

BACKGROUND PAPER ON THE NIGERIA EXTRACTIVE INDUSTRY TRANSPARENCY INITIATIVE

Measures to Enhance Petroleum Revenue Transparency for Public Information and Policy Making

A. Introduction

Policy makers in Nigeria need good information on public finances to devise the right policies, and the public needs good information to trust the policy makers in handling the country's wealth. Knowledge about the significant revenue flows from the oil and gas sector is currently marred by inconsistencies and deficiencies, and these give rise to concerns about governance both within Nigeria and internationally. The Federal Government of Nigeria (FGN) has recognized that improvements in the transparency of petroleum revenue data are needed for the effective management of public resources and to improve the image of Nigeria at home and abroad. This note outlines the arguments for enhancing transparency, summarizes current practice on revenue assessment, collection and reporting, and makes preliminary recommendations on how to implement policy goals. In this endorsement of the objectives of the Extractive Industries Transparency Initiative (EITI) and their congruence with Nigerian policy. Finally, annexes to the note identify: a) a number of practical issues arising in the pursuit of transparency; b) technical assistance required to support transparency objectives; and c) a possible timeline and milestones for the implementation of those objectives.

B. Why Transparency Matters

A number of persuasive arguments can be made in favour of greater revenue transparency in the petroleum sector:

- *Democratic Debate.* Transparency is needed to allow democratic debate on fiscal policy and spending priorities.

Accurate information on revenues received is the starting point for such debate. An argument sometimes advanced against transparency in petroleum sector operations is that pressure to increase spending will build up once the availability of fiscal resources from that sector is made known. However, it would seem better to inform the public and foster constructive debate. The existence of oil resources cannot be kept secret, and lack of information on the resulting revenues can be a source of debilitating social and political tensions.

- *Accountability.* Revenue transparency will act to increase accountability in both the executive and legislative branches of government at all levels (Federal, State and Local), reducing opportunities for corruption and the potential for waste of public funds.
- *Economic Management and Forward Planning.* For economic management, budget decisions and forward planning, government needs to be able to both accurately monitor its current financial position and make adequately robust projections of future revenues.
- *Access to Finance and Investment.* Enhancements in transparency are increasingly demanded not only by citizens within the country, but also by international financial institutions (public and private), donor organizations and international civil society. Lack of transparency is seen as a major obstacle to the creation of a favourable investment climate, better management of public resources and poverty reduction. Progress on the transparency front can be expected to attract increased finance and investment.
- *Why Petroleum?* The arguments above might equally apply to sectors other than petroleum. Petroleum is often singled out, however, because of the very substantial economic rents and revenues oil and gas are capable of generating. Certainly an emphasis on petroleum is justified in Nigeria,

where it accounts for over 70 percent of revenues at all levels of government, 40 percent of GDP, and more than 85 percent of foreign exchange earnings.

- *Collection of Revenue vs. Use of Revenue.* As suggested above, revenue transparency is only the starting point, albeit a very important one, for a broader campaign to improve governance. Once revenues collected are accurately known and reported, focus can shift to a debate on how well they have been used.

C. Components of Petroleum Revenues in Nigeria

To begin to tackle petroleum revenue transparency issues, a basic understanding of the several components of petroleum revenues is essential. As a result of varying applicable legal, fiscal and contractual arrangements, a variety of revenue sources and their beneficiaries can be identified:

- *Bonuses.* These are lump sum cash payments to the FGN on one or more of the following: a) signature of contracts to explore and produce; b) declaration of commercial discovery, and c) attainment of certain production levels. Bonuses have typically been treated as confidential, at least at the individual contract level.
- *Royalties.* Royalties are levied as a percentage of production and vary depending on, among other things, location (onshore or offshore, deep water or shallow), the nature of the contract (tax and royalty, or production sharing) and on whether production is oil or gas. Rates are public, but actual obligations are less transparent when precise information on volumes and prices is lacking. Rates for oil range as high as 20 percent; rates on gas vary from zero to 7 percent.
- *Profit Taxes.* The Petroleum Profit Tax (PPT) is levied on income, at rates which, in the case of oil, depend on the

type of contract involved. The rate on tax and royalty contracts (which account for almost all current production) is 85 percent; on production sharing contracts (which have replaced tax and royalty for all new contracts), 50 percent. Income from natural gas is taxed at the Corporate Income Tax (CIT) rate of 30 percent.

- *Production Shares.* Investors operating under production sharing contracts (PSCS), are obliged to pay the Government, through NNPC, a share of their production after recovery of cost. The share is negotiated contract by contract, and increases as function of either daily or cumulative production.
- *Government Sales of Crude Oil.* The FGN holds an average 57 percent equity interest in tax and royalty contracts. This interest is managed by the National Petroleum Investment Management Service (NAPIMS), which is part of NNPC. NNPC transfers all revenues attributable to sales of the FGN's share of crude oil production directly to its contractual partners (the so-called "cash calls"). The revenues so transferred are made up of two implicit, but conceptually different flows – tax and royalty payments on the sales involved, and dividends earned by the FGN as a return on its investment of public funds. No distinction is made between the two flows until NNPC's annual accounts are prepared, at which time NNPC's auditors retroactively calculate and identify tax and royalty obligations and the residual dividend.
- *Domestic Market Allocation.* The FGN has for some years allocated a significant part of its share of crude oil production to NNPC to use in meeting the demand for petroleum products on the domestic market, either through swapping the crude for products on the international market.¹ Until very recently, the price charged to NNPC for this crude oil was well below the international market price.² The amount of the subsidy involved is substantial and for

revenue transparency or accountability purposes, it should be captured, either as an upward adjustment to the revenues received by the FGN from its crude oil sales to reflect their true value, or as implicit revenue received by NNPC.

- *Other Taxes and Charges.* Several other taxes and charges apply to petroleum operations and contribute to revenues from the sector. The most notable of these are the Education Tax payable to the FGN (2% of pre-tax income) and a charge levied as a percentage (3%) of the annual operating budget of oil producers³ and payable to the Niger Delta Development Commission (NDDC).

These several different components of petroleum revenues are packaged differently according to the type of contractual arrangement that applies. For example, the tax and royalty contracts (also known as Joint Venture contracts or MOU contracts), as their name implies, call for payment of PPT and royalties, while the PSCs combine bonuses, royalties, PPT and production share payments. Bill contractual arrangements are subject to Education Tax and NDDC levies.

D. Institutional Responsibilities

Principal institutional responsibilities for the assessment, collection, and reporting of these revenue streams are as follows:

- *DPR.* The Department of Petroleum Resources (DPR) in the Ministry of Petroleum is responsible for the monitoring and collection of royalties, and for the production data used in the calculation of PPT.
- *NNPC (COMD/NAPIMS).* Within NNPC, the Crude Oil Marketing Department (COMD) is responsible for verifying production and sales data, and for establishing a representative price for tax purposes for different crude oils

based on market realizations. The National Petroleum Investment Management Service (NAPIMS) is charged with approving capital expenditures and purchase contracts and monitoring operating and financial results from the Joint Ventures (JVs) and PSCs. NAPIMS receives management reports and audited accounts from the upstream companies, which positions it for review and audit of PPT filings.

- *FIRS.* The Petroleum and International tax Department (PITD) of the Federal Inland Revenue Service (FIRS) is responsible for assessing and collecting PPT and other direct taxes from the JVs and PSCs.
- *CBN.* The Central Bank of Nigeria (CBN) is the depository for royalties, PPT and other direct taxes, and provides collection information for reconciliation with the tax assessments of the FIRS.
- *Crude Oil Reconciliation Committee.* The Crude Oil and Other Revenue Reconciliation Committee is supposed to perform the actual reconciliation of the above listed revenue streams with the CBN accounts. The Committee works under the direction of the Ministry of Finance and is composed of high level representatives from the NNPC, FIRS, DPR and CBN.
- *Petroleum Products Sales Reconciliation Committee.* This Committee is mainly concerned with the reconciliation of revenues received in relation to petroleum products sales, which is not the direct concern of this note. It also, however, reconciles revenues received in relation to FGN's allocation of crude oil to NNPC for purposes of meeting domestic petroleum product market demand and in this capacity is a relevant agency. It is similarly constituted to the Crude Oil Reconciliation Committee.
- *Institutional Issues.* On paper, procedures for the assessment, collection, and monitoring of petroleum

revenues appear adequate. In practice, however, the institutions involved have not been able to deliver the levels of control and accuracy required to reduce risks of revenue loss and provide credible revenue data. There are regularly discrepancies among different agencies in the reporting of revenue flows. These need to be understood and resolved.⁴

E. Current Petroleum Revenue Reporting Sources

A variety of sources for information on petroleum revenues now exist, of varying degree of confidentiality and accuracy:

- *Company Accountants and Audits.* All oil companies operating in Nigeria are required to prepare annual financial accounts, and to have these audited by third parties. The accounts contain detailed information on all payments made to the Government, but are not typically public. NAPIMS annual accounts are an exception.
- *Tax/Payment Returns.* All companies are likewise required to file annual tax returns with the FIRS detailing payments due. These are confidential. Nominally, they are subject to audit by the FIRS and by NAPIMS.⁵
- *Government Agencies.* The institutions discussed under the preceding heading all prepare reports on the various inputs to or components of petroleum revenue – volumes, price, cost, royalties, PPT etc. As noted, however, discrepancies are common among these several reports. These discrepancies, together with acknowledged weaknesses in institutional capacity, undermine the credibility of the reports. The data series prepared are not generally put into the public domain or at least are certainly not easily accessed. The Federal Statistics Office (FSO) does publish a series on petroleum revenues, but with a considerable lag and its accuracy is questionable.

