

Downstream Sector Watch

Second Edition

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Introduction

The Nigeria's downstream sector has continued to underperform due to the current regulated price regime. While government tries to incentivize investment in the sector by introducing fiscal policies and measures to attract investors, such as exemption of petroleum products from value added tax, gas utilisation (downstream operations) incentive and pioneer status incentive, the potentials of the sector to leapfrog economic growth remain stifled, due to the prevailing price fixing regime.

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 Coronavirus disease ("Covid-19") that was first identified in Wuhan, Hubei, China in December 2019.

Countries around the world have responded by introducing measures to curtail the impact of the pandemic on their economies 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, has responded by creating a special intervention fund for the health sector and reducing interest rate from 9% to 5% on some intervention funds, amongst others. Also, the government has reduced the pump price of petroleum motor spirit (PMS) from ₦145/litre to ₦121.50/litre, to ease the impact on citizens. But the question still remains whether this is a fair price when compared with the price per litre of fuel in other countries where fuel price is deregulated.

Measures introduced by the government to curtail the spread of Covid-19 include the lockdown imposed by the Federal Government in Lagos, Ogun and Kano States, and the Federal Capital Territory, Abuja. The lockdown initially entailed restrictions on movement, except for essential goods and services covering health care providers, food producers/marketers, banking

sector, PMS distribution and certain port operations. With the partial easing of the lockdown and other measures from 4 May 2020, it is hoped that the spread of the virus will be contained, and the infection rate curve will be flattened within the shortest possible time.

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

The DPR has initiated steps to compel fuel marketers and gas plant owners to meet its minimum safety training requirements or lose their operating licences. This initiative, which is set to be in full force by September 2020, was rolled out by the DPR in order to reduce the number of accidents in 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 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 PMS) is hurting the economy – resulting in huge under-recovery of the 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 ("the Project") during the 4th quarter of 2019. The Project team consists of 89 members drawn mainly from five regulatory agencies - the Nigerian National Petroleum Corporation (NNPC or "the Corporation"), DPR, Petroleum Products Pricing Regulatory Agency, Petroleum Equalization Fund and the Department of State Security. The team was charged with the task of ensuring transparency in the supply and distribution of products, with a directive to ensure that "...all molecules of regulated petroleum products imported

by the NNPC are well accounted for and utilized in-country...”

With the dwindling foreign exchange reserve and fall in government revenue occasioned by the twin impact of fall in crude oil price and Covid-19 pandemic, the Project is expected to help curb unnecessary diversion of refined products which should ultimately help the nation to properly account for domestic consumption. The closure of Nigeria’s borders is also aimed at curbing the illegal diversion of PMS to the neighbouring 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 litres in August 2019 to 50.22 million litres.

- **NNPC to rehabilitate existing refineries**

The NNPC is in the process of rehabilitating its four crude oil refineries, located in Port-Harcourt (two refineries), Warri and Kaduna, with a combined refining capacity of 445,000 barrels per day (bpd) 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 early April 2020, NNPC will engage independent third parties to fix the Port Harcourt refineries under an “*Operation and Maintenance*” 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 Liquefied Natural Gas Limited 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 bpd 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. Certainly, continued price-fixing regime for PMS is not sustainable, and the current low crude oil price regime provides the right environment for the government to fully deregulate the downstream sector.

- **Checkmating unethical practices and pipeline vandalism**

Pipeline vandalism 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 June 2019. The Nigerian Extractive Industry Transparency Initiative further stated that Nigeria has lost about \$41.94 billion in 10 years due to pipeline vandalism.

Nigeria’s Senate President, Ahmed Ibrahim Lawan, has also condemned these unholy activities and called for the imposition of stiff sanctions and prosecution of the culprits. He has further directed the Senate Committee on Petroleum (Downstream) to review the current security measures for pipelines across the country along with the NNPC.

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

Tax issues in the downstream sector

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

The Finance Act, 2019 (“the Act”) has made some amendments to Section 39 of the Companies Income Tax Act (CITA), with respect to incentives available to investors in downstream gas utilization operations. Two key changes brought about by the Act are as follows:

- i. Deletion of the provision 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 provision will no longer apply, and gas companies would be at liberty to obtain loans and deduct the interest expenses without recourse to the Minister.
- ii. Clarification regarding the treatment of computed capital allowances has now been provided. Thus, companies cannot duplicate capital allowances (CA) claim under the provision of the CITA and under the Industrial Development (Income Tax Relief) Act, i.e., the enabling law for pioneer status incentive. This amendment is aimed at avoiding a double claim of tax incentives by gas operators.



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

The Honourable Minister of Finance in the exercise of her powers under Section 38 of the VAT Act, has expanded the list of items exempted from VAT.

The new petroleum-related VAT-exempt items contained in the Value Added Tax (Modification Order), 2020 are:

- i. Aviation Spirit
- ii. Motor Spirit, Super
- iii. Motor Spirit, Ordinary
- iv. Kerosene Type Jet Fuel
- v. Kerosene
- vi. Natural Gas
- vii. Other Liquefied Petroleum Gases and other Gaseous Hydrocarbons

This is a welcome 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 the 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 resulting in a sluggish growth. However, the little but steady gains over the last 4 years are now 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, their impact on stakeholders will depend on how early the country overcomes the devastating impact of Covid-19.

Nonetheless, the Federal Government should urgently unfold its long overdue plan for a complete deregulation and transformation of the sector. Apart from eliminating the long-standing fuel subsidy albatross once and for all, it will release the much-needed cash to fund infrastructure development in the country, attract new investments to the sector, foster competition between operators, and promote efficiency in the entire value chain.

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