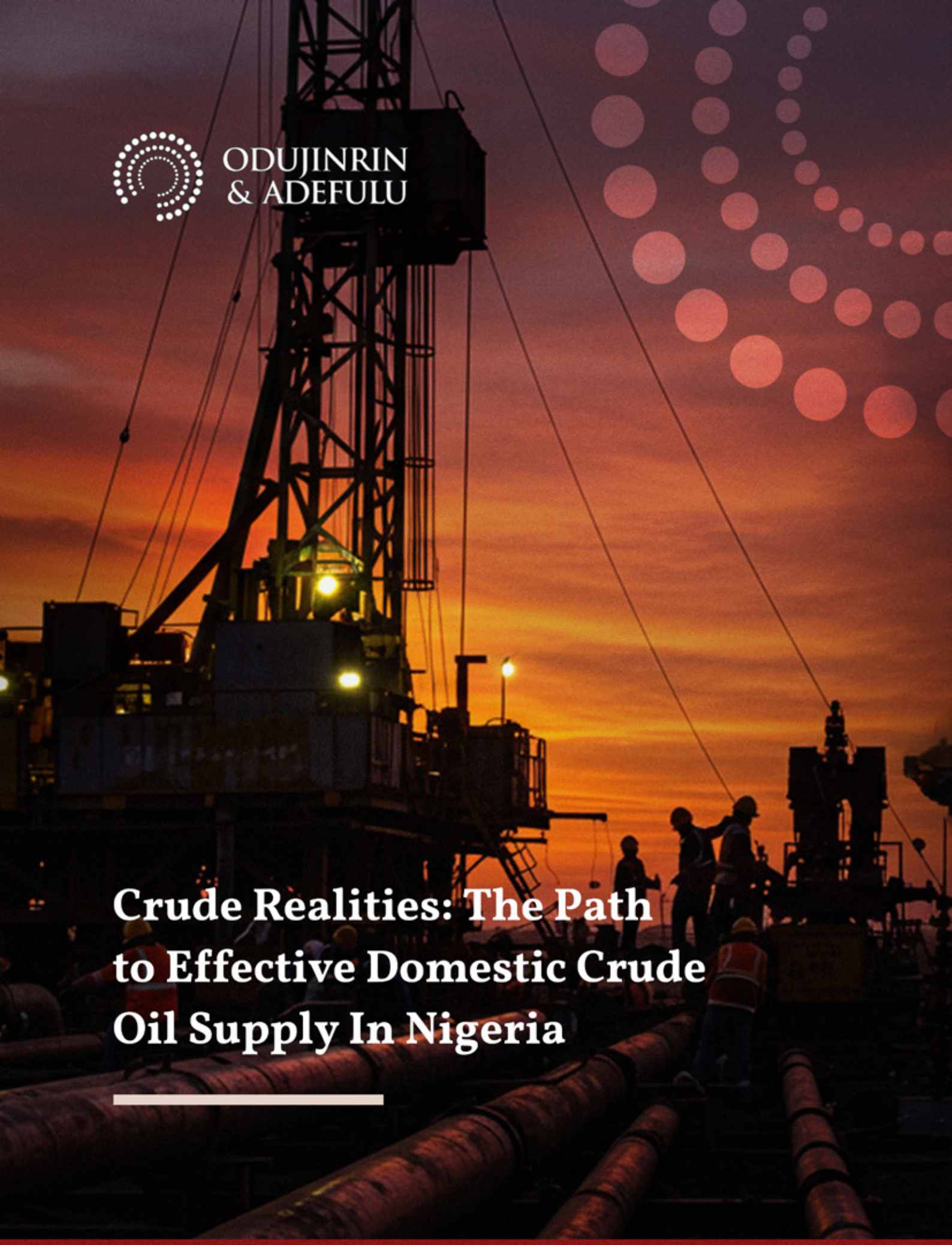

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Crude Realities: The Path to Effective Domestic Crude Oil Supply In Nigeria

Nigeria's reliance on imported petroleum products has long posed a significant economic burden, costing the nation billions of dollars annually[1]. A key strategy for addressing this challenge lies in bolstering domestic refining capacity and output. The Domestic Crude Oil Supply Obligation ("DCSO") represents a strategic effort to achieve this goal by creating an unbroken supply of crude oil for domestic refineries. Enshrined within the framework of the Petroleum Industry Act 2021 ("PIA"), the DCSO mandates a portion of domestically produced crude oil to be allocated for local refining and ultimately local consumption.[2] This aims to bolster domestic refining capacity, enhance national energy security, and reduce reliance on imported petroleum products.

However, DCSO's implementation has been plagued by challenges, creating a significant gap between its legal mandate and reality, impacting both upstream producers and domestic refineries. This article examines these challenges, analyzing the interplay between the legal framework, stakeholder perspectives rooted in on-the-ground realities, and proposing solutions to optimize the DCSO regime, ensuring its effectiveness and maximizing its benefits for the industry and the Nigerian people.

Legal Framework for the Domestic Crude Oil Supply Obligations in Nigeria

Framework under the PIA

The DCSO regime was introduced under the PIA in 2021, backed by the implementation framework under the Production Curtailment and Domestic Crude Oil Supply Obligation Regulations, 2023 (the "Regulations") as well as the Guidelines for the Operationalisation of the Domestic Crude Oil Supply Obligation 2024 (the "Guidelines").

The PIA established the DCSO regime hinged on a "willing buyer - willing seller" principle for domestic crude transactions[3] while also empowering the Nigerian Upstream Petroleum Regulatory Commission ("Commission") to intervene in the event of shortage or inadequate supply conditions, by imposing supply obligations.[4] To effectively manage the process, the Commission is empowered to issue regulations and guidelines on the mechanisms for imposition of DCSOs to avoid disruption to domestic supply.[5]

Essentially, the PIA expects that the sales to the domestic market in fulfilment of DCSO by upstream producers shall be subject to the following conditions:

a. Crude oil may only be sold to holders of refining licenses with operational refineries.
b. Supply terms shall be commercially negotiated between the lessee and the refining licensee, considering the prevailing international market price for similar crude grades.

Refining license holders must provide payment guarantees as required by the lessee, with payments made in either US dollars or Naira, as agreed between the parties. From the above, the Commission's authority to impose DCSO on upstream producers should only override competitive crude oil supply to address shortages or prevent inadequate supply conditions. The Regulations and Guidelines should reflect this principle, which is broken down in two legs as follows:

a. Crude oil supply to the domestic market is a competitive arrangement between upstream producers and operating refineries; and
b. If competitive supply fails, causing

[1] *https://businessday.ng/real-sector/article/nigerias-imports-jump-81-in-six-years-on-refined-petroleum-wto/*
[2] *Nigeria consumes about 50 million litres of petrol daily-imports*
[3] *Section 109(1) of the Petroleum Industry Act*
[4] *Section 109 (3) of the Petroleum Industry Act*
[5] *Section 109 (2) of the Petroleum Industry Act*

inadequate supply or shortages, the mandatory DCSO system is activated.

Framework under the Regulations

The Regulations, issued by the Commission provide a detailed framework for implementing the DCSO regime. Poignantly, the Regulation allows the Commission to enforce DCSOs, ensuring that domestic obligations are met before allowing crude oil exports.[6]

Nonetheless, the Regulation upholds the competitive arrangement enshrined in the PIA, as one of its key components is the Commission's mandate to publish bi-annually, the domestic crude refining requirements of operating refineries received from the Nigerian Midstream and Downstream Petroleum Regulatory Authority ("**Authority**"), including detailed information on their capacity, crude specifications, and forecasted needs.[7] This publication, coupled with corresponding information on upstream producers' production forecasts, location, terminal stream, crude quality, aims to facilitate informed commercial negotiations between the upstream producers and refiners on a willing buyer – willing seller basis.[8]

The Regulations further establish a process for addressing supply shortages or inadequate supply conditions through the Commission's issuance of Requests for Quotations ("**RFQs**") to upstream producers, seeking offers to supply the required volumes and grades of crude.[9] This information is then shared with affected refineries to enable "willing buyer, willing seller" contracts.[10] If negotiations stall, contracted quantities are insufficient, or unreasonable obligations are demanded of the refiner, the Commission can impose the DCSO on upstream producers to supply the necessary volumes.[11]

It is important to note that the criteria for imposing the DCSO are similar to those under the free-market arrangement, prioritizing proximity of upstream and the refining facilities, crude specification matching, weighted proportion of total production, as well as existing offtake, supply and export contracts.[12]

Framework under the Guidelines

To facilitate the application of the PIA and Regulations, the Commission issued the Guidelines. Notably, the Guidelines stipulate that the price of crude supplied to domestic refineries shall be agreed, using the fiscal oil price differentials published by the Commission for the relevant month.[13] The PIA expressly benchmarked the domestic supply pricing around the international market price of crude.

In addition, the Guidelines further require the Commission, before issuing an RFQ to address a crude oil supply shortfall, to ensure that every capable lessee allocates a portion of its forecasted production to domestic consumption.[14]

Overview of DCSO Implementation Challenges

The implementation challenges stem from the application of the divergent provisions of the Guidelines when compared to the guiding principles under the PIA, particularly regarding the determination of domestic crude allocation, and the pricing principles for domestic supply.

While the PIA primarily emphasizes a "willing

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[6] Regulation 9 of the Production Curtailment and Domestic Crude Oil Supply Obligation Regulations
[7] Regulation 10 (1) & (2) of the Production Curtailment and Domestic Crude Oil Supply Obligation Regulations
[8] Regulation 10 (3) & (4) of the Production Curtailment and Domestic Crude Oil Supply Obligation
[9] Regulation 11 &12 of the Production Curtailment and Domestic Crude Oil Supply Obligation
[10] Regulation 12 (3) of the Production Curtailment and Domestic Crude Oil Supply Obligation
[11] Regulation 12 (4) of the Production Curtailment and Domestic Crude Oil Supply Obligation
[12] Regulation 13 of the Production Curtailment and Domestic Crude Oil Supply Obligation
[13] 2.3 of the Guidelines
[14] 2.10 of the Guidelines

buyer, willing seller" arrangement, and the Regulations provide for RFQ process to address supply shortfalls, the Guidelines introduce a preallocation mechanism requiring upstream producers to earmark a portion of their forecasted production for domestic supply. This shift from purely market-driven negotiations to a predetermined allocation system creates friction among upstream producers.

The preallocation mechanisms, as argued by upstream producers, also limit their commercial flexibility, as it forces them to commit crude volumes in advance, potentially at the expense of the fixed supply contracts, or forward sale contracts to international traders who have bridged the financing gap created by limited funding due to environmental shift from fossil fuels investments.

More than that, this deviation, which establishes a regulatory mandate compelling upstream producers to prioritize domestic supply based on projected needs rather than actual demand-driven negotiations, raises concerns about regulatory overreach, as it alters the competitive dynamics envisioned under PIA, potentially reducing the flexibility and efficiency that the willing buyer, willing seller model was designed to promote.

The position of the upstream producers is to ensure that the DCSO regime does not:
• result in offtake default that would trigger a cross default on virtually all the other finance obligations held by the producers, including their obligations to local banks, third party suppliers and local sub-contractors; • seriously impact on the ability to raise the current production levels to the Government's stated objective of over 2 million barrels of oil per day as there will be tightening of available capital arising from the lack of credit worthiness of producers in the eyes of lenders of capital;
• put the Nigerian State in an adversarial position with the international traders who finance a significant portion of upstream activities.

There is also commercial concern around pricing given that the PIA favoured the prevailing international market price for similar grades of crude oil as opposed to the fiscal oil price differentials published by the Commission favoured in the Guidelines The upstream producers would prefer negotiation based on the prevailing international market price over the fiscal oil price differentials which though offer stability but can be inflexible and potentially manipulable.

Lastly, another important consideration is that when the PIA references leases with domestic crude supply obligations[15], it explicitly mentions leases alone, which, by definition,[16] refers to a petroleum mining lease. This means that the DCSO regime should only apply to leases granted or converted under the PIA. The attempt by the regulators to also apply the regime to non-converted leases creates a dual regulatory landscape, which potentially may cause confusion and misapplication of regulations for entities still governed by the Petroleum Act.

Recommendations for Achieving Effective Domestic Crude Oil Supply in Nigeria

To create an effective DCSO regime, it is essential to align implementation with the legal framework set out in the PIA while ensuring efficiency for all stakeholders. First, the Commission should adhere to the foundational principles of "willing buyer, willing seller" model

[15] *Section 109 of the Petroleum Industry Act*
[16] *Section 318 of the Petroleum Industry Act*

and use the RFQ process strictly as intended, to address supply shortages, rather than as a blanket preallocation mechanism. This ensures that the process remains market-driven, minimizing unnecessary disruptions to both upstream producers and refiners.

Additionally, a collaborative approach is needed, where stakeholders, including the two regulators, upstream producers, and refinery operators, engage in structured dialogue to refine the implementation of the DCSO. Such engagement should focus on developing a transparent and flexible system that balances the need for a reliable domestic crude supply with the commercial realities of both producers and refiners.
Execution of long-term crude oil sales and purchase agreements under the willing buyer, willing seller framework with refiners in line with industry's best practices, is also encouraged to secure supply to the domestic market. Ultimately, a lasting solution requires integrated operations where all parties work towards a streamlined system that ensures domestic crude supply without imposing rigid or impractical constraints. This can be achieved by enhancing regulatory clarity and fostering trust between stakeholders to create a sustainable and efficient domestic refining ecosystem.

In conclusion, while the DCSO holds immense promise for reducing Nigeria's reliance on costly petroleum imports and bolstering domestic energy security, its implementation has been hampered by significant challenges. To succeed, Nigeria must realign implementation with the PIA, prioritize market-driven solutions, and foster stakeholder collaboration, thereby achieving energy security and economic benefits.

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