

Nigerian Economics

What's New?

Fiscal Policy Update. Fuel Subsidy – A Catch-22 Situation.

December 2011.

It is a capital mistake to theorize before one has data. Insensibly one begins to twist facts to suit theories, instead of theories to fit facts.

- Arthur Conan Doyle (Sherlock Holmes)

Executive Summary



The removal of subsidy as planned by the federal government has its pros and cons. In this report we have attempted to bring insight into the dynamics of the issue in contention i.e. the Petroleum Support Fund (PSF).

In this report, our insight covers the rationale behind the PSF, the expected pump price (if subsidy is removed) as well as key considerations for pricing. We shed light on the demand and supply dynamics for information and the readers' contribution to the affairs of the Nigerian nation.

Please have a good read.

Regards

This report has been prepared to serve a broad range of potential clients, basically, individuals and organizations interested in the dynamics of the Nigerian economy. The Nigerian Economics series is a complimentary publication of Straplan, which seeks to bring insight into trends in the Nigerian economy, markets and industries.

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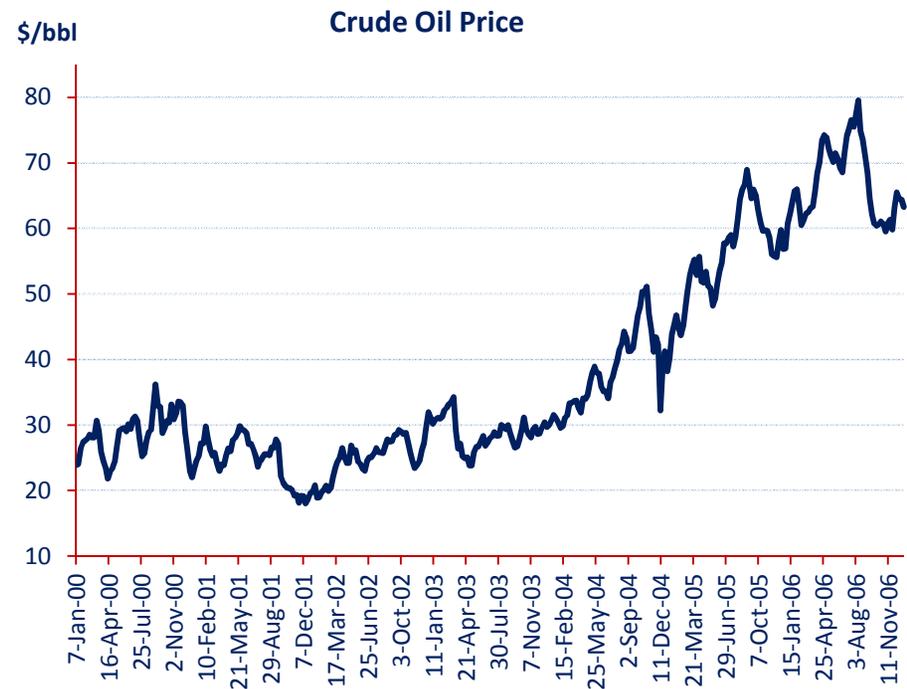
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The Petroleum Support Fund



The Petroleum Support Fund (the PSF), AKA the 'Intervention Fund,' or 'subsidy,'

- The administration of the Fund started in 2006 by the government to stabilize the domestic price of petroleum products against fluctuations in the international price of crude oil and exchange rate variations.
- The Fund is to support the purchase of petroleum products imported into the country at any price above N65/litre.
- When the PSF was created in 2006, as part of the recommendations of the Petroleum Products Pricing Regulatory Committee in 2003, oil prices had only peaked at \$80/bbl in 30 years.
- Since then, oil prices had peaked at \$147/bbl, and prices reflect that this is the age of high oil prices.
- The PSF is funded by the three tiers of government and provided for in the federal government's annual budget.



Expected Market Price ex-Subsidy

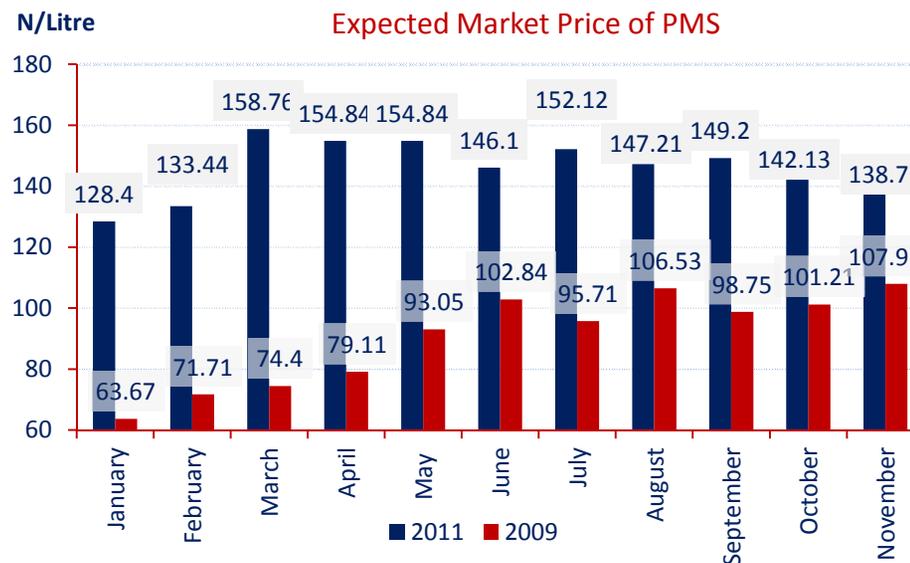


Up from N65 to what...?

- The FG plans to exclude provisions for the annual deductions in support of petrol (premium motor spirit –PMS) consumption from its medium term (2012-2014) fiscal strategy, starting with the 2012 budget.
- The removal of subsidy means the pump price of petrol would no more be stable but rise and fall in line with the vagaries of the international market price of crude oil. This would continue until Nigeria can locally refine at least 80% of its petrol consumption.

Domestic price of petrol to reflect international prices ...

- If oil price is pegged at N65, average subsidy/litre increases or drops in line with the international price of crude oil.
- Nigerians would have bought PMS at N63/litre PMS in January 2009, and N158.7/litre in March 2011 based on the landing cost of fuel.



Source: PPPRA, Straplan Research

* Expected Market Price of PMS = Landing Cost + Distribution Margins

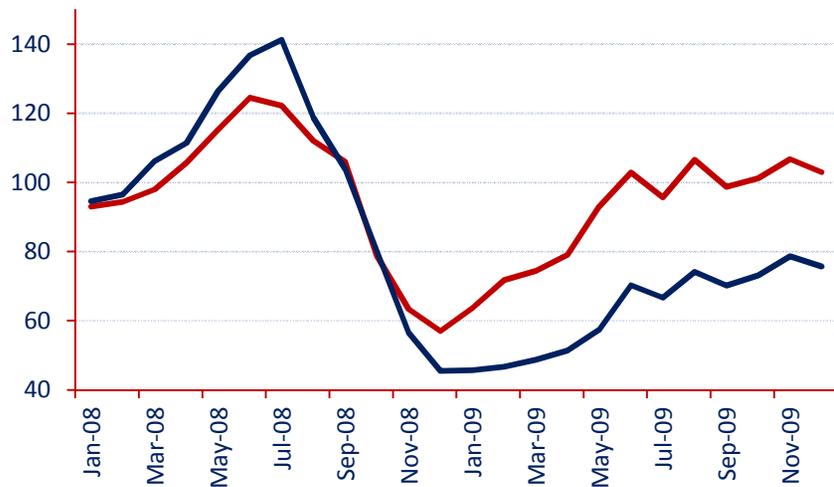
Expected Market Price ex-Subsidy



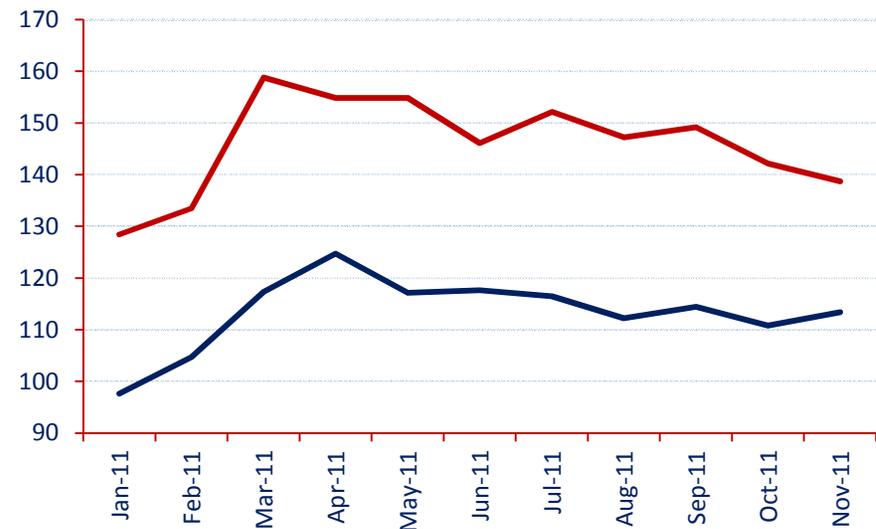
The international price of crude oil plays a pivotal role in Nigeria's fiscal structure

- Currently, the level of subsidy (mainly PMS) has been on the rise due to high international price of crude oil, growing consumption (influenced by population and development), as well as exchange rate differentials.
- Crude oil plays a pivotal role in Nigeria's economic structure as government revenue, subsidy levels, and prices of imported refined products all mirror its price direction.

PMS Price (less subsidy) vs Crude Oil 2008/9



PMS Price (less subsidy) vs Crude Oil Price 2011



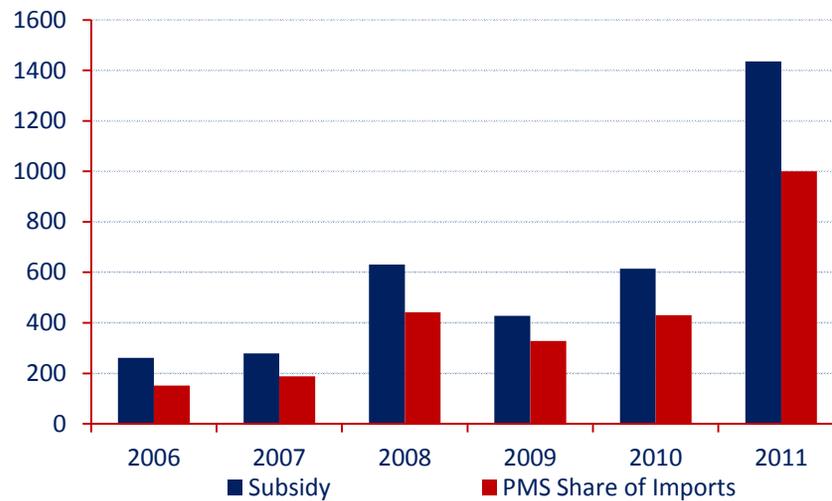
— Expected Pump Price of PMS (N/Ltr) — Bonny light (monthly ave \$/bbl) — Bonny Light (monthly ave \$/bbl) — Expected Pump Price of PMS N/Ltr

Source: PPPRA, EIA, Straplan Research

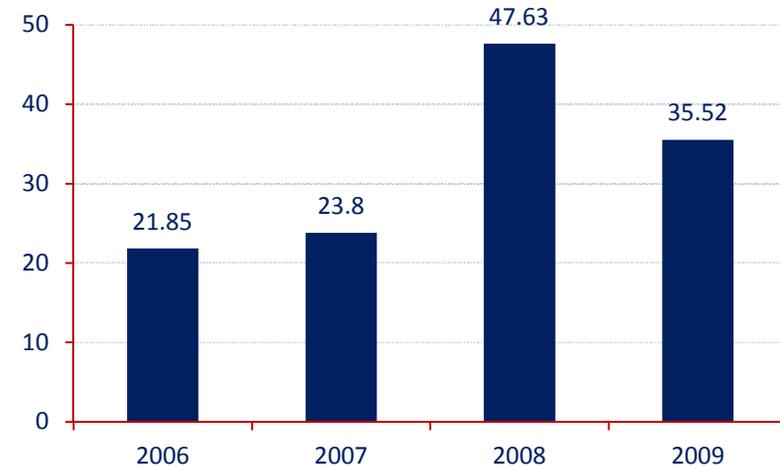
Rising Subsidy Levels

- The government pays so much for each litre of petrol bought in Nigeria, even when smuggled out to neighbouring countries by arbitrageurs
- On the premise that government is the biggest spender in the economy, two thoughts occurred to us:
- Perhaps government is the largest buyer of petrol and as such responsible for the rising demand
- We wonder if the government had factored in the increase in cost of fuel and implications on its recurrent budget as from 2012.

Rising Subsidy Levels



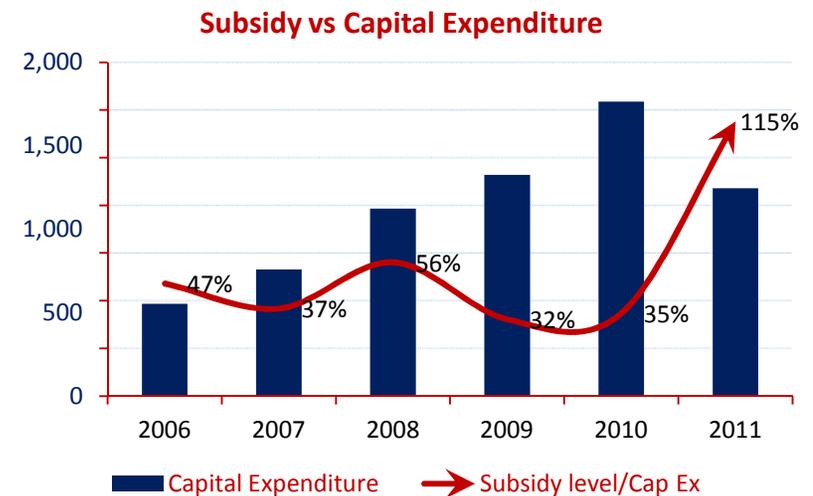
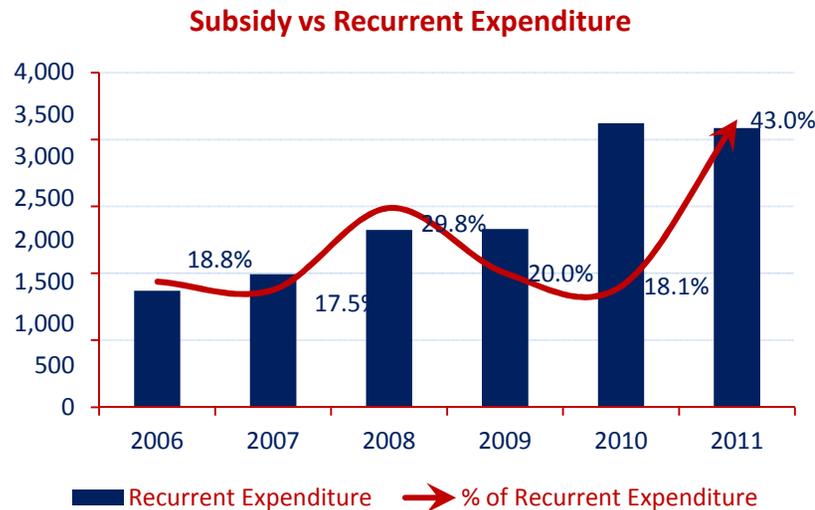
Average Subsidy in N/litre



Source: PPPRA, Straplan Research

Is the subsidy level sustainable?

- The Nigerian government pays for the consumption of petroleum products above its budget for capital expenditure in the country. This invariably means that the consumption of petroleum products takes priority over Nigeria's capital project (basically infrastructure).
- Given the vulnerability of Nigeria's fiscal structure which is reliant on oil prices, supporting consumption of same product appears to have put Nigeria in a catch-22 situation.
- If petroleum prices rise further, the level of subsidy would continue to rise. On the other hand, if petroleum prices decline (expected due to weakening demand in Euro Area and America), Nigeria's revenue would drop and subsidy would further weaken the country's treasury.

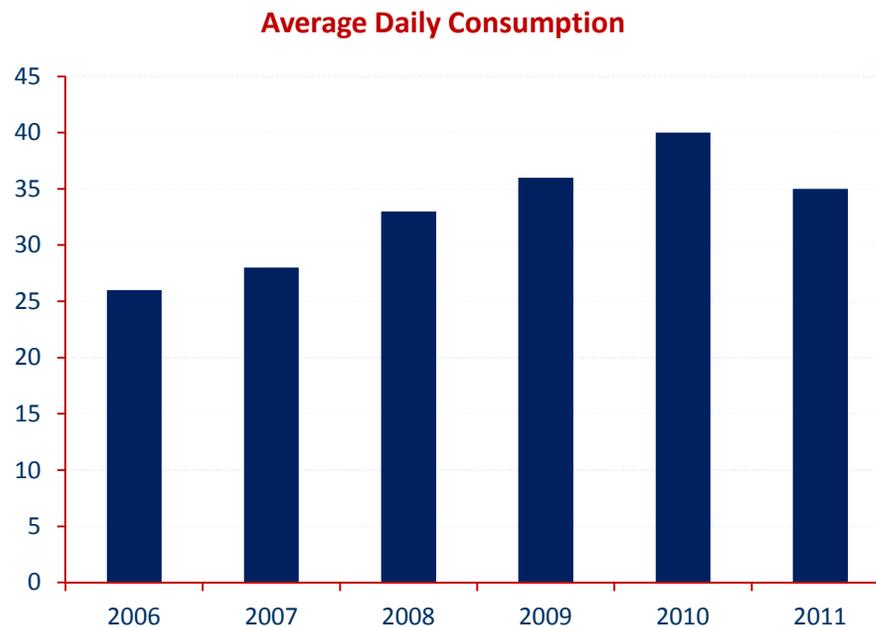


Source: Straplan Research

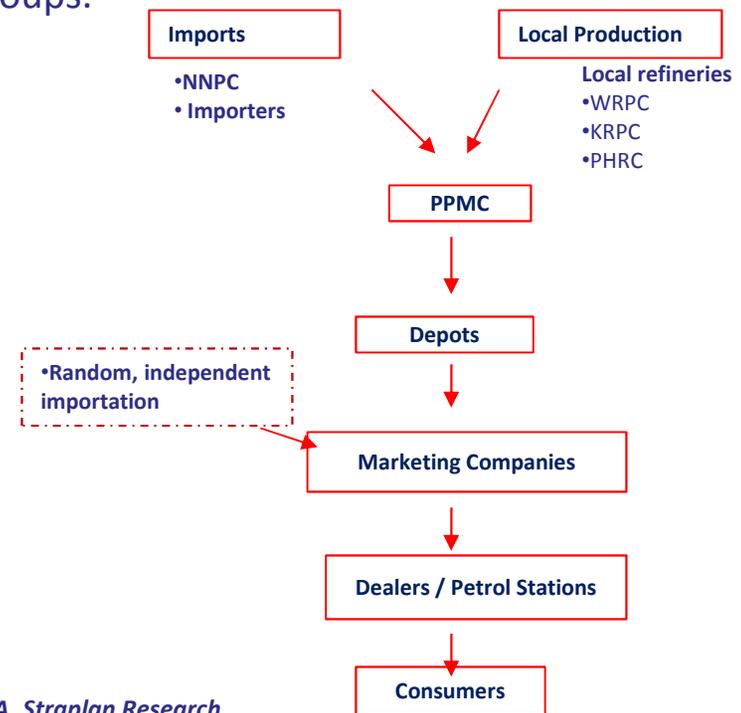
Consumption Pattern

Demand continues to rise while supply is import-dependent...

- Rising demand levels call for a review of the scheme, to reassess what drives the real demand for petroleum products, especially PMS. It is believed that demand is lost to rent seeking and diversion (smuggling)
- Reports show that new-car imports soared in the year (which we believe is politically induced), and we expect a corresponding increase in demand for fuel.
- As such fuel subsidy would continue to benefit those who mostly consume the product, who usually are within the middle and high-income groups.



Source: PPPRA, Straplan Research



Supply



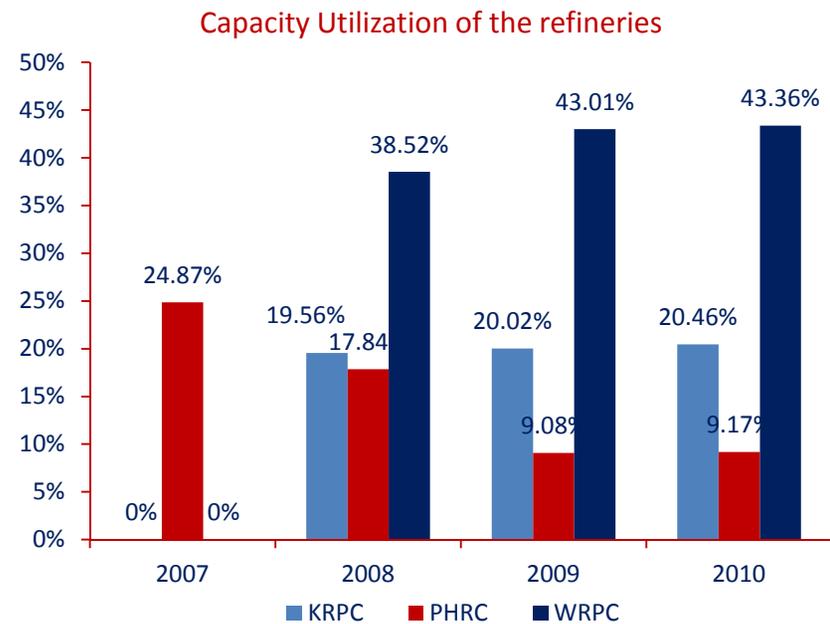
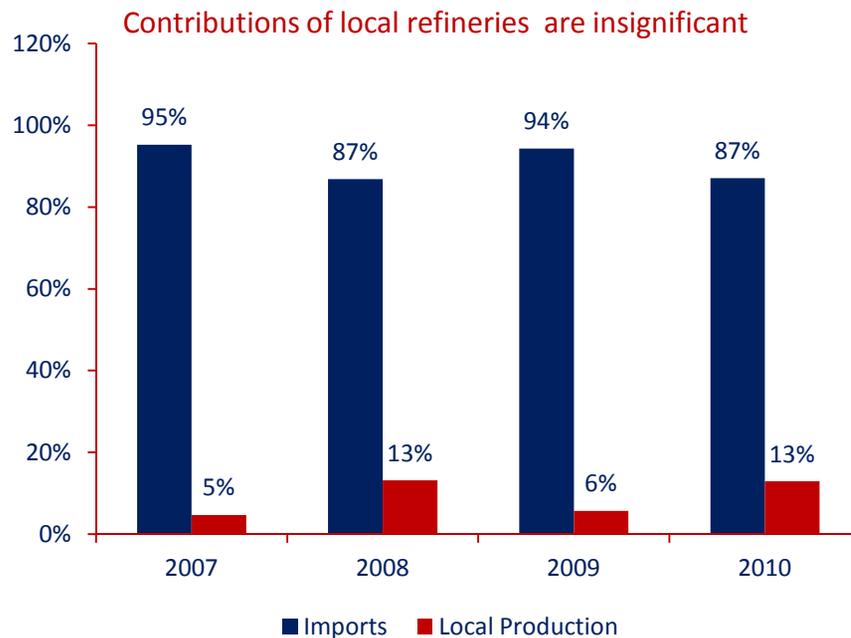
- The three refineries are set up to produce about 445,000 barrels of refined petroleum products daily.
- It would cost between \$2billion-\$5billion to set up a 250,000barrels/day refinery (depending on the complexity of the refinery). This means that the present subsidy level can build two 250,000barrels/day refineries and augment current local output.
- At full capacity utilization, the refineries can only provide about 55% of the current level of PMS consumption (i.e. 22million litres).
- As the refineries are not in order, over 90% of crude output are exported.

	Refineries	Year Commissioned	Installed Output Capacity (*bpd)
1	Port Harcourt Refining Company (PHRC Old)	1965	60,000
2	Port Harcourt Refining Company (PHRC New)	1989	150,000
3	Warri Refining & Petrochemical Company (WRPC)	1978	125,000 (up from 10,000)
4	Kaduna Refining & Petrochemical Company (KRPC)	1980	110,000 (up from 100,000)

Supply



- The best that a Nigerian refinery (WRPC) has worked in the last four years is at 43% of its capacity. Combined capacity is below 25%.
- It costs about \$5 to produce a barrel of oil (159 litres) locally, however, over 80% of consumption is imported at higher costs.
- There is an obvious need for more refineries, although we gathered that the federal government is planning to set up three refineries in Lagos, Kogi, and Bayelsa states.

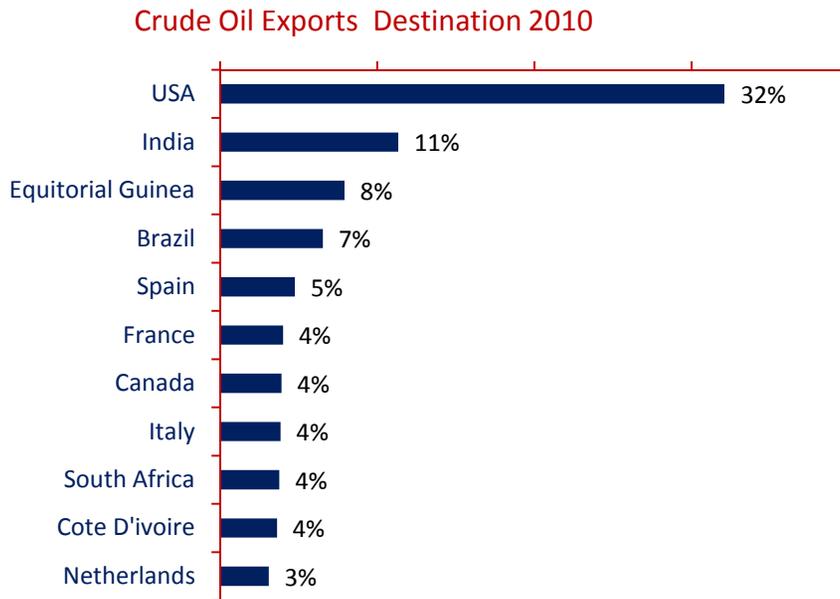


Source: NNPC, Straplan Research

Trade Partners



- Nigeria is always vulnerable to crisis in these countries because of our dependence on oil.
- We expect oil prices to decline from current levels, ceteris paribus, in view of weakening demand for oil that would follow the crisis in Europe and America.



- Some Sources of Importation**
-
- Netherlands
 - India
 - France
 - United Kingdom
 - Sweden
 - Spain
 - Israel Estonia
 - Belgium
-

Source: NNPC

An important condition for successful subsidy reform is the credibility of the government's commitment to compensate vulnerable groups for fuel price increases, and, more generally, to use the freed public funds in a beneficial way. –G-20 Report 2010

- Government needs to ensure public trust in the reform agenda through broad communication, and implementation of compensatory social policies. Groups that are severely affected by subsidy reforms — including but not restricted to the poor — need to be compensated.

We expect

- phased removal of subsidy based on a sustainable, transparent and accountable plan on provision of basic infrastructure to cushion the immediate impact of the hike.
- Nigerians to reduce consumption and change lifestyle
 - Use more public transport
 - Pool cars amongst yourselves
 - Reduction in car importation
 - Increase in demand for buses

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