SPOTLIGHT ISSUE

NIGERIA'S FUEL SUBSIDY

AUGUST 2015

SDN

NIGERIA'S FUEL SUBSIDY:

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For original articles see:
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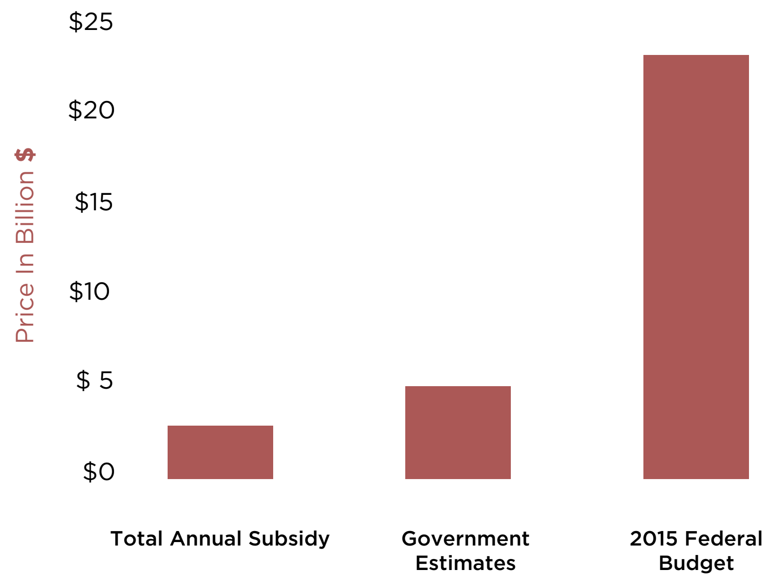
President Buhari recently stated that Nigeria's costly fuel subsidy programme will continue whilst his new Administration balances priorities in the midst of depleting Government coffers. An expensive decision as the administration struggles with cash shortages resulting from a record-low oil prices that are predicted to continue. According to our independent analysis based on average domestic fuel consumption, subsidies claimed by fuel marketers cost Nigeria $2.9bn over the last year. This is a 400% increase since 2007 and a sum equivalent to 13% of the Federal Budget, passed in April 2015. However, official Government data estimates the cost of the subsidy at $5bn. It's interesting to note that the Berne Declaration calculated no less than $6.8 billion of unjustifiable subsidies were paid out between 2009 and 2011, that's $2.3bn a year, strangely close to the difference between our independent analysis and official Government estimates. So what has happened to the more than $2bn that the government says it has spent on subsidies but has never been received by the fuel marketers? We will address all these issues in this month's articles.

WHAT DOES THE SUBSIDY COST



CALCULATING THE SUBSIDY

The fuel subsidy is calculated as the difference between the Expected Open Market Price (EOMP) and the retail price at the pump, currently fixed at N87 ($0.44), all provided in the relevant pricing templates. The EOMP is calculated as the sum of allowable landing costs (primarily cost of imported product & freight costs) plus distributor margins. Landing costs represent around 85% of total allowable costs in the calculation and therefore factors that affect landing costs will also affect the eventual subsidy paid.

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The two main drivers of these costs are global oil prices, as changes in imported product and freight costs often reflect underlying crude prices, and the $:N exchange rate, as the pricing template is denominated in Naira, with actual costs of product and freight often financed in $.

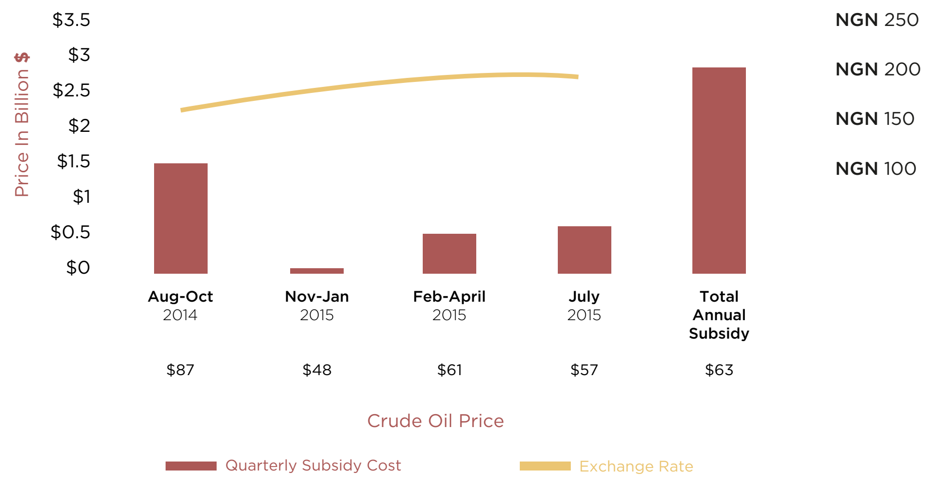
A LONG (AND EXPENSIVE) YEAR

The relatively stable period of high oil prices since 2011 resulted in enormous profits for the Nigerian Government, contributing to a relatively stable exchange rate as the status quo prevailed and Federal reserves were easily replenished once spent. However, in the last year as the world moved quickly to a decade low oil price, vast dollar sums were converted and spent on Nigeria's recent election, some say the most expensive to date, as the two major opposition parties campaigned furiously across the first quarter of 2015. The situation was made worse by an extreme vulnerability and dependency of the Nigerian economy on oil revenues (the country literally needs to import almost everything): even with its decimated revenue, the government had to continue to spend billions of dollars to pay for most basic commodities, including food, further depleting country's reserves. The combination of these factors caused the Naira to devalue by 25%, despite Central Bank intervention.

MISSED THE BARGE?

The falling price of oil initially caused a reduction in subsidy payments as the imported cost of product and freight costs fell proportionally; the subsidy available to marketers in January 2015 was N2.94 ($0.02) per litre down from N22.29 ($0.1) per litre in October 2014. However, as the oil price stabilised, the exchange rate began to depreciate and the subsidy began to increase again to N38.76 ($0.19) per litre in April 2015 and N44.86 ($0.23) per litre in July 2015 as exchange rate movements affected the claim calculation.

QUARTERLY SUBSIDY COST



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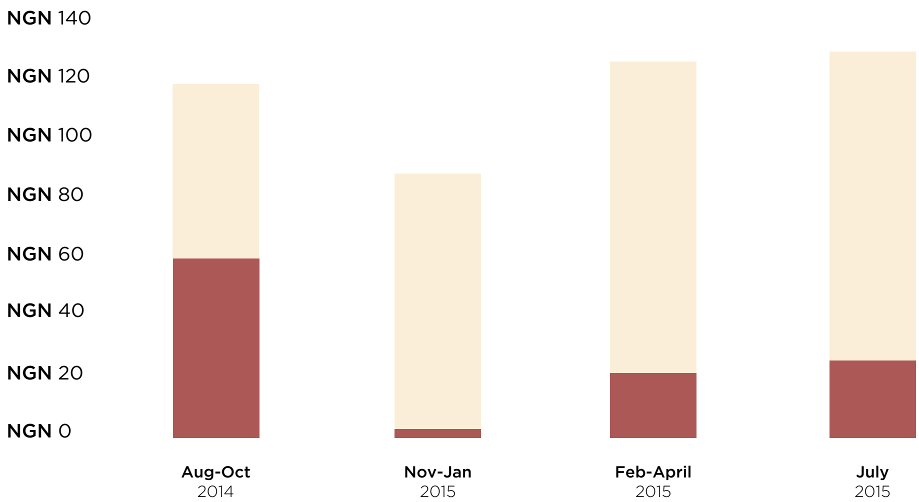
ALLOWABLE SUBSIDY COSTS



With derivative markets expecting a further devaluation of up to 15%[1], the short-term stability of the Naira is uncertain, problematic when trying to come up with a strategy to address the spiralling costs of the programme.

The removal of the subsidy at today's prices would likely result in pump prices floating around N125 per litre (as opposed to the subsidised price of N87). Profit margins for marketers would disappear, threatening petrol supplies which in turn could grind Nigeria and the new Administrations reform efforts to a halt. You can understand why the President is in no hurry to pull the plug. In 2012 the Nigerian government attempted to abolish the subsidy which led to unprecedented nationwide strikes, causing the administration to back down.

A FINE BALANCE

Any plan to remove the subsidy will be a balancing act; artificially low petrol prices are seen by many as the only benefit Nigerian citizens have gained from the discovery of oil in 1956. The subsidy programme cannot continue indefinitely, but with rising fuel consumption, how can Nigeria address increasing subsidy costs whilst maintaining fuel supplies and without sending shockwaves through Nigeria's delicate socio-economic fabric?

The subsidy may not be President Buhari's immediate priority, but one thing is clear: demonstrating that the new Administration is seriously tackling corruption around the subsidy will go a long way to garner public support should the subsidy be removed in the future.

1 http://www.reuters.com/article/2015/07/15/nigeria-sp-idUSL5N0ZV2H220150715, accessed 20 July 2015

NIGERIA’S FUEL SUBSIDY:

HOW DOES THE NIGERIAN FUEL SUBSIDY WORK?

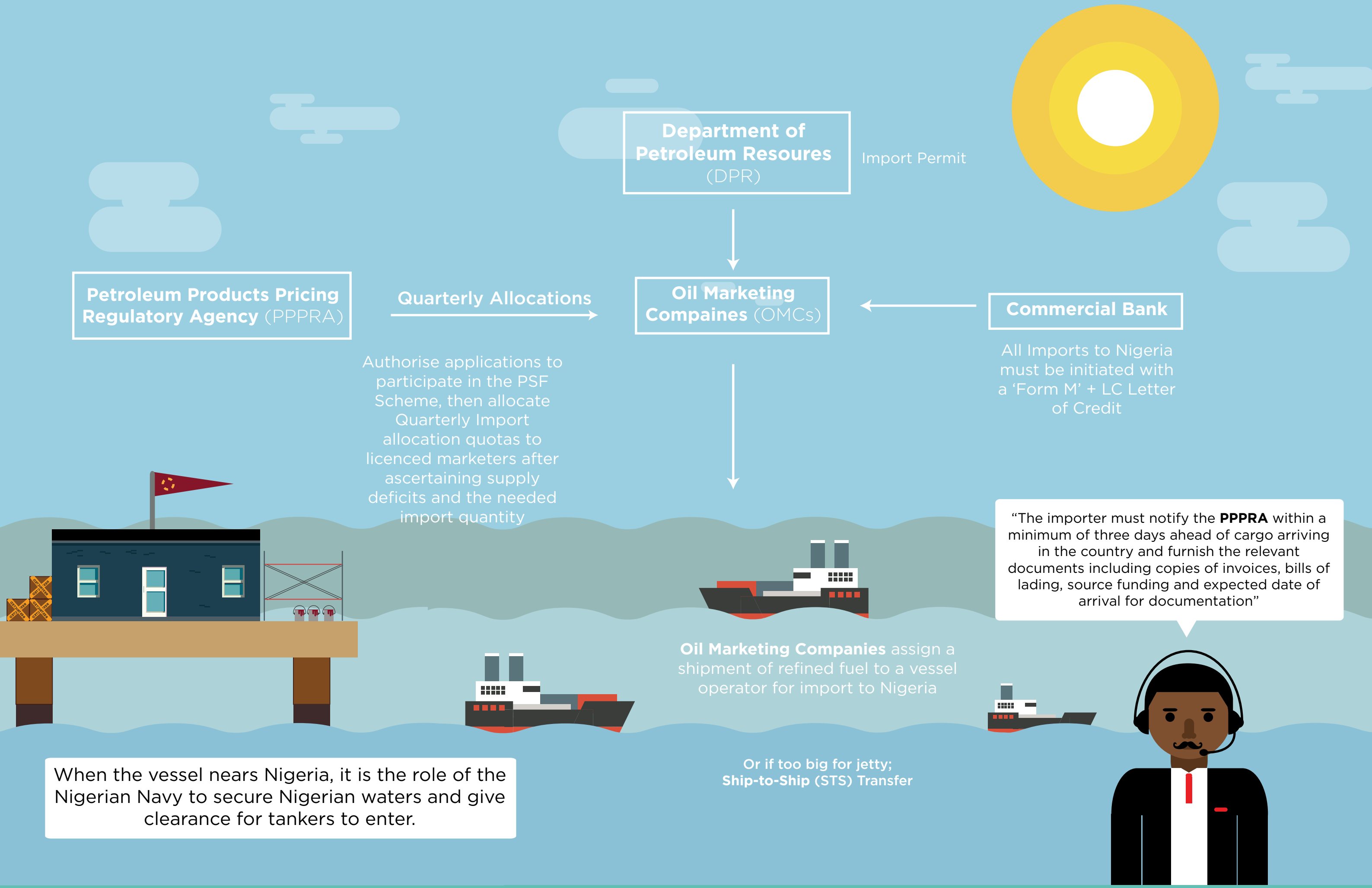
What is generally known as Nigeria's petroleum subsidy is actually paid from the **Petroleum Support Fund** (PSF). This is administered by the **Petroleum Products Pricing Regulatory Agency** (PPRA) under Published Guidelines that came into effect in January, 2006.

The PSF is funded by the three tiers of government (Local Government Areas, States, and Federal Government) to stabilise the domestic prices of petroleum products against volatility in prices in international crude and refined products.

The aim is to regulate prices to ensure uninterrupted availability of products in the country based on determined petroleum products supply gaps. The mandate is to safeguard efficiency and prudence in the importation, distribution, marketing and availability of petroleum products to Nigerians.

In an attempt to understand this complicated process, what follows is a clear outline of the process the Federal Government uses in an attempt to regulate supply and price for Nigerians

Before fuel can be imported to Nigeria, Oil Marketing Companies (OMCs) must apply from three key sources



Upon arrival, before any discharge can take place the vessel operator for the **Oil Marketing Companies** must provide documents to the **Nigerian Customs Service** and **Nigerian Ports Authority.** They must give clearance to commence the process of docking and discharging a stated quantity of the cargo to storage tanks.

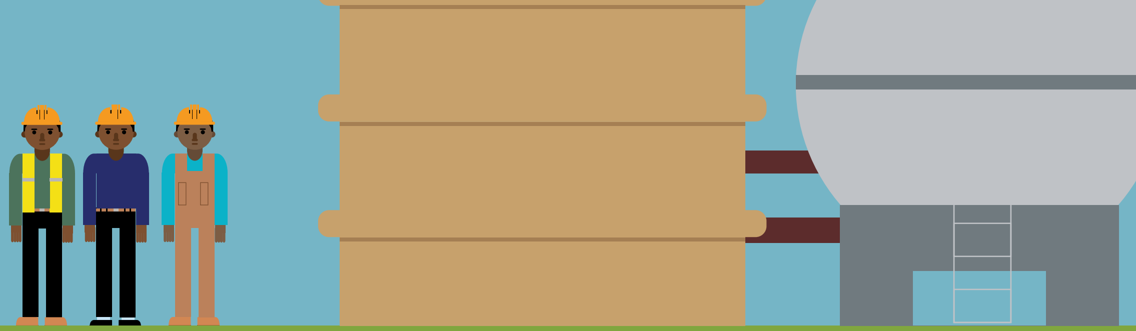
After all the cargo has been discharged to the storage tanks at the depot, it is inspected by various agencies.

The Department of Petroleum Resources verifies the quantity of petroleum products imported and analyses the quality.

The Office of the Accountant General, **Federal Ministry of Finance Consultants**, and **PPPRA** staff witness and confirm the quantity delivered at the jetty and into the shore tank, and from jetties to depots.

Since 2011, in a bid to avoid adulteration and volume distortions the volumes and quality are verified - both on the vessel and in the shore tank at the jetty - by independent Government-appointed auditors and cargo inspection agents.

The Nigerian Ports Authority levy the relevant administrative charges.



"A certificate with the precise details of the amount and the quality of the cargo delivered at the depot is issued by the department of petroleum resources and signed by all parties involved in the inspection"

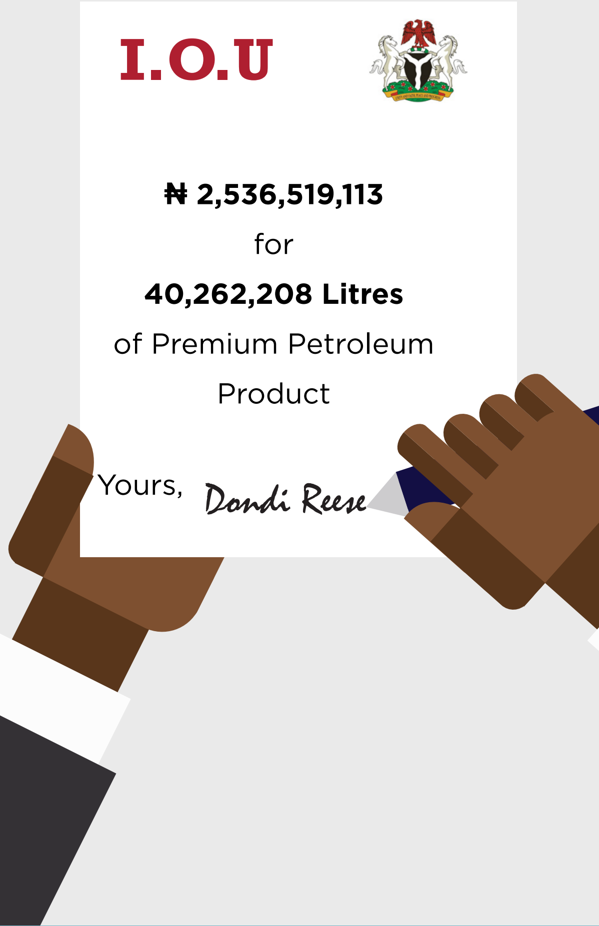
This Certificate acts as a formal receipt for proof of delivery for all parties.

Next, this certificate is forwarded to the **Petroleum Products Pricing Regulatory Agency.**

It is the duty of this agency to compute the applicable subsidy in line with their **Petroleum Support Fund** (PSF) template, and deduct applicable charges.

Under the PSF scheme, the **PPPRA** introduced **Sovereign Debt Initiatives** in 2010 as an interim payment in order to ease the delay experienced in the subsidy settlement and the attendant negative effects such as foreign exchange differentials and interest rate demands by marketers.

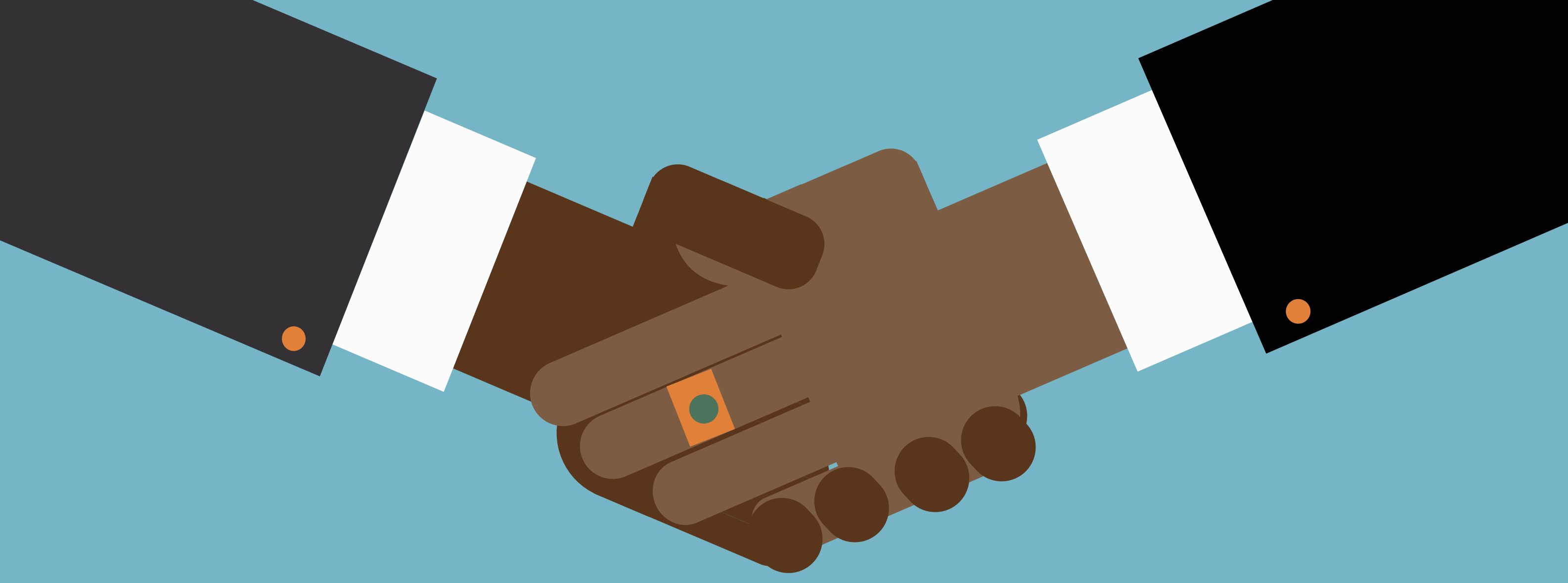
These mechanisms guarantee the timely payment of subsidy, thereby enabling marketers to access financing and support from banks thus facilitating a seamless supply of petroleum products in the system.



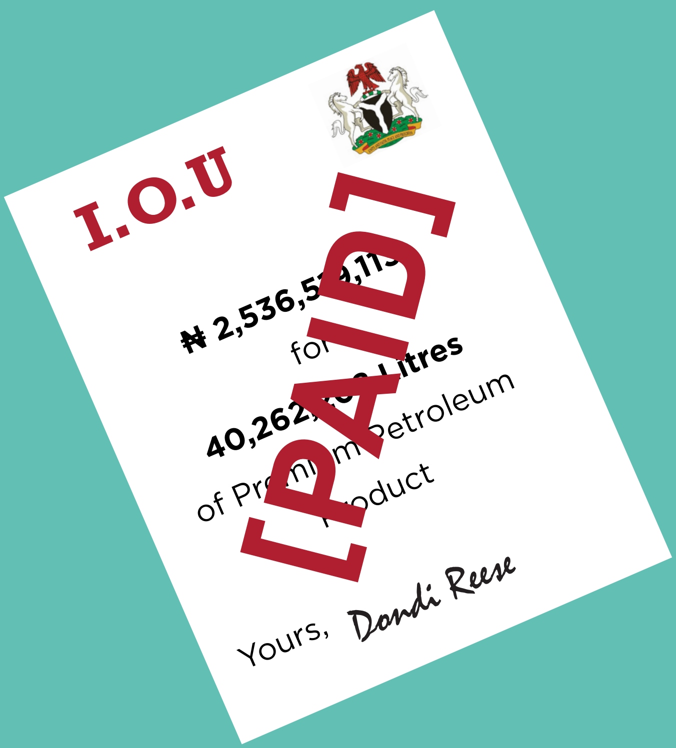
After charges are paid by **OMCs**, the first of these **Sovereign Debt Instruments** used by the **PPPRA PSF** unit is the **Sovereign Debt Statement** (SDS). This states the subsidy due to the **OMC** for delivering a cargo of petroleum product

Oil Marketing Companies take the **Sovereign Debt Statement** to debt management office **(DMO)**

The **Debt Management Office (DMO)** issues a **Sovereign Debt Note (SDN)**, guaranteeing payment to **Oil Marketing Companies** within 45 days for the petroleum product imported.



The Central Bank of Nigeria makes the payment for subsidies to **Oil Marketing Companies**



Funding for these charges are sourced by the **Federal Ministry of Finance.**

The bill is settled by the **Central Bank of Nigeria** and **OMCs** receive the subsidy allocation for imports.

NIGERIA'S FUEL SUBSIDY:

LACK OF TRANSPARENCY AND MISMANAGEMENT OF FUEL SUBSIDY REVENUES

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The domestic fuel supply is a monopoly of the state-owned oil company, the Nigerian National Petroleum Company (NNPC), and its subsidiaries. Buhari recently announced he intends to dismantle the NNPC to separate regulation and operations, but has not yet revealed a timeframe. Some of the most opaque procedures that have evolved within the organisation are detailed below. This follows the National Resource Governance Institute in-depth analysis of how the NNPC sells its oil, published last week (http://www.resourcegovernance.org/publications/inside-nnpc-oil-sales).

With insufficient refining capacity, Nigeria is forced to import almost all the fuel it needs – despite being the Africa's largest and world's 6th largest exporter of crude oil. Keeping the country running is therefore dependent on a regular flow of imports.

To smooth the importation process and keep supply constant, domestic prices of petroleum and diesel are kept low by a $5billion Federal subsidy - equivalent to a fifth of the federal budget, and more than double education spending - paid to marketers importing the products. At the pump, petroleum costs N87 per litre ($0.44), diesel N150 per litre ($0.76).

STATE-OWNED PROCESS

The NNPC is a state-owned oil company that controls the domestic fuel supply . It acts as the public's steward of national crude reserves, and licences importers and distributors, fixes local pump prices, owns fuel stations and depots and administers payments of subsidies to distributor.

The NNPC is therefore acting as the regulator, importer, distributor, marketer, producer, competitor, claimant, payer and payee. NNPC dominance over imports has been built up over decades of state control. Until the introduction of the Petroleum Support Fund Scheme in 2006, it was the sole importer of petroleum products. With the Fund, private marketers are permitted to take part in the importation. The monolithic enterprise still remains largely unaccountable to anybody, which is problematic because it is not doing a very good job of managing imports. Fuel scarcity is common for Nigerians, crippling the economy and pushing consumers to the black market where prices are two to three times more.

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AVENUES FOR CORRUPTION

Between 2007 and 2014 the amount paid in subsidies has increased by 400% (from N188billion to N971.1billion). Clearly legitimate consumption did not increase at this pace. The few investigations allowed to examine the opaque operations of NNPC have found large amounts of diverted funds.

An audit in 2009 identified over $800m of unresolved differences between what companies said they paid in taxes, royalties and signature bonuses against what the government said it received. That sum exceeded the 2009 budgets for the Ministries of Education, Health and Power.

The audit also revealed that the largest amount owed to the government was an estimated US4.7bn by NNPC for payments of domestic crude. In 2012, the Farouk Lawan Committee Probe and then the Presidential Verification Committee on Subsidy Administration found over N232 billion mis-paid to marketers for petroleum not supplied in 2011. This claim was for 197 subsidy transactions, equivalent to double the amount of deliveries made.

Examining the issue in more detail, the Berne Declaration calculated that no less than $6.8 billion of unjustifiable subsidies were paid out between 2009 and 2011.

In 2012, the Central Bank governor brought the issue right to the doorstep of the President, writing a letter accusing NNPC for failing to transfer $20 billion in oil revenues between January 2012 and July 2013. This works out as roughly $1 billion a month, in a country where 140 million people live on less than $2 per day.

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SWAP DEALS

The Federal Government engages international commodity traders in crude-for-products swap deals. In the deals, companies are allowed to lift crude oil from Nigeria for free, sell the products in the international market, and then use the proceeds to import petroleum products of equal value.

However, companies are not kept track of in the diffuse process, and as such it is estimated that $8 billion per year are lost through the arrangement.

It is a difficult and complicated process to trace as the NNPC deducts payments internally from the revenue it generates selling the country's crude oil. What is clear from the few superficial probes conducted is that the subsidy scheme creates huge opportunities for mismanagement of revenues.

A more comprehensive autopsy may be forthcoming following the extractive industry transparency legislation for companies registered in EU countries coming into effect this year. The US have stalled a parallel bill since its inception in 2012. If momentum can push it over the final hurdle of the Securities and Exchange Commission then analysts and activists can begin to shine a light inside the darkest machinery.

NIGERIA'S FUEL SUBSIDY:

A CRIPPLING PARADOX: NIGERIA'S FUEL SCARCITY

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A CRIPPLING PARADOX: NIGERIA'S FUEL SCARCITY

Nigeria, the world's 6th-largest producer of crude oil, is forced to import refined oil from abroad because it doesn't have the refining facilities to cater for the domestic demand for gasoline and diesel.

Today, Nigeria imports 85% of its domestic consumption. The government keeps prices at the pump well below market price (currently N87 [$0.44] per litre) and pays the difference to fuel importers in subsidies. The subsidy, along with corruption in the public and private sectors and government mismanagement, is the root cause of frequent fuel scarcity.

The most recent deficit took place in May 2015, when Nigeria's fuel importers claimed they were due $1bn in arrears, allegedly in foreign exchange differentials, and shut down their depots in protest. The resulting fuel shortage had a severe impact on businesses across the country. Since there is no reliable electricity grid, much of Nigeria relies on diesel-powered electricity generators. The refusal of the oil importers to release their supplies meant that the country was almost brought to a standstill. Banks, airlines, and three mobile phone operators announced that they would be forced to cut back on services if the situation was not resolved.

In the proceeding chaos, panicked Nigerians formed long queues outside petrol stations and black market vendors took to the streets, selling jerry cans of fuel at inflated prices. It soon became virtually impossible to buy fuel anywhere.

It is clear that the disproportionate amount of power wielded by these oil importers is in large part due to the Nigerian government's fuel subsidy. Without the subsidy, the importers would receive the profits from their sales at market value and would no longer be able to hold the government to ransom.

Ending the subsidy would also help to tackle corruption. In what essentially amounts to procurement fraud, fuel marketers have long benefited from the subsidy system, by overcharging the state for fuel they import and/or by failing to deliver the product they are paid for, diverting it instead to neighbouring countries where it is sold by smugglers for further profit.

Deregulating the market would reduce the influence of the fuel marketers and therefore be a step towards ending fuel shortages and tackling the corrupt tactics of the fuel marketers.

However, removing the subsidy is a highly-charged political move. It is widely viewed by the Nigerian citizens as the only advantage from being in an oil producing country. Previous President Goodluck Jonathan backtracked on a subsidy removal in 2012 after facing furious widespread protests.

Vested interests in the higher echelons of the political and economic world, who benefit from the international fuel importers' racket, would also fiercely oppose a removal of the subsidy.

Another obvious solution to the government's excessive reliance on fuel importers would be for Nigeria to refine its own oil. Previous governments have tried this: the three refineries owned and operated by the state in Port Harcourt, Warri, and Kaduna could be refining 445,000 barrels/day, which is more than enough to cater for Nigeria's domestic demand. In 2010, Nigeria imported 196,808 barrels/day.

However, a combination of corruption, disrepair, and inefficiency means that the three refineries operated at just 11.69, 25.52, and 16.7 percent capacity respectively between January and September 2014.

Removing the fuel subsidy could also help solve this problem: a deregulated price for fuel on the Nigerian market would stimulate demand for investment in domestic refining. A higher price for fuel would make it economically viable for investors to invest in building refineries or repairing existing ones.

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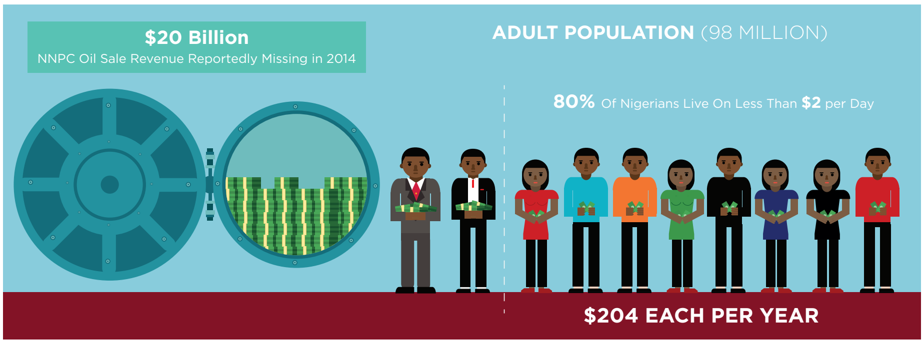
Nigeria's new president, Muhammadu Buhari, is considering whether or not to end an expensive fuel subsidy programme, although many Nigerians see cheap fuel prices as perhaps the only benefit they receive from living in an oil-rich country. One way forward might be through more effective use of the potential of cash transfers for achieving a measure of social protection.



WHAT IS THE ALTERNATIVE TO THE FUEL SUBSIDY?

The fuel subsidy in Nigeria reflects the continuing challenge facing Buhari's Government in seeking to build an inclusive society. Removing a billion dollar fuel subsidy is particularly problematic in a developing nation as it inevitably impacts the poor and growing middle classes hardest.

THE 'RIGHT PRICE' FOR FUEL

The IMF's methodology for 'Getting Fuel Prices Right' requires adjusting market prices with 'corrective taxes' in order for fuel prices to reasonably reflect the pollutant side effects of these resources [2]. Given the ironic reliance of Nigeria on imported fossil fuels, the current price of petrol falls well below the commodities recommended cost (N87 per litre, $0.44) considering its contribution to environmental degradation. However, in many developing countries, these corrective taxes would produce a far higher price than the average daily consumption could bear. If this particular methodology was applied in Nigeria, the price of gasoline would nearly double, from $1.77 a gallon to $3.3 a gallon. The median daily consumption is currently $1, and the resultant change in fuel prices per gallon as a percentage of this consumption would be 155% [3].

REDISTRIBUTION OF WEALTH

Delivering the 'right' price in Nigeria would have devastating consequences for the country's poorest. Many are now pointing to direct cash transfers as a way to overcome the human and political costs of adjusting these costs. The World Bank's 2012 report 'The Cash Dividend' stated that it is not whether cash transfers should be used in sub-Saharan Africa, but how. The UK's Department for International Development (DFID) has since supported numerous projects involving cash transfers to citizens.

2 http://www.greenfiscalpolicy.org/wp-content/uploads/2014/11/Getting-Energy-Prices-Right-Full-Publication.pdf

3 http://www.cgdev.org/blog/reducing-energy-subsidies-without-hurting-poor?utm_source=150714&utm_medium=cgd_email&utm_campaign=cgd_weekly&utm_&&&

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The rationale behind cash transfers is that you can more efficiently catalyse development by placing resources in the hands of the people. State transfers are designed to advance individual empowerment over 'top-down' initiatives which have previously cultivated the dominant rent-seeking culture. Recent research by the Center for Global Development concludes "Creating citizen shareholders and putting the wealth of nations into the hands of the true owners—the people—is a powerful idea that deserves attention. Now is the time to put it to the test." (Oil to Cash: Fighting the Resource Curse through Cash Transfers 2015).

AN OBVIOUS CHOICE?

Pledged by Buhari in the 2015 election campaign, and favoured by many international NGO and donors, cash transfers are an in-style policy choice for the Nigerian Government. It is also a policy that can boast success in other developing nations such as India, South Africa and Mexico. Last year Goodluck Jonathan officially announced the introduction of biometric identity cards for all Nigerian citizens; the dual-functioning cards certify identity as well as providing a payment function delivered by Mastercard. Universal provision of identity cards is the natural prerequisite of delivering a cash transfer system. India swapped its subsidies for monetary payments in 2013, using biometric identity cards to administer payments.

The yet-to-be-passed Petroleum Industry Bill contains a provision for 10% of oil revenues to be allocated to the development of petroleum-producing communities. If this bill is passed this 10% allocation could be also be used to fund the cash transfers, as well as the revenue allocated to fuel subsidy.

BUILDING CITIZENSHIP

Of course, a clear case for cynicism at the efficacy of cash transfers is easy to construct given the administrative headache it presents. One could easily lament that a new redistributive system would inevitably fall under the auspices of corruption and would not necessarily deliver the welfare gains that it intends. However, Buhari's government is running out of options. The continuing financial burden of the current fuel subsidy, alongside its failure to alleviate poverty and extend a helping hand to the poorest Nigerians, means there is a need for decisive action. Cash transfers both attempt to redistribute the countries vastly unequal wealth, as well as developing a greater sense of citizenship with the government delivering to the individual.

NIGERIA'S FUEL SUBSIDY:

ADDRESSING NIGERIA'S FUEL SUBSIDY

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According to Buhari, "poor security, sabotage, vandalism, corruption and mismanagement – not necessarily subsidies – are the most serious problems of Nigeria's oil sector"[4]. At a time when Government accounts are strained to support a depreciating currency, Government arrears and a low oil price, the President seems to be balancing priorities against the desperate need for short term cash and stable petroleum supplies; a sensible approach in the midst of several major domestic crises facing Nigeria.

HOW, WHEN AND WHY?

So what is the right approach to address the subsidy in the context of Nigeria's short- term cash needs?

Firstly, controlling costs. The Presidents focus on addressing channels of corruption will support efforts to ensure only justified claims are approved and paid, reducing payments previously available to patronage and therefore ensuring that subsidy payments can be properly forecasted based on consumption trends. Nigeria's need to import oil is a paradox as an oil-producer and therefore renewed long- term efforts to maximise output of its four refineries would reduce imports and the fundamental need for a subsidy in the first place. Promoting downstream deregulation through the passage and implementation of the much anticipated Petroleum Industry Bill would lead to a more competitive downstream market place and stable long term pump price.

A more straightforward solution could be to adjust the pricing template and push all exchange rate risk onto the marketer. By removing the exchange rate factor in the calculation, variable costs linked to a volatile exchange rate will no longer result in subsidy payment variations. Claims would then simply be based on proven import quantity.

In addition, reliable tracking and independent scrutiny of Nigeria's production, sales and imports would go a long way to open up the opaque world of Nigerian oil-politics. This is possible using commercially available satellite ship tracking but the political inertia to get there will require strong leadership and international support. If this could be achieved oil production quota's allocated to marketers could be agreed to satellite tracked loads coming into the country and therefore any discrepancies identified and investigated.

Whatever strategy President Buhari chooses to address this program one thing is clear – he will be moving against very powerful forces, entrenched since the advent of democracy. But even small steps will go a long way to restoring public faith in political leadership where a lifetime of oil politics is characterised by violence, pollution and patronage.

4 http://news.yahoo.com/cash-strapped-nigeria-keep-fuel-subsidies-another-quarter-072327192 html, accessed 20 July 2015