

UNDERSTANDING THE NEW GUIDELINES
FOR THE OPERATIONALIZATION OF THE
DOMESTIC CRUDE OIL SUPPLY OBLIGATION
2024: KEY IMPLICATIONS FOR LESSEES AND
DOMESTIC REFINERY OPERATORS IN NIGERIA

📍 LAGOS | ABUJA | CALABAR

INTRODUCTION



Earlier this year, the Nigerian Upstream Regulatory Commission (Commission) issued the Guideline for the Operationalization of the Domestic Crude Oil Supply Obligation 2024 (the Guidelines). The Guidelines are designed to facilitate the implementation of Domestic Crude Oil Supply Obligations (DCSO) as mandated under Section 109 of the Petroleum Industry Act, 2021 (PIA), and Part III and IV of the Production Curtailment and Domestic Crude Oil Supply Obligations Regulations, 2023 (the Regulations). The DCSO is the obligation of an upstream crude oil producer (Lessee) to dedicate a specific volume of crude oil produced as feedstock for domestic refineries as stipulated in Section 109 of the PIA.¹

The Guidelines establish mechanisms for the supply of specific crude oil volumes to domestic refineries and applies to all Nigerian lessees of oil producing fields and licensed domestic refineries and also imposes significant responsibilities on lessees and domestic refinery operators.²

This newsletter aims to examine the practical implications of the Guidelines, outlining the critical steps lessees and domestic refinery operators must take to align with the new regulatory expectations, avoid penalties, and foster operational harmony in the Nigerian upstream oil and gas sector.

¹ See Para 1.1 of the Guidelines

² Ibid.

³ 2.2 of the Guidelines

⁴ 2.3 of the Guidelines

⁵ 2.4 of the Guidelines

⁶ 2.5 of the Guidelines

CRUDE OIL SUPPLY AGREEMENTS AND DELIVERY OBLIGATIONS

Refineries must negotiate crude oil supply agreements with lessees using data provided by the Commission, as outlined in Regulations 10(1)-(4)³. Pricing is based on fiscal oil price differentials published by the Commission.⁴ By the 25th of the second preceding month (M-2), lessees and refiners must agree on a delivery window.⁵ Any changes due to operational constraints must be communicated by lessees at least 21 days before Laycan.⁶ Refiners are responsible for arranging logistics to ensure loading during the agreed window, with penalties applying under the Supply & Purchase Agreement (SPA) for delays or disruptions,⁷

All crude oil purchased for domestic use must be delivered directly to the designated refinery and processed locally. Unauthorized diversion, swapping⁸, or use without the Commission's approval can lead to suspension from Domestic Crude Oil Supply Obligation (DCSO) allocations and further penalties, including prosecution⁹. Long-term supply contracts between lessees and refiners are contingent on the refinery being operational at the time of crude supply.¹⁰

WHAT LESSEES MUST KNOW AND DO:

1. Timely Engagement with Stakeholders

Lessees must actively participate in monthly meetings for Domestic Crude Refining Requirement (DCRR) and Production Curtailment, occurring between the 10th-19th business days of the preceding month (M-2).¹¹ Lessees are mandated to submit their cargo programs, including allocations to domestic refineries.

2. Contractual Obligations under DCSO

Failure to respond to the Commission's Requests for Quotations (RFQs) or delays in

⁷ 2.6 of the Guidelines

⁸ 2.7 of the Guidelines

⁹ 2.8 of the Guidelines

¹⁰ 2.9 of the Guidelines

¹¹ 3.1 of the Guidelines

doing so will attract penalties as specified in Section 18(1) of the Regulations. Lessees must ensure they enter into contracts with refiners as per DCSO requirements. Non-compliance, unless justified by Force Majeure (FM) or approved by the Commission, will result in penalties, including administrative fines under Section 18(2).¹²

3. Payment Security Mechanisms

Before delivery, Lessees must receive acceptable **Irrevocable Letters of Credit (LCs)** from refiners' banks, valid for 90 days from the laycan date¹³ or **Standby Letters of Credit (SBLC)** for long-term contracts.¹⁴ For refiners with lower capacities, irrevocable bank guarantees are permissible, provided they meet stringent criteria, including coverage of the crude oil's sales value and enforceable replacement policies.¹⁵

4. Handling Defaults by Refiners

Lessees are entitled to enforce penalties, including suspension of DCSO allocations to defaulting refiners, and may draw on LCs or bank guarantees for compensation. Refiners' failure to lift allocated crude oil within the agreed laycan can result in operational disruptions like production curtailment. Lessees can enforce fines equivalent to delayed royalties and other penalties detailed in the Supply and Purchase Agreement (SPA).

However, it must be noted that under Section 6 of the 1999 Constitution of the Federal Republic of Nigeria (as amended), the power to impose penalties lies solely with the courts. Any regulation or guideline that grants this authority to entities other than the judiciary is unconstitutional. This

position was reaffirmed in **NOSDRA v. ExxonMobil**,¹⁶ where the Court of Appeal held that penalties or fines constitute punishments for legal violations and can only be imposed by the courts.¹⁷

5. Forecasted Production Allocation

Lessees must allocate a portion of their forecasted production to meet domestic consumption needs.¹⁸ The Commission will develop non-discriminatory metrics for determining these allocations. The Commission will notify lessees and refiners of minimum volumes reserved for domestic refineries.¹⁹ Lessees can independently negotiate additional sales with refiners beyond the regulatory mandated allocations.²⁰ Every six months, the Commission will publish reports on lessees' and refiners' domestic supply records.²¹

WHAT DOMESTIC REFINERY OPERATORS MUST KNOW AND DO:

1. Financial Commitments and Payment Instruments

Refiners must secure crude oil purchases with LCs or SBLCs which must meet the lessee's approval criteria and be submitted at least six (6) banking days before the laycan²². Smaller refiners may provide bank guarantees, valid for one year and easily drawable by lessees in event of default.²³

2. Adherence to Offtake Obligations

Refiners must lift crude oil within the agreed delivery window to avoid penalties such as suspension of future DCSO allocations²⁴ and financial penalties, including liquidated damages for distressed cargo sales in marine deliveries. Operators unable to offtake due to FM must provide

¹² 5.2.1 of the Guidelines

¹³ 4.3.1 of the Guidelines

¹⁴ 4.3.3 of the Guidelines

¹⁵ 4.4 of the Guidelines

¹⁶ (2018) LPELR-44210 (CA). 5

¹⁷ See also S.P.D.C.N. Ltd v Ajuwa (2015) 14 NWLR (Pt. 1480) 403 at 473

¹⁸ 2.10 of the Guidelines

¹⁹ 2.13 of the Guidelines

²⁰ 2.14 of the Guidelines

²¹ 2.15 of the Guidelines

²² 4.3.1 of the Guidelines

²³ 4.4.1, 4.4.2 and 4.4.3 of the Guidelines

²⁴ 5.5.1 of the Guidelines

documented declarations to avoid penalties.

3. Compliance with DCSO Allocations

Refiners must ensure their capacity aligns with their allocation under the DCSO. Non-compliance, especially repeated failure to offtake, will result in severe penalties and may lead to reputational damage.

4. Addressing Supply Shortages

Refineries unable to source adequate crude oil must report the issue to the Commission, detailing the shortfall and reasons. The Commission may, depending on the circumstance, intervene to:²⁵

- Direct lessees to enter crude purchase agreements.
- Facilitate negotiations on contract terms or pricing disputes.
- Direct parties to agree on a fair price based on published Fiscal Oil Price differentials.

ISSUANCE OF RFQ AND CRUDE OIL SUPPLY MONITORING



If the processes outlined in paras 2.10 to 2.17 of the Guidelines fail to ensure adequate crude oil supply to the domestic market, the Commission will issue a RFQ. The RFQ will seek to gather offers for additional crude oil supply, specifying required grades and volumes, and is informed by data from the Nigerian Midstream and Downstream Petroleum Regulatory Authority (NMDPRA) to assess shortages. The RFQ will be issued between the 1st and 2nd business days of

M-2 (two months before delivery), with lessees required to respond by the 5th business day using the Commission's template.²⁶

NEGOTIATION AND SUPPLY AGREEMENT FRAMEWORK

Upon receiving responses, the Commission will share bids with refiners by the 6th to 7th business day of M-2. Refiners and lessees must finalize a Supply and Purchase Agreement (SPA) between the 8th and 11th business day of M-2, following a willing buyer, willing seller approach. If negotiations fail by the 12th to 13th business day, the Commission may issue a Domestic Crude Supply Obligation (DCSO) Order after evaluating both parties' positions. Price disputes are to be resolved using fair pricing comparisons based on Fiscal Oil Price differentials, and no DCSO Order will be imposed if the refiner is found unreasonable.²⁷

LESSONS FROM OTHER JURISDICTIONS FOR NIGERIA'S DCSO IMPLEMENTATION

The implementation of the DCSO in Nigeria faces several challenges, including dwindling production levels, operational inefficiencies, and pre-existing contractual commitments by producers. These constraints highlight a potential gap between mandated supply obligations and the actual capacity of upstream producers to meet the needs of domestic refineries. Addressing these issues is critical to ensuring the success of the DCSO framework under the PIA.

Other countries with similar obligations offer valuable lessons. In Indonesia, regulatory frameworks require producers to allocate 25% of their production to the domestic market.²⁸ However, enforcement challenges arise when production falls short of refinery demand, leading to operational misalignments. Although Indonesia mitigates this with incentives like a "Domestic Market Obligation holiday," which is the equivalent of Nigeria's DCSO,²⁹ the policy still struggles to balance producer viability with refinery needs. Similarly, India prioritizes

²⁵ 2.16 and 2.17 of the Guidelines

²⁶ 2.18 – 2.20 of the Guidelines

²⁷ 2.20 a-e of the Guidelines

²⁸ See GR-35 and GR-27 (amendment of GR-79)

²⁹ See GR-27

domestic refinery supply over exports but grapples with logistical inefficiencies and profitability concerns, demonstrating the need for flexibility and robust mechanisms to align policy with practical realities.

Nigeria can learn from these experiences to avoid pitfalls. The DCSO framework must incorporate adaptable enforcement mechanisms, transparent and competitive pricing structures to incentivize compliance, and incentives that encourage compliance without jeopardizing producer operations. Flexible dispute resolution systems combined with incentives such as tax breaks and waivers for genuine operational challenges, can balance enforcement with industry viability. By drawing on these international lessons, Nigeria can establish a sustainable and effective DCSO implementation strategy.

ANY IMPLICATION(S) FOR FINANCIERS AND PROJECT SPONSORS

DCSOs have significant implications for financiers and project sponsors in Nigeria's oil and gas sector. It introduces a layer of regulatory risk, as compliance with the obligation to supply crude oil to domestic refineries may impact project cash flows, disrupt existing supply agreements, and potentially affect debt servicing capacity. Financiers must now consider the DCSO as a critical factor in assessing the bankability of upstream projects, while project sponsors must address the challenge of balancing regulatory compliance with commercial imperatives. Additionally, the DCSO could influence investment decisions, requiring sponsors to ensure robust project structuring, clear off-take arrangements, and contingencies for meeting supply obligations without undermining their financial and operational models.

WHAT ARE THE CHALLENGES OF DCSO IMPLEMENTATION FOR LESSEES

The implementation of DCSO will also pose several challenges for lessees in Nigeria's upstream sector. Lessees may face operational disruptions as they are compelled to divert crude oil to domestic refineries, which could conflict with existing off-take agreements and affect

international market commitments. Compliance with the DCSO may also have negative financial implications for upstream producers especially if the mandated supply terms are less favorable than export arrangements, potentially impacting revenue and profitability.

Moreover, the capacity and reliability of domestic refineries to process the supplied crude oil remains a concern, as inefficiencies could result in delays, losses, or disputes. Operational planning is further complicated by potential mismatches between the quality of crude demanded by domestic refiners and the lessee's production capabilities. Adjustments to meet these requirements could incur significant costs. Additionally, the stringent timelines and procedural requirements of the RFQ process heightens the risk of non-compliance, exposing lessees to penalties. Lastly, navigating the regulatory and reporting requirements of the DCSO will require lessees to invest in additional administrative and legal resources, adding complexity and cost to their operations.

OUR THOUGHTS ON THE WAY FORWARD

While the Guidelines for the Domestic Crude Oil Supply Obligation 2024 aims to enhance Nigeria's energy security by ensuring a steady supply of crude to domestic refineries, this goal must be balanced with the interests of lessees, whose ultimate aim in embarking on the venture is profitability. While the Guidelines impose clear obligations, it is crucial that the regulatory framework accommodates the commercial realities of lessees, ensuring both energy security and the preservation of their business interests.

The way forward lies in striking a balance between the objectives of the Guidelines for DCSO and the operational and commercial realities faced by lessees. Lessees valued freedom to engage in business transactions with parties of their choice under a "willing buyer, willing seller" model must not be lost. The Commission must foster collaboration between stakeholders to ensure clear, practical, and mutually beneficial implementation strategies. Flexibility in supply arrangements, such as tiered obligations or phased rollouts, could help lessees manage their

commitments without jeopardizing existing contracts. Strengthening the capacity and reliability of domestic refineries is critical to ensure they can efficiently process the mandated crude supply.

Additionally, incentivizing lessees through tax breaks or other benefits could mitigate the financial burden and encourage compliance. A key concern, also lies in the absence of a robust dispute resolution framework for pricing or quality disagreements between lessees and refiners. The tight RFQ timelines and procedural complexities exacerbate logistical challenges, increasing non-compliance risks. Lessons from other jurisdictions emphasize the need for flexibility in policies to reflect operational realities. Transparent dialogue and a supportive regulatory framework will be essential to ensure that the DCSO achieves its intended goals without undermining the growth and stability of Nigeria's upstream oil and gas sector.

CONTACTS



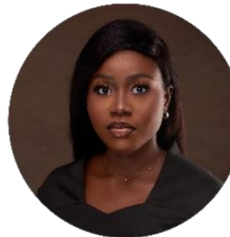
OLA ALOKOLARO

ola.alokolaro@advocaat-law.com



HASSAN SHERIF

hassan.sherif@advocaat-law.com



VICTORIA OBI

victoria.ob@advocaat-law.com



OLUWATIMILEHIN ILORI

oluwatimilehin.ilori@advocaat-law.com