KPMG

Downstream Sector Watch

KPMG in Nigeria

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Introduction

Nigeria's downstream sector has continued to underperform due to the current regulated price regime, in preference for full deregulation of the sector.While government tries to incentivize investment into the sector, the potentials of the sector to leapfrog our economic growth remain stifled, due to the over-regulation.

This newsletter highlights some of the recent events within the sector, including the regulatory and tax matters affecting the industry.

Updates in the downstream sector

- **Covid-19**

  The global economy is currently grappling with a pandemic occasioned by the rapid spread of the novel Corona Virus (or Covid-19), a disease that was first identified in Wuhan, Hubei, China in December 2019. As of 26 April 2020, Covid-19 has spread to over 190 countries with more than 2,981,000 cases and over 206,000 deaths reported.

  Countries around the world have responded by introducing measures to curtail the impact of the pandemic on the economy and the well-being of their citizens. These measures include tax reliefs, welfare support to families and grant of loans to businesses. In Nigeria, the government, through the Central Bank of Nigeria (CBN), has responded by direct intervention through granting special intervention fund to the health sector and reduction of interest rate from 9% to 5% on some intervention funds, amongst others. Specifically, the government has reduced the pump price of petroleum motor spirit (PMS) from N145/liter to N123.50/liter, to ease the impact on citizens.

  Measures introduced by the government to curtail the spread of Covid-19 include the lock-down imposed by the Federal Government across two States in the country (Lagos and Ogun) and the Federal Capital Territory, Abuja. The lock-down entails restrictions on movement, except for essential and critical needs of the society covering health care providers, food producers/ marketers, banking sector, PMS distribution and certain port operations. With these measures, it is hoped that the spread of the virus will be contained, and the curve of infection flattened within the shortest possible time.

- **Department of Petroleum Resources (DPR) moves to enforce safety standards**

  The Department of Petroleum Resources (DPR) has initiated steps that will compel fuel marketers and gas plant owners to meet the minimum safety training requirements set by it, or they lose their operating licenses. This initiative, which is set to be in full force by September 2020, was conceived by the DPR in order to reduce the number of accidents related to the downstream sector operations and environmental pollution in Nigeria.

  This initiative is quite timely, as the DPR revealed that based on statistics at its disposal, 70 per cent of accidents in the Nigerian oil and gas industry between 2013 and 2019 occurred in the downstream sector. Such accidents include those from fallen tankers, petrol station fires, gas explosion and vandalism. We hope that once this initiative is activated, it would reduce such accidents to the minimum.

- **Nigeria tightens security in the downstream sector**

  The lack of effective monitoring of the supply and distribution of petroleum products (particularly, premium motor spirit, PMS) is hurting the economy – resulting in huge under-recovery and or subsidy bill. In a bid to ensure improved transparency and accountability in this segment of the sector, the Federal Government of Nigeria (FGN) launched the "Operation White" project during the 4th quarter of 2019. The Project team consists of 89 members drawn mainly from five agencies - the Nigerian National Petroleum Corporation (NNPC), Department of Petroleum Resources (DPR), Petroleum Products Pricing Regulatory Agency (PPPRA), Petroleum Equalization Fund (PEF) and the Department of State Security (DSS). The team was charged with the task of ensuring transparency in the supply and distribution of products, with a directive of ensuring that *"...all molecules of regulated petroleum products imported by the Nigeria National Petroleum Corporation* (NNPC) *are well accounted for and utilized in-country..."*

With the dwindling foreign reserve and fall in government revenue occasioned by the twin impact of fall in oil price and Covid-19, the Project is expected to help curb unnecessary diversion of refined products which should ultimately help the nation properly account for domestic consumption. The closure of Nigeria's borders is also aimed at curbing the illegal diversion of PMS to the neighboring countries, help ascertain the actual quantum of PMS consumed in the country and ultimately manage the subsidy bill.

It appears that this initiative has started yielding results given that as at September 2019, the daily PMS consumption in Nigerian has reduced from 60 million in August 2019 to 50.22 million liters.

- **NNPC to rehabilitate existing refineries**

The NNPC is in the process of rehabilitating its four oil refineries, located in Port-Harcourt (two refineries), Warri and Kaduna, with a combined refining capacity of 445,000 barrels per day (bsp) of crude oil, but under a different model from what the country has witnessed to date.

According to the Group Managing Director (GMD) of NNPC, Mallam Mele Kyari, in an interview with Arise Television, a sister broadcasting station of ThisDay newspaper early April 2020, NNPC will engage independent third parties to fix the Port Harcourt refineries under an "Operate and Maintenance" (O&M) contract, for a fee. NNPC will not run them. The same model will be implemented for the other two refineries in Warri and Kaduna. While the operation of this model lasts, NNPC will evaluate what exactly to do with the refineries. The GMD hinted that the Nigeria LNG Limited (NLNG) model may eventually be considered for the operation of the refineries.

Aside from this traditional source of PMS for the country's energy security, NNPC has also disclosed that it was in the process of establishing two new 200,000 barrels-per-day condensate refineries. Once completed, it should ease the pressure occasioned by the subsidy on imported products, and eventually get Nigeria to be a net exporter of petroleum products.

Expectations are high from stakeholders regarding the refineries, and the earlier that the government decides what to do with them, the better for the country as a whole. For certain, continuous regulation of PMS pricing is not sustainable, particularly, in light of the global forces on price of crude oil and its downstream impact on PMS pricing locally.

- **Checkmating unethical practices and pipeline vandalization**

Pipeline vandalization appears to be an intractable problem in the downstream sector, as product losses have continued unabated. The GMD of NNPC recently disclosed that the Corporation recorded 45,347 pipeline breaks on its downstream pipeline network across the country between 2001 and January to June of 2019. The Nigerian Extractive Industry Transparency Initiative (NEITI), further stated that Nigeria has lost about $41.94 billion in 10 years due to pipeline vandalization.

Nigeria's Senate President has also condemned these unholy activities and called for the imposition of stiff sanctions and prosecution of the affected persons. He has directed the Senate Committee on Petroleum (Downstream) to review the current security measures for pipeline across the Country along with the NNPC.

Taking proactive security measures as being planned should reduce the incidences of vandalization and product theft and make the sector a bit attractive for increased investment.

Tax issues in the downstream sector

- **Gas utilization incentives in the downstream sector**

The Finance Act (the Act) recently signed by the President, has made some amendments to section 39 of the Companies Income Tax Act (CITA), with respect to the incentives offered investors in the downstream gas utilization operations. Two key changes brought about by the Act are as follows:

i. Deletion of the section of the law that requires companies to obtain Ministerial approval before treating interest on loans obtained for gas operation as a tax-deductible expense. Thus, from the commencement of the Act, this obnoxious provision will no longer apply, and gas companies would be placed on the same pedestal as companies in the other sectors of the economy who do not require such authorization from the Minister.

ii. Clarification regarding the treatment of computed capital allowances has now been provided. Thus, companies cannot duplicate capital allowances (CA) claim incentives under this provision of the CITA and under the Industrial Development (Income Tax Relief) Act, i.e. the law administering the pioneer status incentive. This amendment is aimed at avoiding a double claim of tax incentives by gas operators.

Matters arising from the amendment

The key implication of this amendment for downstream companies in their pioneer (tax-free) period is the provision on the claim of CA. The current practice for such companies is to either freeze their CA claim during the pioneer period and carry forward the entire allowance to the post-pioneer period, or not compute CA on assets bought during pioneer and treat them as new additions for the purpose of CA at the beginning of the post-pioneer period.

This Act has now clarified that the pioneer status only exempts companies from the payment of CIT. It does not exempt companies from computing their total profit and relieving their CAs computed from their assessable profit, as prescribed in other sections of the CITA. Thus, gas companies in their pioneer period should compute their CAs, use it to offset their assessable profit (if any) during the pioneer period and carry forward the unutilized CA to the post-pioneer period.

It is therefore expedient for companies processing their pioneer status application, and those already in their pioneer period to review their projected capital expenditure vis-à-vis their projected assessable profit during the pioneer period to ensure that they apply for and or claim the pioneer status incentive at the most beneficial point during their operation.

- **Value Added Tax (VAT) exemption on petroleum products**

  Nigeria's Minister of Finance, according to the power vested in that office via section 38 of the VAT Act, has expanded the list of items exempted from VAT.

  The new VAT-exempt items contained in the Order, dated 24 December 2018, are:

  i. Automotive Gas Oil

  ii. Aviation Turbine Kerosene

  iii. Household Kerosene

  iv. Locally produced Liquefied Petroleum

  v. Premium Motor Spirit

  This is a welcomed development, as it has effectively resolved the long-standing debate on the applicability or otherwise of VAT on the supply of the listed petroleum products. Nonetheless, the implication is that the input VAT incurred on raw materials utilized in producing petroleum products will not qualify as allowable input VAT any longer. Rather, it will be expensed through the income statement by the entity incurring the cost.

Conclusion

The downstream sector has witnessed a lot of challenges over the years, with a slow and sluggish growth. However, the little but steady gains over the last 4 years is seemingly under threat as a result of the current slump in crude oil prices and the impact of Covid-19 pandemic. While the government has taken some fiscal policy and other measures to respond to the challenges, the extent to which the impact of all these measure would be felt by stakeholders will depend on how early the country overcome the devastating impact of the lockdown order occasioned by Covid-19.

Nonetheless, the Federal Government should urgently revisit the clamor for a complete deregulation of the downstream sector (not a price "modulation" mechanism), as this would provide the elixir to liberate the sector and contribute meaningfully to the country's economic growth. Thus, funds hitherto channeled towards the subsidy would be available for addressing other pressing needs, particularly, infrastructure deficit.

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