Mini Report
SERIES

THE NIGERIAN ECONOMIC SUMMIT GROUP

Making Nigeria's Oil & Gas Sector Deregulation Work for Economic Growth and National Prosperity

1. INTRODUCTION

Emerging and developing countries have become the epicentre for urgent socio-economic reforms and restructuring due to the global economic fragility, macroeconomic instability, and socio-economic challenges. For Nigeria, one topic of debate has dominated policy space since the return of democracy in 1999. The topic is whether the Nigerian Government should fully or partial deregulate the country's oil & gas industry.

Past reforms or deregulation policies have led to a complete phasing-out of subsidies on some petroleum products like Liquified Petroleum Gas (LPG) in 2021, gasoline oil in 2017 and kerosene in 2009. Unlike in the case of these petroleum products, the complete removal of subsidies on petrol has been challenging considering its heavy use for household, industrial and transportation activities. Consequently, the impact of fuel subsidy removal will be felt across a long chain of end-users - individuals, businesses, transporters and end-users of food and non-food items - in the form of higher commodity prices. Therefore, the Nigerian polity is polarised into two: ***the Government*** – which supports fuel subsidy removal and the ***average citizen and trade unions*** – which oppose the removal of the fuel subsidy.

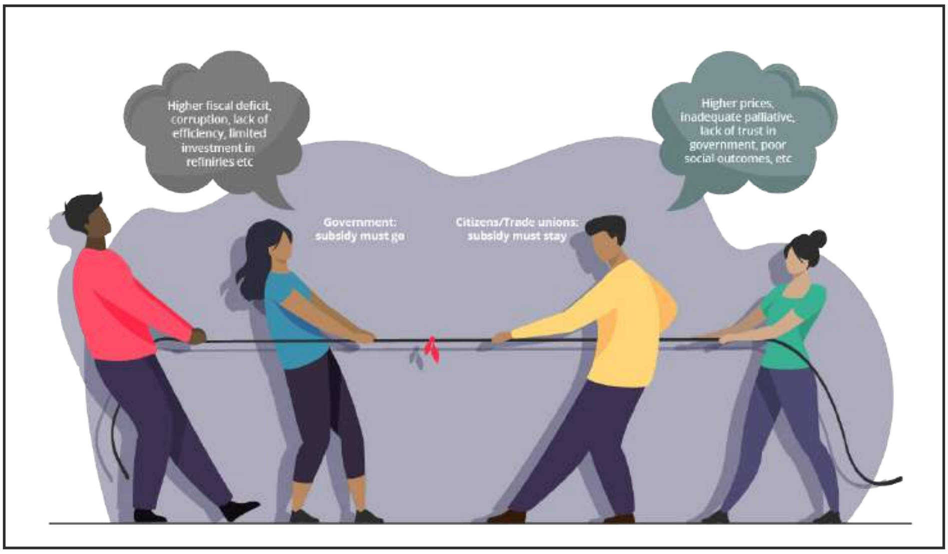
This question appears to be a more recurring debate since the 2000s when successive administrations in Nigeria started contemplating the complete deregulation of the oil & gas industry.

- For Government, there is a fear of complete deregulation creating a private monopoly due to the sector's capital-intensive nature.

- The private sector argued that expected inflows of investments might be affected without a fair pricing system that comes with deregulation.

- The people considered the inflationary pressure that would come with either full deregulation of the sector or subsidy removal.

Figure 1: Re-Shaping the Narratives: Opposing Views on Fuel Subsidy Reforms



Source: NESG Research

2. BACKGROUND – SETTING A STAGE FOR OIL & GAS INDUSTRY REFORMS

On the sectoral level, oil & gas contributes about 34.9 percent of the total revenue of the Nigerian Government and 85.2 percent of the country's exports. The industry continues to struggle, with a poor contribution to the country's GDP (at 8.1 percent) in the first three quarters of 2021 (NBS; FMFBNP; 2021). Notwithstanding the poor and volatile performance of the industry, the oil & gas industry still holds enormous prospects such as:

- Source of needed massive investment potentials, particularly the midstream oil and gas sector;
- Wealth creation opportunities via job creation;
- Provision of inputs for light manufacturing industries such as petrochemical, plastics & rubber production, drugs & pharmaceutical; and
- Enormous gas reserves to earn foreign exchange and support external reserves accretion.

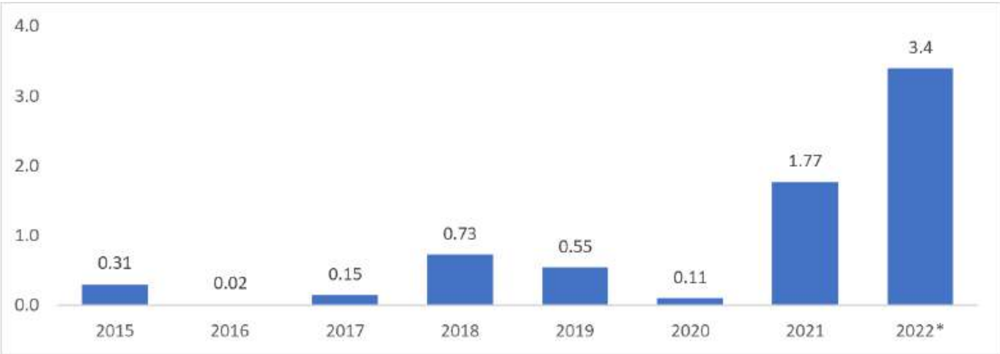
In response to creating a competitive sector, the newly assented Petroleum Industry Act (PIA) 2021 promises several reforms. To optimise the benefits associated with the PIA, there is a need to implement its provisions properly. Ultimately, it is anticipated that reforms initiated via the PIA will help attract investments, improve efficiency and productivity, as well as maximise socio-economic outcomes associated with a highly performing oil and gas industry.

Some of the reforms' targets of the PIA include:

- Propel Petroleum Industry Growth: provide the institutional, legal, competitive, and commercial framework for developing the oil and gas industry in Nigeria.
- Robust Institutional Framework: create a transparent and accountable governance system that enables a conducive business environment in the petroleum industry.
- Improve Administration: complete liberalisation of the downstream industry and promotion of fair and commercial competition among industry players.
- Strengthen Fiscal Framework: expand the petroleum industry's capacity to enhance government revenue through a new, clear and dynamic set of rules.
- Host Community Development: ensure direct socio-economic benefits to the host communities of petroleum facilities to enhance harmonious co-existence.

In addition to the need for complete deregulation, one of the contentious policy issues in the sector is the fuel subsidy reform. This is one of the many difficult decisions Nigeria might have to take in 2022. The fuel subsidy, conceived initially as a short-term support tool, has endured over time, thereby becoming a threat to fiscal sustainability. In the last three decades, Nigeria has spent substantial government revenue on subsidies, which has become increasingly unsustainable. The strain in public finances resulting from huge fuel subsidy costs has forced the Government to adjust the pump price of fuel from time to time. However, partial deregulation — currently known as the price modulation system — only provides temporary relief as the fuel subsidy cost gathers momentum whenever international crude oil prices rise.

Figure 2: Subsidy in Nigeria (N' Trillion)



***Proposed Figure| Data: NNPC; Chart: NESG Research**

From the government fiscal position, between 2015 and 2021, Nigeria has spent a cumulative sum of N3.64 trillion on fuel subsidies, rising from N307 billion in 2015 to N1.77 trillion in 2021 – representing a whopping increase of 477 percent (see Figure 2). Following the fall in the crude oil price to as low as US$9 per barrel in April 2020 (average price in 2020 was US$42 per barrel) as a result of the COVID-19 pandemic, fuel subsidies accounted for over 5 percent of the federal Government's retained revenue from around 11 percent in 2019 when crude oil price averaged US$66 per barrel. However, the current rebound in the crude oil price has increased the fuel subsidy burden. According to the NNPC, the Nigerian Government will spend about N3.4 trillion on fuel subsidies in 2022. This subsidy expense figure is about 31.7 percent of projected government revenue of N10.74 trillion in 2022.

On the other hand, the private sector argued that without a fair pricing system that comes with deregulation, expected inflows of investments would be hard to achieve; meanwhile, the average citizens considered the inflationary pressure that would come with subsidy removal and the impacts on the cost of living & welfare.

[1]The Petroleum Industry Act (PIA) 2021 sought to overhaul Nigeria's oil & gas industry. The bill, now PIA, was passed by the National Assembly in July 2021, and President Buhari assented to it in August 2021. Based on the gazetted copy of the Act, the PIA regime commenced on August 16, 2021. The law aims to provide a new dimension for the country's oil and gas industry. The following are five areas/scopes covered in the PIA: 1. Governance and institutions, 2. Administration, 3. Host Community Development, 4. Petroleum Industry Fiscal 5. Framework and other miscellaneous provisions.

3. WHEN DO SUBSIDIES BECOME AN UNNECESSARY BURDEN?

Remove or retain fuel subsidies? This is one of the many difficult decisions Nigeria might have to take in 2022. The fuel subsidy, conceived initially as a short-term support tool, has endured over time, thereby becoming a threat to fiscal sustainability. What was introduced in the 1970s to cushion the pass-through effects of rising international crude oil prices on Nigeria's domestic fuel price has become a topical issue with substantial fiscal and social dimensions. Over the years, the Government's fuel subsidy burden has heightened, especially during periods of high crude oil price, thereby threatening its sustainability as a price stabilisation tool.

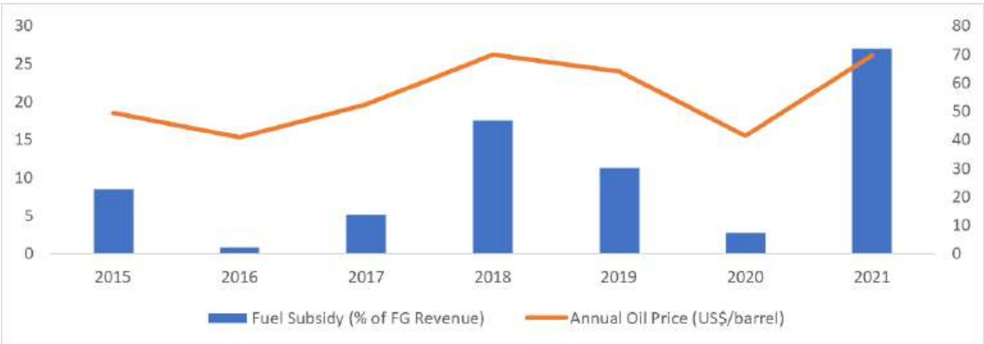
The rationale behind fuel subsidies in Nigeria, like any other country, is to moderate the impact of rising global oil prices on the welfare of Nigerians. At some point, subsidy payments will constitute a significant drain on public finances, as it is one form of transfer payments. Here are some arguments in support of ending the burden of fuel subsidies:

- It is becoming unaffordable for the Government, particularly in times of persistent increase in crude oil prices. Since fuel subsidies are put in place to stabilise petrol pump prices, in periods of higher global oil prices, the Government faces two options: upward adjustment of the cost of PMS or a phase-out of the subsidy on petrol;

- When government revenues from oil and non-oil sources are under intense pressure - Rather than being captured explicitly as an expenditure item in the annual budget estimates, the cost of the petrol subsidy is treated as "forgone revenue". The NNPC directly calculates fuel subsidy costs from the gross oil and gas revenues that it transfers to the Federation Account. This is where the issue of transparency and accountability becomes essential. For instance, pre-COVID-19, fuel subsidies accounted for 11.3 percent of FGN Retained Revenue in 2019, and this share rose more than doubled to 27% in the first eleven months of 2021.

- When there is perceived widespread corruption in subsidy disbursements – about 39 percent of annual fuel subsidy payments is lost to corruption (CPPA, 2012). However, we believe that the best way to address persistent corruption is to tackle its root cause.

Figure 3: Fuel subsidy costs (% of FGN Retained Revenue)



Data: NNPC | Chart: NESG Research

Can Nigeria continue to bear the cost of fuel subsidy amongst other forms of subsidies?

From the Brazilian experience, oil subsidy reforms were implemented in phases, starting with removing subsidies on products consumed by low-income households. The subsidies on petroleum products consumed by the political elite were delayed for about ten years and were subsequently removed (see IMF, 2013). Comparatively, Nigeria has introduced subsidies across different products – fuel and non-fuel. Despite the so-called power sector deregulation, the authorities subsidise electricity tariffs. Conversely, the government's interventions in the agricultural sector have been dominated mainly by loans and advances to smallholder farmers, with subsidies primarily focused on the production segment. More specifically, fertilisers and fishing inputs are sold to smallholder farmers at subsidised rates.

However, it is important to note that the fiscal burden imposed by subsidies on petrol far outweighs that on other products. The subsidy in the power sector is reflected in the distribution companies' under-pricing of electricity tariffs and the government bears the gap between the cost-reflective tariff and the regulated user-charge of electricity through annual budgetary allocations to the sector. Comparatively, the subsidies on PMS constitute a direct and massive drain on the nation's treasury as it must be deducted before the net oil revenue are transferred to the Federation. Fuel subsidy is treated as a forgone revenue rather than as an expenditure item in the budget just like other forms of subsidies in the agricultural and power sectors.

4. ACTION POINTS FOR THE GOVERNMENT ON THE BEST PATH TO TAKE:

1. Consider gradual phasing-out of the subsidy: There is a need to develop a phase-out subsidy plan. The Government can remove the fuel subsidy partly to allow for adjustments to the new prices by the citizens. Past experiences in Nigeria have shown that the abrupt removal of fuel subsidies will only stoke public demonstrations and protests. Unlike in the case of Brazil, where authorities removed subsidies on fuel products one after the other, Nigeria could consider a gradual adjustment in the pump price of petrol, perhaps to reflect the state of key macroeconomic stability indicators, such as the exchange rate. However, this adjustment will raise another concern as persistent exchange rate depreciation will translate to higher petrol prices. The Government, therefore, needs to address the underlying drivers of macroeconomic instability in the country. One of such drivers is the considerable pressure on external reserves due to high bills on petroleum product imports, which could have otherwise been saved if the existing refineries were in good working condition.

2. Implement effective and efficient social interventions before subsidy removal to gain citizens' trust: One of the key reasons for opposition to fuel subsidy reforms in Nigeria is the absence of sustainable and enduring social protection schemes. The ad-hoc nature of social investment programmes in Nigeria with limited coverage needs review. The Government could leverage different platforms — census, mobile money, CBN's Bank Verification Number (BVN) and the national social register — to ensure the coverage of the most vulnerable public members while implementing mitigating measures. Although we note that effecting such transfers before subsidy removal comes with additional fiscal pressure, we believe that this is necessary, given the low level of trust between the citizenry and the Government. This could also be considered a cost for the Government to bear in the subsidy removal debate.

3. Address inefficiencies in the oil and gas sector: The NNPC needs to publicise its internal operations and financial position regularly. After about 44 years of existence, the state-owned oil company published its first audited financial report in June 2020. This implies that decades of NNPC's operations have been marred by irregularities in the use of public resources due to a lack of accountability. These irregularities create an atmosphere of distrust and a loss of confidence in the Government and its agencies. Until transparency and accountability are deeply entrenched in Nigeria's oil and gas sector, critical reforms in the industry will be vehemently opposed by the labour unions and civil societies.

4. Intensify efforts to improve revenue: Even if the fuel subsidy is removed, there is likelihood that the government fiscal deficit will increase in the medium term if the Government's revenue growth rate does not outpace that of expenditure. In essence, fuel subsidy removal will only alleviate the fiscal deficit situation in the short term. Efforts to enhance the country's oil and non-oil revenues must be intensified. However, we cannot over-emphasise the need to block revenue leakages, expand the tax nets, and strengthen partnerships with state governments to explore the resources at the subnational level.

5. CONCLUSION

The removal of subsidies on petrol will come at a cost. Tough reforms are costly, and the cost of inaction is also enormous. But the Government must work to minimise this cost on citizens through direct and indirect interventions. Implementing subsidy reforms without complementing the policy with effective mitigating measures will only elevate economic hardship for Nigerians and could stoke social unrest as a result. For instance, the abrupt removal of fuel subsidies pronounced on January 1, 2012, led to nationwide protests and demonstrations which lasted for a week. This cost the country over N320 billion in economic losses per day (see Bazilian and Onyeji, 2012). Since the EndSARS protest in 2020, Nigeria has been in a fragile state. Therefore, abrupt fuel subsidy removal might lead to protests which should be avoided at this critical juncture. More importantly, rebuilding public trust is not an easy task, but if government actions continuously favour credibility over discretion, the trust deficit will be narrowed. This, the NESG believes, will also go a long way in improving public acceptance, as reforms will be implemented in the general interest of the populace.

ABOUT NESG

The NESG is an independent, non-partisan, non-sectarian organization, committed to fostering open and continuous dialogue on Nigeria's economic development. The NESG strives to forge a mutual understanding between leaders of thought so as to explore, discover and support initiatives directed at improving Nigeria's economic policies, institutions, and management.

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