To comply with the Guidelines, the LC must be delivered to the lessee no later than six (6) banking days prior to the first day of the agreed LAYCAN.[1]

The LC must be valid for a minimum duration of 90 days, commencing from the second day of LAYCAN. To safeguard the transaction, the LC is required to be backed by a reputable financial institution with a minimum credit rating of BBB, as agreed by the lessee. A BBB rating signifies that the issuing institution possesses adequate financial strength and is categorized as investment-grade, offering reasonable assurance of payment reliability.

[21] 4.3.1 of the Guidelines
[22] 4.3.3 of the Guidelines
[23] 4.4 of the Guidelines
[24] 4.3.1 of the Guidelines

In scenarios where the refiner and lessee have entered into a long-term supply and purchase agreement, the requirement for a standard LC may be substituted with a Revolving Stand-by Letter of Credit (SBLC).[25] This arrangement provides continuous payment assurance and reduces the administrative burden of issuing a new LC for each transaction, thereby streamlining the financial and operational obligations of both parties.

ii. Crude Oil Offtake Obligations by Refiners

Refiners are obligated to ensure the timely lifting of crude oil within the stipulated delivery window to avoid incurring penalties. These penalties may include suspension of future Direct Crude Supply Obligations (DCSO) allocations, financial liabilities, and liquidated damages arising from the distressed sale of marine-delivered cargo.[26] In instances where operators are unable to offtake crude oil due to force majeure, they must provide duly documented evidence substantiating their claim.

iii. Alignment with DCSO Allocations

Refiners must ensure their operational capacity is adequately aligned with their allocations under the Direct Crude Supply Obligations (DCSO). Non-compliance, particularly repeated failures to offtake the allocated crude, can attract significant penalties and result in substantial reputational harm.

THE IMPACT OF THE GUIDELINES ON PROJECT SPONSORS OR FINANCIERS

The Guidelines offer clear frameworks for crude oil allocation, delivery, and pricing, reducing uncertainties in feedstock supply. For project sponsors, this predictability fosters a more stable investment environment, particularly for refinery development and upgrades. Financiers can rely on the streamlined processes to mitigate supply chain risks and support sustainable cash flow projections.

The mandatory use of financial instruments such as Letters of Credit (LCs) or Standby Letters of Credit (SBLCs) minimizes payment defaults. This improves the creditworthiness of refiners, offering financiers greater confidence in funding projects tied to domestic crude oil supply. Additionally, robust financial guarantees allow project sponsors to secure loans at favourable terms. Refiners must ensure operational readiness to receive and process crude oil, as long-term contracts are conditional upon such readiness. This places a premium on investing in infrastructure to prevent penalties or missed allocations, emphasising the need for financiers to evaluate the technical and operational robustness of refineries before extending credit.

While non-compliance regarding supply or offtake obligations may attract severe penalties, including suspension from future allocations or legal liabilities, it is important for Project sponsors and financiers to prioritise adherence to these Guidelines in operational plans, contracts, and risk assessments to avoid disruptions.

[25] 4.4.1-4.4.3 of the Guidelines
[26] 5.5.1 of the Guidelines

CONCLUSION

The implementation of the Guidelines for Operationalising Domestic Crude Oil Supply Obligations represents a transformative step toward addressing the long-standing challenges of feedstock shortages in Nigeria's refining sector. By establishing clear frameworks for crude oil allocation, pricing, and delivery, the Guidelines promote efficiency, transparency, and collaboration between lessees and refiners.

This regulatory advancement not only enhances operational stability within the petroleum value chain but also strengthens Nigeria's energy security by ensuring a steady supply of domestically refined petroleum products. Additionally, the robust enforcement mechanisms and financial safeguards foster a conducive environment for investment, enabling project sponsors and financiers to mitigate risks and support the growth of the refining industry.

As stakeholders navigate this evolving landscape, adherence to these Guidelines will be critical in achieving the broader economic and strategic objectives of the PIA, ultimately driving sustainable development and self-reliance in Nigeria's energy sector.

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[25] 4.4.1-4.4.3 of the Guidelines
[26] 5.5.1 of the Guidelines

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