COVID-19 and the Nigerian oil and gas sector – impact on the Nigerian economy and key mitigation measures

Introduction

Although the oil and gas industry in Nigeria represents a relatively modest percentage of the country's total GDP, the government's ability to put together an annual budget, contribute to the provision of basic services from security to health and education, and to service foreign debt is heavily dependent on the revenue generated from the sector.

The oil and gas industry, both globally and in Nigeria, has been hit hard over the last couple of months by twin crises – a conflict between Russia and Saudi Arabia over production allowances which, although partially addressed now, initially led to over-production and a price fall; followed by the COVID-19 global pandemic, which has seen global demand plummet. As a result, the price of Brent crude (the nearest comparator for Nigerian crude) has more than halved, with sector commentators predicting 2019 pre-crises prices will not be seen again before 2022 at the earliest.

This briefing note will explore the budget implications of these crises for the Nigerian economy and set out what could be done with respect to the nation's oil and gas industry to help the sector optimally contribute to Nigeria's economic recovery.

The Big Picture

Global Economy

As a result of the COVID 19 pandemic, economic forecasts predict a global recession for the year 2020 and possibly beyond. The IMF's World Economic Outlook, April 2020 predicts the global economy to contract by 3% during 2020, although to rebound to 5.8% GDP growth in 2021, as economic activity normalises post-COVID. Standard and Poor has a slightly more modest forecast of a 2.4% contraction in global GDP in 2020, followed by 5.9% growth in 2021. McKinsey offers four scenarios for the impact of COVID 19 on African economies, ranging from a cut in African GDP growth in 2020 by 3.9% to 0.4% under the best scenario (contained global and African outbreak) to an eight percentage point cut in growth resulting in a contraction of 3.9% in African GDP during the year in the worst case (resurgent global outbreak, Africa widespread).

Against this background an IMF Blog post of April 14, 2020 predicts a 3.4% fall in Nigerian GDP in 2020, followed by a 2.4% increase in 2021. To counter these negative trends the IMF has already made commitments to Nigeria for both debt relief and a new $3.4 billion facility under its Rapid Financing Instrument. Meanwhile, China and the G20 have already provided debt relief to Nigeria starting May 1st.

Crude Oil Markets and Crude Price Forecast

During a period where demand was clearly going to drop precipitously due to COVID19, Saudi Arabia and Russia fought over market share, with the Saudi's initiating a production increase of ~3 million barrels/day (mmbd). This has subsequently been reversed with agreed cuts across OPEC and Russia of ~10 mmbd or 10% of the worlds demand in 2019. However global demand is estimated to have fallen in the range of 29 mmbd in April and 23 mmbd in 2Q20. The resulting miss-match between production cuts and demand declines means that storage will be full in May with the real possibility of further pressure on oil prices.

The US Energy Information Administration has forecast an average Brent price of ~$33/bbl in 2020 and ~$46/bbl in 2021

The effects on the Nigerian budget and economy

The original 2020 Nigeria budget was passed on the assumption the oil price would average US$57/bbl. The value was N10.6 trillion (~$30 billion), comprised of oil related revenues and other internally generated revenues of N8.4 trillion and new debt of N2.2 trillion.

Using a new budget benchmark price for crude of $30/bbl (about half the level of 2018 and 2019 - see Annex 1.1 - and in line with current market predictions) would result in oil and gas sector revenue falling by ~50% from over $30 billion to ~$15 billion. This, however, doesn't take into account Nigeria's share of OPEC production cuts, which would see Nigeria's oil production (excluding condensate) drop about 8% from 1.7 mmb/d to 1.55 mmb/d, which could further lower estimated revenue from $15 billion to around $14 billion. Note this is gross revenue, before costs for meeting the government's obligations to its Joint Venture partners (budgeted between $5.6 billion and $8.5 billion from 2016-2018) and any possible PMS/petrol subsidy are taken into account (see annex 1.2 for a 2018 overview of those costs).

Looking just at the revenue side of the Nigerian budget (excluding borrowing), oil and gas has provided between 45% (Oxford Martin School) and 65% (NEITI) of the budget revenues over the last three years, depending on the year in question and the method of calculation used. So, this drop in the projected oil price has significant implications for the Nigerian economy. A new 2020 budget has now been drawn up of N6.4 trillion (US$18 billion), based on a roughly 39% reduction in projected revenue from the initially approved amount of N8.4 trillion to N5.1 trillion (US$14.5 billion). The remaining balance of N1.3 trillion (US$3.7 billion) will be borrowing, a similar proportion to the original budget.

At the same time, the exchange rate was increased from N305 to N360 to a dollar, based on a devaluation of the Naira by the Central Bank of Nigeria.

Other recent announcements included borrowing $150 million from the Nigerian Sovereign Investment Authority (NSIA) whose 2018 accounts showed a balance of N618 billion (~$2 billion) to shore up federal allocations to the States. This new NSIA borrowing represents about 0.5% of the original 2020 budget or 0.8% of the new budget. Historically the Excess Crude Account (ECA) was established to assist the government with stabilising budget spending during periods of oil price volatility. It was meant to receive all of the revenue the country received when the crude oil price was above the agreed annual budget figure and then be used for specific budgetary needs when the crude price was below the budget figure. However the build-up of the account and subsequent depletion has been well covered by various reports and at present it only holds $72 million so is effectively unavailable at this critical time.

In the original 2020 budget, the largest allocations went to the following sectors, consuming the approximate percentages of the budget shown:

Domestic and Foreign Debt Service	25%
Defence	10%
Education	7%
Health	5%
Humanitarian Affairs	4%
Police	4%
Works and Housing	3%
Interior (Borders / Immigration)	3%
Agriculture and Rural Development	2%
Youth and Sports	2%
Another 33 categories	

How the new N6.4 trillion budget will be allocated is not presently known, but it is safe to assume that halving the original budget will have significant impacts that will be felt across all the sectors listed above.

All of these indicators clearly mean considerable increased pain for all Nigerians where the government has struggled to provide basic services to its citizens in the good times, let alone the bad times.

Challenges for the Nigerian oil and gas sector

Changes in Foreign Exchange practices

The government has effectively ended the parallel market for foreign exchange (FX) but the new rate used of N360/US$1 is about 25% stronger than the parallel market rate of N450/US$1 on April 29, 2020. A recent new directive has the Central Bank of Nigeria (CBN) once again handling the foreign exchange sale of Naira to oil and gas companies which had temporarily been handled by NNPC. The effects on NNPC operations without a smooth flow of FX is hard to predict, but it will certainly lead to a slow down or temporary halt to prompt cash call payments to NNPC's Joint Venture (JV) partners who operate around half of Nigeria's oil production. This could lead to further operational challenges and lower production levels from JV assets.

The effects on the Nigerian Oil Industry and relevant legislation

The Nigerian oil industry is eagerly awaiting the passing of the Petroleum Industry Bill (PIB), which at year-end 2019 was thought likely to happen in the 2nd Quarter, 2020. However, the crude price crash will further delay Final Investment Decisions (FIDs) on various upstream projects and lead to lower production in the next four to 10 years due to delayed or abandoned investment in new production. This puts even more pressure on the PIB to cover a wide band of oil prices to draw globally mobile capital to Nigeria when oil prices stabilise.

A general lack of new investment capital in the global energy markets, including the established Nigerian energy players curtailing their own investments, means that a number of initiatives in Nigeria will be slowed down including:

- The Department of Petroleum Resources (DPR) conducts sales of Marginal Fields on an ad-hoc basis to attract new investment in proven hydrocarbon finds that have not be developed by their previous owners. The next round of this opaque process was rumoured to be initiated shortly.
- Significant bidding and start-up of the Nigerian Gas Flare Commercialisation Program aimed at putting out flares and increasing natural gas availability for industry or power generation.
- The PIB in general – once passed would normally include a road show to international investors. In 2020 the reception of this would not be favourable as investors have more pressing issues to focus on including massive employee retrenchments and preserving some form of cash flow to their relevant shareholders.

One small upside to this situation is the NNPC GMD Kyari stating that the petrol subsidy would end. If true, this would save in the range of US$1 billion+ annually in rumoured (but not transparent) subsidy payments as well as providing new profits to either NNPC or private marketers in the range of US$500 million in a six-month period – see Annex 1. However, all of the new policies, procedures and clear governance over this change are still waiting to be rolled out, and it's not clear if this new "profit" would go to NNPC, private marketers, or disappear due to lack of enforceable policies and procedures. Subsidy was not included in any parts of the 2020 budget, but the potential profits if accrued to NNPC and returned to the Federation Account could increase funding by about 3%.

Forward view - In 2020 where should Nigeria focus its efforts in the oil and gas business to maximise the sector's contribution to economic recovery?

Nigeria has been exposed to oil price swings for over 40 years now. Successive governments have tried stabilisation accounts such as the ECA and NSIA and have sought to diversify the economy in a number of different ways, with mixed success. The rebasing of the economy by the IMF in 2014 which resulted in Nigeria briefly becoming the largest African economy ahead of South Africa, still highlighted many challenges, notably tax collection and an over-reliance by the State on the oil and gas sector for revenue, despite it now representing well under 10% of GDP. A 2014 PWC report on the rebasing noted that, at 7.8%, Nigeria's tax to GDP ratio compared unfavourably not just to high income countries such as the UK and US (39% and 27% respectively) but also to low income countries such as Tanzania (12%) and Burkina Faso (11.5%). If tax revenue from Nigeria's oil and gas sector were isolated then the tax to GDP ratio to that sector would be around 27% while for non-oil sectors around 4.6%, "one of the lowest in the world" according to PWC. The government needs therefore to work on both internally generated revenue (IGR) as well as continued efforts to diversify the economy towards sectors that might help with the massive underemployment and unemployment issues in the country.

During a period where new capital investments in the energy sector will be severely limited, Nigeria needs to continue its work to improve transparency and cut costs in the industry if the sector is to play its part in any post COVID-19 economic recovery. This would include addressing the following issues:

Deliver a credible Petroleum Industry Bill (PIB)
Continue work on the PIB making sure that the resultant bill is robust enough to provide confidence over the operation and regulation of the sector to foreign investors, while ensuring new rent sharing includes an oil price band starting from $20/bbl

Hardwire in the end of subsidy
The fall in price of crude has, by default, eliminated the cost of maintaining a subsidised price for petroleum products. Although NNPC has announced the end of subsidy on the back of this, work still needs to be done on new policies and procedures to ensure this change is hardwired in and cannot be rolled back once oil prices start to rise again (the Petroleum Products Pricing Regulatory Agency for example has already started to lobby for subsidised foreign exchange rates to be reinstated for petroleum product importers). As noted above there are potential profits of around $500 million or a 3% increase in the revised 2020 budget if implemented correctly.

Reduce costs and increase development impacts through better regulatory oversight and management of key sector agencies

- Focus on the reduction of cross subsidisation in NNPC and its subsidiaries to find clarity on what headquarters costs really cover
- Develop an efficient domestic gas utilisation plan to ensure revenues that might be lost from exports of Liquified Natural Gas (LNG) are mitigated through domestic consumption
- End waste and leakage of funds through agencies tasked with delivering development benefits in the Niger Delta. The Niger Delta Development Commission (NDDC) is meant

to improve the lives in nine states in the region with historical infrastructure deficits and they receive 3% off all operators' budgets each year regardless of performance. The Nigerian Content and Development Monitoring Board (NCDMB) receives 1% of all contractor invoices paid to help develop local content in the energy industry but they have never accounted for the close to $1 billion they have received over the last eight to nine years. Both organisations should be carefully scrutinised, and the payments stopped until improvements in governance are firmly in place.

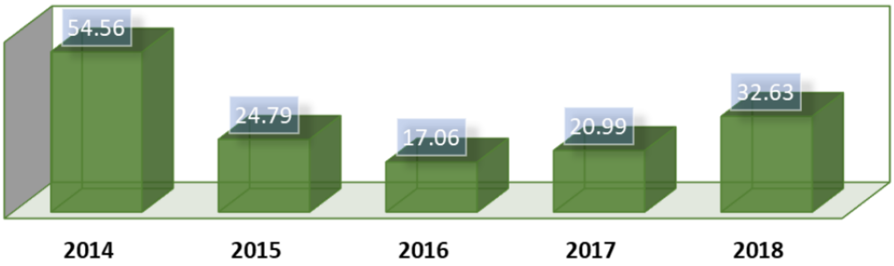
- Increase efficiency of the downstream sector, which has employment potential and could contribute to GDP and generate incomes for a wider array of citizens. This could be done by improving the regulation of the sector to increase both private sector participation and domestic crude utilisation.
- Finally, aggressively tackle the cost of production across the industry. Some areas to consider:
  - The cost of security is estimated to be about $6/bbl – address by visibly improving performance of Ministry of Niger Delta Affairs (MNDA), NDDC and Nigeria Content Development & Monitoring Board (NCDMB) on delivering development benefits in the Delta
  - The Nigeria Petroleum Development Company (an NNPC subsidiary) has seen the number of assets they operate increase dramatically in a short period of time from 2012-2016. They have very high costs and low efficiency. Continue the move to the Independent Joint Venture (IJV) model (as Nigeria LNG is run) for efficiency and better chances of raising new capital.
  - The National Petroleum Investment Management Service (NAPIMS), a NNPC subsidiary, is tasked with management of NNPC's non-operated assets in Joint Ventures with oil companies. However, they lack the needed professionalism and efficiency including high staffing and long decision-making times. Focus on making timely (30-60 day) decisions and replacing their costly financial reporting system with standard industry reporting.
  - Organised trade unions and other labour factors have led the Nigerian energy sector to a very high cost basis with uncertain productivity. Staff rarely receive pay cuts during industry downturns and continually receive increases in annual salaries. Benchmark staff costs and productivity worldwide and get Nigerian labour costs and productivity in line.

Annex 1.1 – General Data

Nigeria GDP – 2018 – US$400 billion
Nigerian Government External Debt – 2019 ~$27 billion
Nigerian Foreign Capital Reserves – 1Q 2020 - ~$35 billion

2018 NEITI Annual Report – Nigerian Government Financial Flows – US$ billions

FIGURE 3. 2: FIVE-YEAR AGGREGATE FINANCIAL FLOWS



% change in Revenue		**-56%**	**-31%**	**+23%**	**+55%**
% change in Avg Brent		**-47%**	**-15%**	**+23%**	**+31%**
Avg Brent Price $/bbl	$99	$52	$44	$54	$71

Annex 1.2 - Removal of Petrol Subsidies – possible profits for importers

The Federal Government of Nigeria is negotiating with fuel marketers to lower the price from N143/litre to N123.5/litre but this is still above the import cost depending on the FX rate used. If N400/US$1 is used, and US$25/bbl crude is assumed, it could be expected that petroleum products could be imported at a price of around N80-N100/litre and a reasonable profit could be made in this business.

Assuming N45 million/litres/day at N25/litre profit and N400/US$1 and six months of this regime in the 2nd half of 2020 this would lead to new profits in the system of about N200 billion or ~US$500 million or twice that amount on a full year basis.

Annex 1.3 - 2018 Example - Gross Oil and Gas Revenue inflows and uses

2018 NEITI auditted data	**US$ Billions**	**N Trillion at N305/US$1**
Gross Revenues from Oil and Gas Sector	$32.6	₦ 9.9
JV Cash Calls Paid	-$5.2	-₦ 1.6
To NNPC Accounts	-$4.0	-₦ 1.2
3rd Party Project Financing (oil and gas)	-$2.1	-₦ 0.6
Segrated to FIRS, NDDC, NCDMB & FMF	-$1.4	-₦ 0.4
Transferred to Federation Account	**$19.9**	**₦ 6.1**
% of Gross Revenues	61%	61%
2018 Nigerian Government Budget		**₦ 9.1**
% of Budget from Energy Sector		**67%**