THE INCENTIVES IN THE FISCAL FRAMEWORK OF THE NIGERIAN MoUs WITH THE INTERNATIONAL OIL COMPANIES: HAVE THE OBJECTIVES BEEN ACHIEVED?

Humphrey Onyeukwu
ABSTRACT:
The Nigerian Government had entered into Memoranda of Understandings (MoUs) with the various major International Oil Companies (IOCs) in the 1990s providing incentives to the companies at a period when the Oil market was experiencing oil price recession. The MoUs, amongst other fiscal terms guaranteed the IOCs a minimum profit per barrel of oil produced and a lower tax rate from the standard tax rate prescribed under the Petroleum Profit Tax Act. However, the Nigerian Government has recently indicated its intent to terminate the MoUs and replace it with a standard tax plan. In the light of these recent developments, the paper discusses the fiscal incentives in the framework of these MoUs and their impact on investments and government revenue. The paper analyses the impact of the MoUs using international economic drivers like Foreign Direct Investments (FDI) and contemporary local economic paradigms. The paper concludes by examining the question whether the MoUs as a tax instrument have achieved its objectives.
LIST OF ABBREVIATIONS

**CNOOC**  Chinese National Oil Company

**IOC**  International Oil Companies

**JV**  Joint Venture

**MoU**  Memorandum of Understanding

**NNPC**  Nigerian National Petroleum Corporation

**NOC**  National Oil Companies

**PPTA**  Petroleum Profit Tax Act

**PSC**  Production Sharing Contract

**RGT**  Revised Government Take
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4. THE FISCAL INCENTIVES OF THE MoUs AND THEIR IMPACTS ON ECONOMIC DRIVERS
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1. **INTRODUCTION**

Revenues accruing from oil and gas are at the foundation of Nigeria’s economic and social performance. They account for over 40% of the country’s Gross Domestic Product, 70% of budget revenues and over 95% of foreign exchange earnings\(^1\). The industry is the main hub of the Nigerian economy and each successive government has always adopted policies aimed at sustaining the prime position of the oil industry in generating national revenue.

The oil glut of the 80’s impacted greatly on global oil prices and the very low OPEC quota foisted on the country highly depleted foreign exchange earnings and created distortions in the economy. This caused the government to re-negotiate their petroleum agreements with the International Oil Companies operating in Nigeria at that time and these negotiations birthed the Memorandum of Understandings. These MoUs introduced fiscal and incentives regime different from the petroleum profit tax therefore creating a lower petroleum profit tax from the standard tax rate of 85% and 20% royalty regime.

The MoUs provided some guarantees that the IOCs shall retain a minimum profit margin per oil barrel and a bonus for additions to oil reserves. The introduced guarantees aimed to cushion the impact of the recession in the oil market on the operations of the IOCs and retain their confidence in committing to additional investments in oil and gas exploration which was at its lowest ebb. The terms of the MoUs could not be sustained in the face of the recent increasing oil prices which have consistently maintained a record high of above $100 per barrel. Consequently, the Nigerian Government has proposed a policy to cancel the agreements and replace it with a standard tax plan\(^2\). The focus of this

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\(^1\) Joint United Nations Development Programme/World Bank Energy Sector Management Assistance Programme (ESMAP), *Taxation and State Participation in Nigeria’s Oil and Gas Sector*. (August 2004)

\(^2\) Julie Ziegler, *Nigeria Seeks to Replace Output Accord, Shell Says*, Bloomberg News
paper is to examine the fiscal incentives introduced by the MoUs and evaluate whether the objectives for which it was set up was achieved. The paper shall address these issues using the tool of the economic concepts that have guided the design of fiscal regimes to study whether the interests of the government have been best served in the prevailing circumstances.

In addressing this issue, chapter one introduces the paper. Chapter two dwells on a broad descriptive of the Nigerian oil and gas fiscal and tax regime, considering the Petroleum Profit Tax Act, the tax royalty and memorandum of understanding arrangements and the production sharing contractual arrangements. Chapter three analyses the economic concepts guiding fiscal regime design and uses the tool to examine the MOU incentives and fiscal regime. Chapter four highlights the principal specifics of the fiscal incentives introduced by the MoUs and evaluate its impacts on economic drivers such as generating direct investments in the Industry. It makes an assessment on whether the government has had a fair share of the economic rent inherent in the system. Chapter five concludes the paper.

2. THE NIGERIAN OIL AND GAS FISCAL AND TAX REGIME

2.1 Petroleum Profit Tax Act

April 2008).
The principal legislation guiding the taxation of the operations of oil companies operating in Nigeria is the Petroleum Profit Tax Act. The legislation was initially enacted in 1959 and has gone through several amendments. Some features of the Petroleum Profit Tax Act to be noted are:

(a) The profits of the company in any accounting period on which tax would be based is the aggregate of the proceeds of sale of all chargeable oil sold by the company in that period; the value of all chargeable oil delivered by the company to a refinery without a formal sale or to an adjacent storage tank for refining by the company during the period; the value of all chargeable natural gas during the period as determined in accordance with the Fourth Schedule to the PPTA and all incidental incomes to the company which are traceable to any of its petroleum operations during the period.

(b) The tax rate on the profits of a company engaged in petroleum operations is 85% as the PPTA prescribes that the assessable tax for any accounting period of a company is an amount equal to 85 per cent of the chargeable profits for the period.

(c) The chargeable profit of the company subject to taxation is determined by the amount of its assessable tax for any accounting period less the deductible expenditure items or outgoings. The deductible expenses includes amongst others,

1. All non-productive rents, the liability for which was incurred by the company during the period. These

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3 Cap 354 Laws of the Federation of Nigeria 2000

4 Schedule Four of the PPTA was introduced into the Principal Act by Act No. 95 of 1979. It was enacted as a means of converting chargeable natural gas into bands of chargeable oil equivalent to determine the value of the gas component in the profits calculation on which PPT is based.
are annual rents paid in respect of oil prospecting licences (OPLs) or oil mining leases (OMLs).

II. All royalties the liability which was incurred by the company in respect of locally disposal of chargeable oil for that accounting period.

III. All royalties, the liability for which was incurred by the company during that period in respect of crude oil or casing head petroleum spirit won in Nigeria.

IV. Sums incurred by way of interest payable on capital employed in carrying out petroleum operations.

V. Any expense incurred for repair of premises, plant, machinery or fixtures employed in petroleum operations or for renewal, repair of implements, articles and utensils so employed.

VI. Contributions to a pension, provident or other society, scheme or fund.

VII. All sums, the liability of which was incurred by the company during that period to the Federal Government or any other State or Local Government Council in Nigeria by way of duty, customs and excise duties, education tax (other than tax imposed as petroleum profits by the PPTA) or any other tax, fee or other like charges.
2.2 The Tax Royalty/Memorandum of Understanding Arrangements

The Tax/Royalty Memorandum of Understanding applies to the joint ventures between the Nigerian National Petroleum Corporation (NNPC), the national oil company (NOC) and its IOCs partners. The advent of the Tax Royalty/Memorandum of Understanding fiscal regime in Nigeria is traced to the period of the oil price recession of the 1970’s, the IOCs complained that the combined royalty and petroleum profits tax rates were reducing profit margins to such a level as to discourage further investment. The government then began the practice of granting fiscal incentives which were initially granted by a letter emanating from the Ministry of Finance to the relevant company and later incorporated into the law by amendment of the PPT Act, the Petroleum Regulations or other regulations\(^5\). They granted the letters of incentive in a bid to encourage a favourable climate for investment by the IOCs in the sector.

The first MoU entered between the Nigerian government and the IOCs were in 1986. There were subsequent amendments in 1991 and the current one executed in August 2000. The MoU’s objectives include the creation of fiscal incentives (to the companies) in order for them \textit{inter alia}, to assist in the moving of NNPC’s equity crude to the international market place, increased investment in exploration and development activities and cost efficient operations\(^6\).

The Tax/Royalty Memorandum of Understanding regime is applicable to the Joint Venture Agreements (JVA) between the NNPC and its joint venture partners\(^7\) which currently account for about 95% of Nigerian

\(^5\) An example is the fiscal incentives granted in 1977 vide the letter No. MPR 3007/S.9/Vol.2/184 of 19\(^{th}\) May 1977 was made law in 1979 in the PPT (Amendment) Act and Petroleum (Production and Drilling) (Amendment) Regulations 1979.


\(^7\) The JVs are operated by Shell Petroleum Development Company of Nigeria, Chevron Nigeria Limited, Mobil Producing Nigeria Unlimited, Nigeria Agip Oil Company Limited, Elf Petroleum Nigeria Limited and Texaco Overseas Petroleum Company of Nigeria Unlimited.
crude oil production. The fiscal terms of the Joint Venture (JV) arrangements between the parties is governed by the royalty/tax regime in Nigeria which is comprised of:

1. In Nigeria, royalties are paid based on volume and decreases as the water depth increases. A royalty rate of 20% for oil and 7% for gas in onshore production and a graduated scale beginning with 18.5% for oil in offshore production of water depth of up to 100 metres and failing to a scale of 0.00% for oil in water depth of over 1,000m and 5% for gas in offshore area.

2. A petroleum profit tax standard rate of 85%, however with an initial rate of 65.75% applicable until the company has recovered preproduction expenses.

The intervention of the MoUs guaranteed for the IOCs a profit margin for each barrel of crude produced and lesser amount of tax than it would otherwise had paid under the PPTA provisions. The MOU calls for two tax calculations, one based on PPT and Royalty without any adjustment, and a second referred to as Revised Government Take (RGT) based on the parameters provided in the MoU. The arrangement of the RGT calculations enures to accord a minimum profit after tax and royalty to the IOC on its equity crude. This minimum margin shall be premised on the fact that the technical cost of the operation does not exceed the notional fiscal technical cost which at present is $4.00 bbl. When in any one calendar year the company’s actual capital investment costs exceed $2.00 per barrel on average, then the minimum guaranteed notional margin shall be $2.70.

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9 They are provided under the Schedule I of the Petroleum Act 1969 as amended and Regulation 60, Petroleum (Drilling and Production) Regulations of 1969 as amended.

10 Omoregbe, Yinka, Supra, p. 9
The MoUs provide for cost containment to maintain cost efficiency using a tax inversion rate of 35%. The cost containment provision replaces the Reserve Addition Bonus previously retained in the previous MoUs of 1986 and 1991. Another incentive introduced by the MoU is in respect of Government Take. It prescribes that in calculating Government Take, it shall comprise of royalty and PPT relating to a joint venture company’s operations in respect of an accounting period, is the lower of Government Take (according to the December 31, 1985 Royalty and PPTA provisions (as amended) calculated by the substitution of Posted Price with Official Selling Price) and the Revised Government Take (according to the December 31, 1985 Royalty and PPTA provisions (as amended) calculated by the substitution of Posted Price with Tax Reference Price).

The MoU also guarantee the companies that all taxes, levies and other impositions by the federal, state or local governments, including Central Bank commissions, apart from royalty and petroleum profits tax, shall be set-off against the company’s tax liability.

2.3 **The Production Sharing Contractual Arrangements**

The PSCs, unlike the JV arrangement associated with the Tax/Royalty/MoU system, does not require the Government’s equity participation and funding obligations. The title to the hydrocarbons remains with the state and the IOC acts as the contractor responsible for the execution of the petroleum operations in accordance with the terms of the PSC with the contractor’s compensation in a share of the production. Production, once established, is shared between the government and the contractor in accordance with an agreed formula, which allows for prior recovery of costs at a pre-established rate\(^\text{11}\).

The contractor bears the risks and costs of exploration which it loses if there is no discovery. If there is a discovery it recoups its costs from an

\(^{11}\text{Joint United Nations Development Programme/World Bank Energy Sector Management Assistance Programme (ESMAP), Supra, p. 20}\)
agreed percentage of the production. The balance of the production is shared between the contractor and the NOC in accordance with agreed percentages that normally give a greater portion to the company when production is low and higher volumes of production give corresponding larger shares to the NOC.

Nigerian PSCs have the elements of Cost Oil, Royalty Oil, Tax Oil, and Profit Oil. The crude oil is allocated between the NOC and the contractor in the following order: Royalty Oil, Cost Oil, Tax Oil and Profit Oil. Profit oil is shared subsequent to the deduction of royalty, provisions for cost recovery and tax payments. Cost recovery is usually capped and limited to production less royalty and PPT applied to the contractor’s take at a rate of 50%. The royalty rates are established on the basis of the concession’s location and water depth and profit oil sharing occurs as a function of production rates. For post-2000 Nigeria PSCs, the sharing formula for profit oil between the NOC and the contractor is represented in the Table 1 below:

**Table 1**

<table>
<thead>
<tr>
<th>Cumulative Production (MMB) from Contract Area</th>
<th>Contractor</th>
<th>Corporation</th>
</tr>
</thead>
<tbody>
<tr>
<td>0-350</td>
<td>70</td>
<td>30</td>
</tr>
<tr>
<td>351-750</td>
<td>65</td>
<td>35</td>
</tr>
<tr>
<td>751-1000</td>
<td>52.5</td>
<td>47.5</td>
</tr>
<tr>
<td>1001-1500</td>
<td>45</td>
<td>55</td>
</tr>
<tr>
<td>1501-2000</td>
<td>35</td>
<td>65</td>
</tr>
<tr>
<td>Greater than 2000</td>
<td>Negotiable</td>
<td></td>
</tr>
</tbody>
</table>

The fiscal terms of the PSCs are composed of pre-production payments of signature bonuses, rental fees, bidding fees, royalties and post-production payments of PPT, production bonuses, royalties and profit oil shares. There are also provisions for investment allowances, ring fencing and obligations imposed on operators like the local content policy.

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12 Omorogbe, Yinka, Supra p. 8
The principal features of the Nigerian PSC arrangement with the IOCs are represented in the following tables:

### Table 1  **Summary of Production Sharing Contracts**

<table>
<thead>
<tr>
<th>Feature</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Signature Bonus</td>
<td>US$0.50-1.00MM/Block</td>
</tr>
<tr>
<td>Bid Bonuses</td>
<td>US$10-30MM/Block</td>
</tr>
<tr>
<td>Royalty Oil</td>
<td>Up to 16.67% (subject to water depth)</td>
</tr>
<tr>
<td>Cost Recovery</td>
<td>100% after royalty</td>
</tr>
<tr>
<td>Depreciation</td>
<td>5 Year Straight Line</td>
</tr>
<tr>
<td>Profit Oil</td>
<td><em>Niger Delta:</em> 60% (&lt;30MBD) to 65% (60% (&gt;2BBI)</td>
</tr>
<tr>
<td></td>
<td><em>Frontier:</em> 20% (&lt;350 MMB) to 60% (&gt;2BBI)</td>
</tr>
<tr>
<td>Tax (PPT)</td>
<td>50%</td>
</tr>
<tr>
<td>Consolidation</td>
<td>Ringfence for PSC; All E&amp;P for PPT</td>
</tr>
</tbody>
</table>

### Table 2  **Profit Sharing**

<table>
<thead>
<tr>
<th>Area</th>
<th>Production (MBD)</th>
<th>State %</th>
<th>Contractor %</th>
</tr>
</thead>
<tbody>
<tr>
<td>Onshore</td>
<td>&gt;100</td>
<td>52</td>
<td>48</td>
</tr>
<tr>
<td></td>
<td>100 – 200</td>
<td>57</td>
<td>43</td>
</tr>
<tr>
<td></td>
<td>&gt;200</td>
<td>60</td>
<td>40</td>
</tr>
</tbody>
</table>

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13 Joint United Nations Development Programme/World Bank Energy Sector Management Assistance Programme (ESMAP), Supra, p.22

14 Ibid, p.69
<table>
<thead>
<tr>
<th>Area</th>
<th>Cumm. Production (MMb)</th>
<th>State %</th>
<th>Contractor %</th>
</tr>
</thead>
<tbody>
<tr>
<td>Shallow Offshore (&lt;200m)</td>
<td>&gt;30</td>
<td>60</td>
<td>40</td>
</tr>
<tr>
<td></td>
<td>30 – 50</td>
<td>62</td>
<td>38</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Area</th>
<th>Cumm. Production (MMb)</th>
<th>State %</th>
<th>Contractor %</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deep offshore (&gt;200m)</td>
<td>0 &gt; 350</td>
<td>20</td>
<td>80</td>
</tr>
<tr>
<td></td>
<td>351 – 750</td>
<td>35</td>
<td>65</td>
</tr>
<tr>
<td></td>
<td>751 – 1,000</td>
<td>45</td>
<td>55</td>
</tr>
<tr>
<td></td>
<td>1,001 – 1,500</td>
<td>50</td>
<td>50</td>
</tr>
<tr>
<td></td>
<td>&gt; 1,500</td>
<td>60</td>
<td>40</td>
</tr>
</tbody>
</table>

Table 3 **Royalty Rates**

<table>
<thead>
<tr>
<th>Water Depth</th>
<th>Royalty rates (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Onshore</td>
<td>10</td>
</tr>
<tr>
<td>0 – 200</td>
<td>10</td>
</tr>
<tr>
<td>200 – 500</td>
<td>12</td>
</tr>
<tr>
<td>500 – 800</td>
<td>8</td>
</tr>
<tr>
<td>800 – 1,000</td>
<td>4</td>
</tr>
<tr>
<td>&gt; 1,000</td>
<td>0</td>
</tr>
</tbody>
</table>

3. **CONCEPTS OF RESOURCE TAXATION DESIGN**

3.1 **Economic Rent**

Petroleum fiscal systems are designed to ensure that the economic rents derived from the exploitation of the natural resource are appropriately divided between the government and the investor. The justification for having a separate fiscal regime for the mineral sector is related to the

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15 Ibid, p. 70
special role of economic rent in mineral extraction. According to Thomas Baunsgaard, the scarcity of an exhaustible resource such as minerals, leads to the generation of economic rent when it is extracted.

Economic rent has been viewed from different perspectives by several authors. Garnaut and Ross define it as ‘the excess of total revenue derived from some activity over the sum of the supply prices of all capital, labour and other ‘sacrificial’ inputs necessary to undertake the activity’ Alexander Kemp’s view is that ‘Economic rents from petroleum exploitation are the returns accruing to investors over and above those necessary to sustain (1) ongoing production from existing fields, (2) the development of new but discovered fields, and (3) new exploration’. According to John Cordes, it is the difference between existing market price for a commodity or input factor and its opportunity cost. Opportunity cost is the reservation price or minimum amounts owners of goods or service would be willing to accept and from Daniel Johnston’s perspective, economic rent in the petroleum industry is the difference between the value of production and the costs to extract it. Economic rent is synonymous with excess rent and governments seek to retain as much of it derived using various elements of fiscal instruments such as taxes, fees and levies.

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17 Ibid


22 Ibid, p. 6
Economic rent represents that part of financial return not required to motivate desired economic behaviour and could therefore be taxed without influencing production decisions or distorting the resource allocation of the investor. From the government’s standpoint, its goal is to attract investment and capture the maximum economic rent from its acreages and for the investor, taxing the rent should not affect its capacity to earn an acceptable return on its investment. An appropriate fiscal design presents a win-win situation to both the government and the investor.

Table 4 illustrates the allocation of revenue from oil and gas production for costs and the division of profits.

Table 4

<table>
<thead>
<tr>
<th>GROSS REVENUE</th>
<th>PROFIT</th>
<th>COST</th>
<th>RECOVERY</th>
</tr>
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<tbody>
<tr>
<td></td>
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</tr>
</tbody>
</table>

The graph illustrates that the contractor's exploration costs, development costs, operating costs and share of profit is viewed by the government as costs. What remains is economic rent and an effective fiscal system balances the objectives of the investor and state while capturing an appropriate share of the economic rent. In designing the fiscal instruments, the government will need to weigh its desire to maximize short-term revenue against any deterrent effects this may have on investment.

Ibid, p. 7

Sunley, Emil, Baunsgaard, Thomas and Simard, Dominique (Eds), Revenue from the Oil and Gas Sector: Issues and Country Experience, World Bank Paper. (June 2002)
There are risks in developing resource projects. These are characterised by the prospect risks of failure to find hydrocarbons in commercial quantities, the commercial risk that the geology turns out to be less than favourable and the contract risk of the possibility that the government may seek to renegotiate the terms of the contract once production starts. Nevertheless, these risks can be reduced by the government adhering to a stable fiscal system that specifically targets the economic rent and make adequate provision of available information on exploration data. In corroboration, Johnston advocates that the hallmark of an efficient market is the availability of information.

It is also of note that to measure the rent requires knowledge of the necessary costs, production profiles, oil prices and investors discount rates. Without this knowledge it is difficult to design an ideal system of rent collection that collects a higher share of the rent when they increase either as a result of higher oil prices or lower costs. Where the rent is left to the companies under a period of high prices then the company is said to earn windfall profits and is not in the country’s favour. On the other hand, when too much rent is collected, ongoing production or new field developments are impaired as a result and the system is said to be regressive.

The MoU design of Nigerian fiscal system introduced incentives that ameliorate the associated risks of exploration faced by the operating companies. It address the uncertainty of the oil prices which affect the supply price of investment thereby increasing the economic rent that can be potentially be taxed without discouraging the investment from taking place.

### 3.2 Efficiency


25 Paul Stevens, *An Introduction to the Economics of International Oil and Gas*, Course Notes on Petroleum Politics and Economics, CEPMLP, University of Dundee

26 Johnston, supra, p. 6
According to Alexander Kemp\textsuperscript{27}, an efficient fiscal system should collect the economic rents from petroleum exploitation, but, if distortions are to be avoided, it should not hamper the effort necessary to produce the required exploration and development work\textsuperscript{28}. An efficient tax system collects revenue for the government without distorting the economic activity or affects the investment pattern of the economic actors. The nationalistic posture of government usually have conflicting roles to the profit-oriented corporate-savvy posture of the companies and it is in the design of an efficient tax fiscal system to formulate tax instruments that most efficiently realize these national objectives and avoid policies that induce companies to make economically distorting decisions. Thus, neither a very high tax which reduces the level of activity nor an excessively generous system of allowances which unnecessarily enhances the level of activity is likely to be efficient\textsuperscript{29}.

The efficiency of the fiscal system lies in collecting the economic rents to the state without creating distortions to the actors within the system. The MoU incentives and the Tax/Royalty regime of the Nigerian government fulfill these criteria. While ensuring to encourage a reasonably broad range of investments, the fiscal system also retains a relatively high share of project rents for Nigeria\textsuperscript{30}.

### 3.3 Neutrality

The concept of neutrality addresses the general nature of taxation that when a tax is levied, there is less disposable income left for the private

\textsuperscript{27} Alexander Kemp is a Schlumberger Professor of Petroleum Economics, associated with the University of Aberdeen Business School and has many prolific writings in Resource rent taxation.


\textsuperscript{29} Andrews-Speed, Philip Professor, \textit{Study Guide on Issues in the Design of Fiscal Regimes (Unit 5)}, Course Notes on Mineral and Petroleum Taxation, CEPMLP University of Dundee.

\textsuperscript{30} Joint United Nations Development Programme/World Bank Energy Sector Management Assistance Programme (ESMAP), Supra, p. 24
sector. The reduction in disposable income will necessarily alter the pattern of private spending. A neutral tax would reduce disposable income, but not affect decisions on consumption, trade or production\ref{31}. It captures only the economic rents.

Government’s objectives fall between maximizing its returns on revenue capture and encouraging the IOCs participation in its resource sector. Neutrality for the Government implies that it earns tax revenues when the company earns positive profits and earns nothing when the firm earns nothing. For the company, neutrality is a premier consideration for obvious reasons. It pays tax from its surplus profits, when it has recovered all its exploratory and development costs.

The Nigerian MoU system behaves neutrally in the range of the guaranteed margins. It responds to the cyclical nature of the oil market because if the price of the crude decreases substantially, the tax incidence also responds correspondingly retaining a built-in profit margin should the price crosses the stated threshold.

\section{4. THE FISCAL INCENTIVES OF THE MoUs AND THEIR IMPACTS ON ECONOMIC DRIVERS}

\subsection{4.1 The Fiscal Incentives and Its impact on the Economic Drivers}
Oil is the mainstay of the Nigerian economy and the government's fiscal policies have focused on using the revenues accrued from the sector in driving the other parts of the economy. These aspirations are aligned on the targets to grow crude oil reserves to 40 billion barrels and production capacity to 4.5mmb/d in 2010, maximize oil and gas sector value to the economy and transit from an oil industry to integrated oil and gas

\footnote{Garnaut, R and Ross, A., Supra, p. 26}
industry. These are initiatives that would drive Nigeria’s economic growth.

The major fulcrum for economic growth in most developing economies are sustained by investment inflows, stimulation of growth in local content and emplacement of efficient regulators, institutional reforms and efficient industry. Recent reports have shown that the Nigerian oil and gas industry achieved some of these indices, largely as a result of the MoU fiscal incentives.

Using the above parameters in analyzing the impact of the fiscal incentives on the economic drivers is highlighted below:

1. **Investment inflows:** The industry has experienced favourable investment outlays since the 1990’s to present. It is estimated at about $80 billion between the periods of 1990-2004 and a projected outlay for 2005-2008 at about $67 billion.

2. **Growth in local content:** Stimulated growth in domestic labour and capital flowing from an industry spend of about $12 billion which has provided a basis for developing a national content agenda.

3. **Emplacement of Institutional reforms, efficient regulators and Industry:** Any tax system requires considerable efficient and efficient institutional capacity in order to reap from the fruits of the objectives of the fiscal design. Most especially, the Nigerian MoU system created complex tax calculations with regards to the RGT which form the basis for applying the tax rates. It adjusts government’s take

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independently to a number of different profitability indicators\textsuperscript{34}. This identified complexities of the MoU fiscal system is not helped further by the capacity weakness of the relevant oversight government agencies. The Hart Group’s report which audited the Nigerian oil industry between 1999 and 2004 identified systemic weaknesses with the regulators resulting in significant leakages of oil and gas revenues. Also, there were revenue discrepancies between the companies and government in the region of $232 million\textsuperscript{35}.

### 4.2 Evaluation of the existing Fiscal System

Johnston prescribes that an ideal fiscal system design should have the following elements\textsuperscript{36}:

1. Ensure a stable business environment and minimize sovereign risk.
2. Discourage undue speculation.
3. Provide potential for a fair return to both the state and to companies, balancing risk and reward.
4. Avoid complexity and limit administrative burden (on both the state and companies)
5. Allow enough flexibility to accommodate changes in perceived prospectivity, and economic conditions
6. Promote healthy competition and market efficiency.

The Nigerian fiscal system design cannot be said to be far from ideal using Daniel Johnston’s ideal fiscal system benchmarks. The objectives of the MoU system has been discussed extensively in this paper and in terms of whether such objectives have been achieved, the answer lies in an evaluation of the fiscal system.

\textsuperscript{34} Joint United Nations Development Programme/World Bank Energy Sector Management Assistance Programme (ESMAP), Supra, p. 35.


The first objective was to encourage increasing investments by the IOCs in the oil and gas sector in a broad range of projects. The investment outlay has increased progressively and the projects which were on an economic pretax, are economic on a post-tax basis as well, that is they provide the investor with a post-tax financial return in excess of the 20% cost of capital threshold\textsuperscript{37}. This is a desirable result for investors in the extractive industry.

The complexity of the MoU fiscal design makes the provisions nontransparent and increases the difficulty and cost of tax administration. With relation to oil price which there are three different sharing formulas applying depending on the price band involved and investment costs which there are triggering two different margin sharing schemes depending on their level, are constrains on the tax administration. These are potential conflict points between the state and companies on issues of the relevant government take on the economic rent. A recent case in point is the dispute between the Chinese firm, CNOOC and the Nigerian tax authorities of its actual tax assessment in the acquisition of an oil field. CNOOC has reported in its 2007 Annual Reports that the final tax audit results might affect the acquisition cost of the company for the OML 130 transaction\textsuperscript{38}.

\textsuperscript{37} Joint United Nations Development Programme/World Bank Energy Sector Management Assistance Programme (ESMAP), Supra, p. 23.

4. CONCLUSION

The MoU was introduced at the time that the government was having difficulties selling its equity crude in the international market because of the recession in the oil market at that time and there was a lack of interest by the IOCs to channel investments to the sector. The MoU served its objectives in that extent by ensuring a guaranteed profit margin and introducing incentives that fired the interests of the IOCs to increase explorative activities both on onshore fields and the offshore and deep offshore fields. Therefore, in this regard it can be conveniently be conceded that that it served its purpose but the question of whether
to retain the incentives for the IOCs in the face of the rising oil prices defeats the purpose for which it was introduced into the Nigerian fiscal system in the first place.

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