DEREGULATION OF THE OIL AND GAS INDUSTRY IN NIGERIA

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The Governor of Central Bank of Nigeria, Deputy Governors, Directors, other members of Management, Distinguished Ladies and Gentlemen.

It gives me great pleasure to be invited to present this paper at this Seminar for CBN Executives with the theme "Current Economic Reforms in Nigeria: The case for Deregulation of the Downstream Petroleum sub-sector. This Seminar is coming at a time when the Federal Government has embarked upon economic, social and political reforms to place Nigeria on the path of growth and sustainable development.

All over the world, reasons for reforms in the public sector vary from country to country depending on the objective, peculiarity and the circumstances that the country finds itself. The issue of reforming our downstream sector such as Refining and Distribution of petroleum products has been on for quite some time. It has however, become more compelling in the last few years given the trauma of petroleum products scarcity the nation had continuously witnessed. Equally compelling is the need to develop the gas sector which has the potential of doubling the nation's revenue but has not received focused attention until now.

Downstream Deregulation: Historical Perspective

Prior to 1965, petroleum products domestic requirements were met entirely through importation under a deregulated environment. By 1965, it had become apparent that the Nation could no longer rely on importation for its products needs. Consequently, the first refinery in Nigeria – the Old Port Harcourt Refinery was built in 1965 as a commercial venture to provide petroleum products at market related prices. It was a 35,000 barrels per day refinery jointly owned by Shell (25%), British Petroleum (BP) (25%), the Federal Government (20%), and the three regional governments (10% each).

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However, by mid 1970s, with the advent of the oil boom Government became directly involved in the downstream sector by building two new refineries and taking over the first. The Warri refinery was commissioned in 1978 while the Kaduna refinery came on stream in 1980. Government's main objective was to make petroleum products available throughout the country.

With the change in the ownership structure, the pricing policy was modified and controlled to encourage national distribution at uniform prices. This incidentally introduced the issue of bridging and price equalization at government's expense. This was later inherited by the NNPC. However, these controlled prices did not respond to the continuously changing business and economic environment. Thus, the control of petroleum products prices by government made it difficult to earn enough resources to maintain the refinery and distribution assets.

Today downstream assets include four refineries with a combined installed capacity of 445,000b\d, over 5000 km products pipelines and 21 storage depots spread across the country. Others include 9 LPG depots and the numerous retail stations all over the country.

Since the commencement of government's direct involvement however, prices of major petroleum products such as Premium Motor Spirit (PMS), Automotive Gas Oil (AGO) and Dual Purpose Kerosene were fixed by government. This of course has been a disincentive to private sector investment in refining with dire consequences which include:

(a) *Petroleum Products scarcity ;*
(b) *Funding problems for NNPC leading to irregular maintenance of refining and distribution facilities ;*
(c) *Refining capacity under-utilization ;*
(d) *Smuggling of Petroleum products;*
(e) *Divestment by marketers;*
(f) *Wastages;*

(g) *Adulteration of products and fire hazards;*
(h) *Social and political unrest;*
(i) *Poor economic growth; and*
(j) *Rampant pipeline ruptures and vandalization.*

The question is how can the NNPC, the Refineries and the Distribution sector in particular be repositioned to respond effectively to the dynamics of the oil industry for the maximum benefit of the national economy? It is in this light, that the deregulation of petroleum products prices became a *sine-qua-non* to ensure full cost recovery and reasonable rate of return for any operator.

Government's Policy on Downstream Reforms

We are aware that Government as far back as 1988 commenced a Privatization and Commercialization programme through Decree N0 25 of 1988 which focused on partial and full commercialization of some 145 selected public enterprises. It was aimed at rationalizing government expenditures and programs in response to the declining economic fortunes of the early 80's. Furthermore, through Decree N0 28 of 1999, government emphasized its inability to continuously subsidize inefficient and loss making parastatals and made privatization of such investments the cornerstone of its policy.

The main objectives of privatization as stated in the decree include:

- Restructuring and rationalizing the public sector in order to reduce the dominance of unproductive investments;

- Raising necessary funds to finance socio-economic development in such areas as health, education, and infrastructure;

- Putting an end to dependence on the treasury for funding of otherwise commercially oriented parastatals and encouraging them to look to the capital market to fulfill their requirements;

- Introducing the gradual transfer of control of suitable enterprises to the private sector; and

- Creating jobs, acquiring technical know how and exposing the country to international competition.

Government's Aspirations in the Downstream

The downstream reform is part of Federal Government's Reform Agenda aimed at strengthening the country's economic base through diversification and liberalization of the economy. It also forms part of the objectives of the National Economic Empowerment and Development Strategy (NEEDS) which encourages indigenous participation, increase in local content and technology acquisition. Thus, the downstream reform is aimed at:

- Maintaining self sufficiency in refining;
- Ensuring regular and uninterrupted domestic supply of petroleum products;
- Establishing facilities and infrastructure for the production of refined products targeted at the export market and support to domestic petrochemicals;
- Creating value added from these activities; and
- Providing gainful employment and enabling Nigerians to acquire technical know- how in refining and distribution business.

The downstream reform is therefore expected to ensure:

- petroleum products price determination by market forces;
- absence of government control in the pricing process except for tax purposes;
- freedom of marketers to source petroleum products locally and internationally;
- freedom of marketers to purchase crude oil from local and international sources for processing in the refineries;
- freedom of refineries to enter into processing agreement with marketing companies on the basis of charging fees; and

Right of access to distribution facilities subject to transportation agreement based on tariff.

Current Situation

The downstream sector of the industry has now been deregulated. The sector is expected to become competitive as the private sector sources products either through importation or the establishment of private refineries. Already, eighteen (18) licenses have been issued to prospective investors five of which have been given approval to commence construction. Furthermore, NNPC's monopoly of products supply is being broken through direct importation, storage and distribution of petroleum products by private investors.

To prepare the refineries for future challenges, a sum of $485.4 million was spent on refineries rehabilitation while $254.4 million was spent on the pipelines and depots between 1999 and 2003. These refineries are expected to be on stream at different times this year. Many pipelines and Depots were rehabilitated while rehabilitation of others is on-going.

However, NNPC has been bearing the pains of petroleum products supply due to its inability to charge market related prices until September 2004. Marketers that were supposed to source products could not do much due to uncompetitive prices and consequently, NNPC has continued to be responsible for about 80% of total products imports as shown in Charts 1 & 2.

Chart 1: Petroleum Products Imports Oct 2003 - Aug. 2004 ('000 Metric Tons)

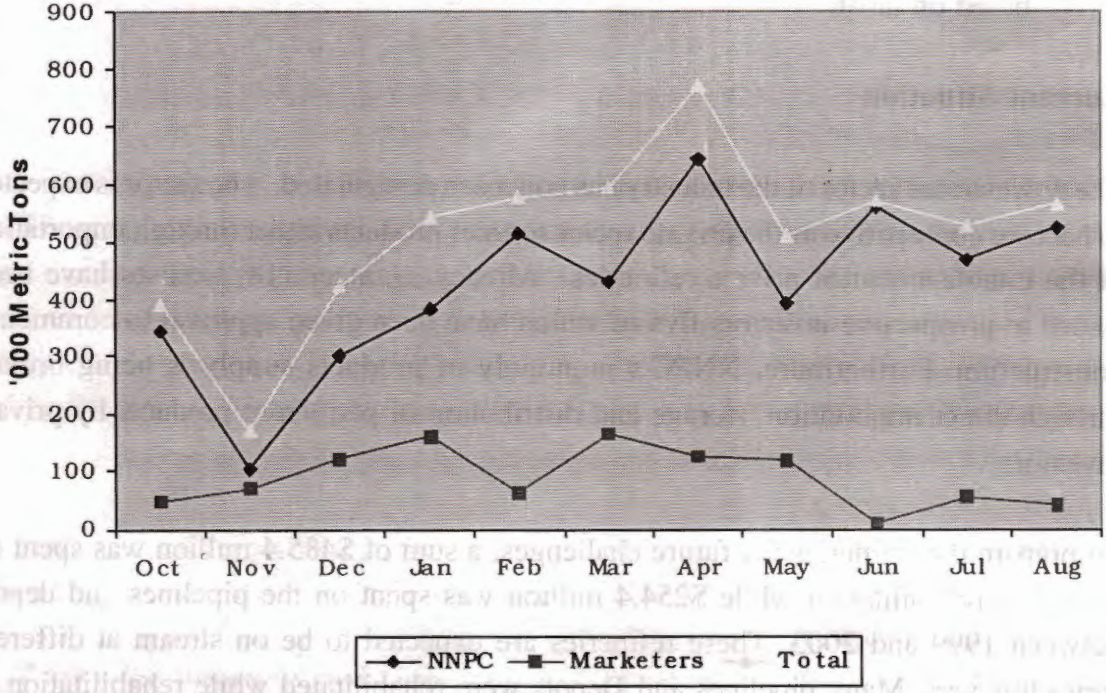
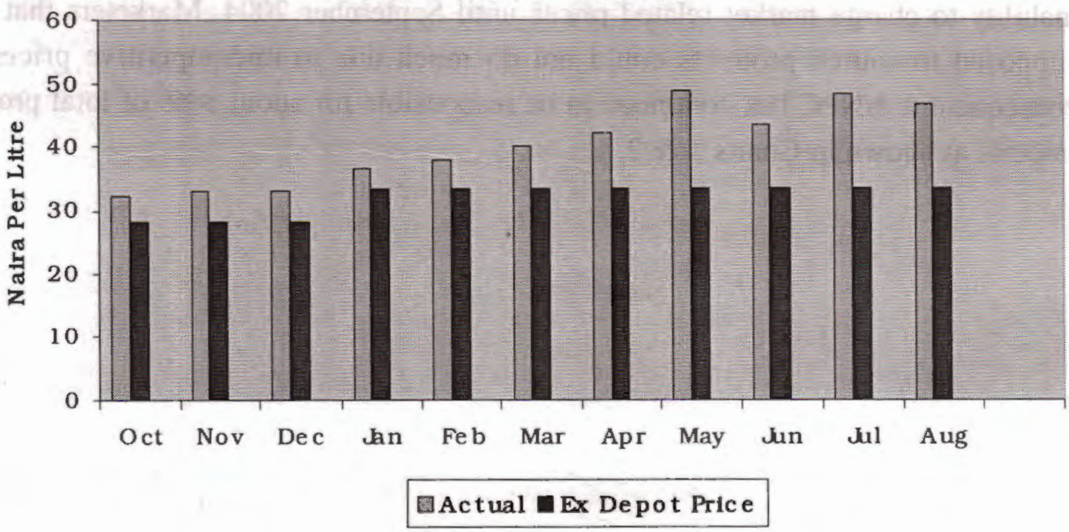


Chart 2: Landed Costs Vs Ex Depot Price



Thus NNPC was subsidizing fuel to the tune of about N350 million per day as at the end of August 2004. This not only resulted in cash flow problems for the corporation, it affected its operations adversely.

Benefits of Downstream Reforms

(a) Efficiency in the Downstream Sector

Deregulation will lead to competition among marketers. NNPC's monopoly in product supply will be broken. Also, the survival of the corporation will be guaranteed under a deregulated regime as it will not continue to subsidize products prices. The downstream reform is therefore expected to refocus NNPC to be able to fulfill the objectives for which it was set up.

(b) Increase in revenue to Government

At present, government sells 445,000 barrels of crude oil to NNPC for refining at international price. This has increased the revenue going to Government. This amount could be used for economic development and poverty alleviation programmes of the Government.

(c) Abundant Fuel Supply

Deregulation of the market implies that a regime of trade liberalization will be in place whereby petroleum products can be imported or exported. This will ensure abundant petroleum products in the economy and eliminate long queues at fuel stations.

(d) Private Sector Participation

Deregulation is very critical to private sector participation in refining because it ensures commercial viability of products supplies thereby enhancing profitability which is the major business attraction. The number of marketers and retail stations are likely to increase, with their positive impacts on business expansion as well as employment generation. Instead of divesting from the industry, marketers are most likely to invest more.

(e) Maintenance of Refining and Distribution Assets

One of the major problems in the past was lack of funds for the rehabilitation and maintenance of the refineries and the distribution facilities. This was as a result of the poor margins received by NNPC on the products manufactured. In a deregulated market, appropriate prices will be charged for products. Part of the proceeds will be used for plant rehabilitation and maintenance which will ensure that capacity utilization is increased and products made available at all times.

(f) Smuggling

The wide disparity in Petroleum Products prices between this country and her neighbours was responsible for the high rate of smuggling of petroleum products. A deregulated petroleum products market will ensure that the price gap is closed and smuggling becomes unattractive.

(g) General

Granted, the low average wage of a Nigerian worker, it may be argued that the economy may not be able to sustain increased petroleum price increases. However, this is quite erroneous as in the long run there will be an adjustment mechanism. The anticipated increase in revenue to Government could be used to cushion the effects of such price increases.

With effective management of resources, appropriate wage levels could be put in place such that employees are paid realistic living wages and salaries. The welfare of the masses can equally be improved through provision of mass transit means of mobility and improved facilities. The adjustment mechanism that will be required will be such that everyone can perceive the advantage of deregulation.

It has been argued that deregulating the petroleum products market will have an inflationary effect based on the crucial role petroleum products play in the economy. While these fears are justified, it must be pointed out that these are short term. Deregulation brings competition and efficiency. Non- availability of petroleum products has a worst effect on the economy as people scramble to purchase the products at any price. Evidence abounds of vehicle operators passing huge price burden to the consumers.

However, deregulation ensures that the products are available at all times. This will have a catalytic effect on the other sectors of the economy – industrial, transport, agricultural and services and improve the country's economic development.

It must be pointed out that many developing countries have successfully deregulated their energy sectors. Kenya, Uganda, Indonesia, Brazil, Argentina and Venezuela are a few of such countries. Petroleum products scarcity has been unheard of in any of these countries.

Natural Gas

Although crude oil will remain an important source of energy for a few more decades, natural gas will no doubt be the fuel of the 21st century as coal was of the 19th and crude oil of the 20th.

Natural gas accounts for about 23% of global energy- mix but it is the fastest growing form of energy at about 3% annual growth compared to crude oil which though constitutes about 39%, of the global energy mix will grow at only about 1.6% and coal at about 1.2% annually as shown in Charts 3 & 4.

Chart 3: Global Energy Mix

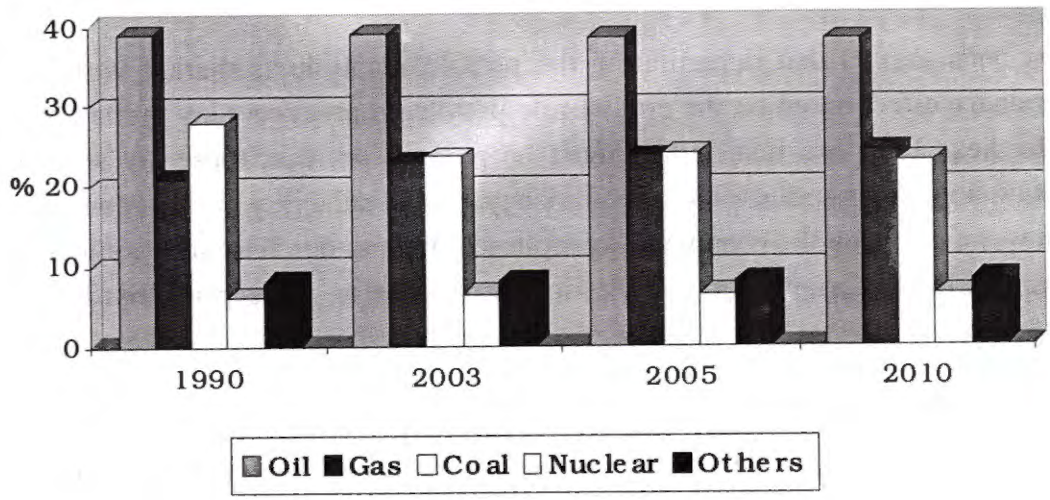
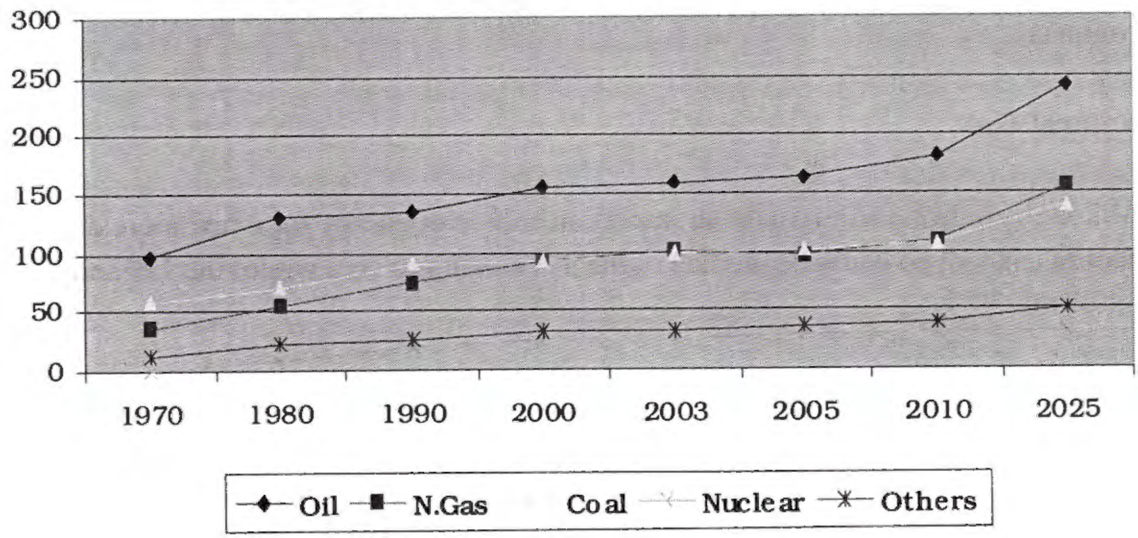


Chart 4: World Energy Consumption By Source (Quadrillion Btu)

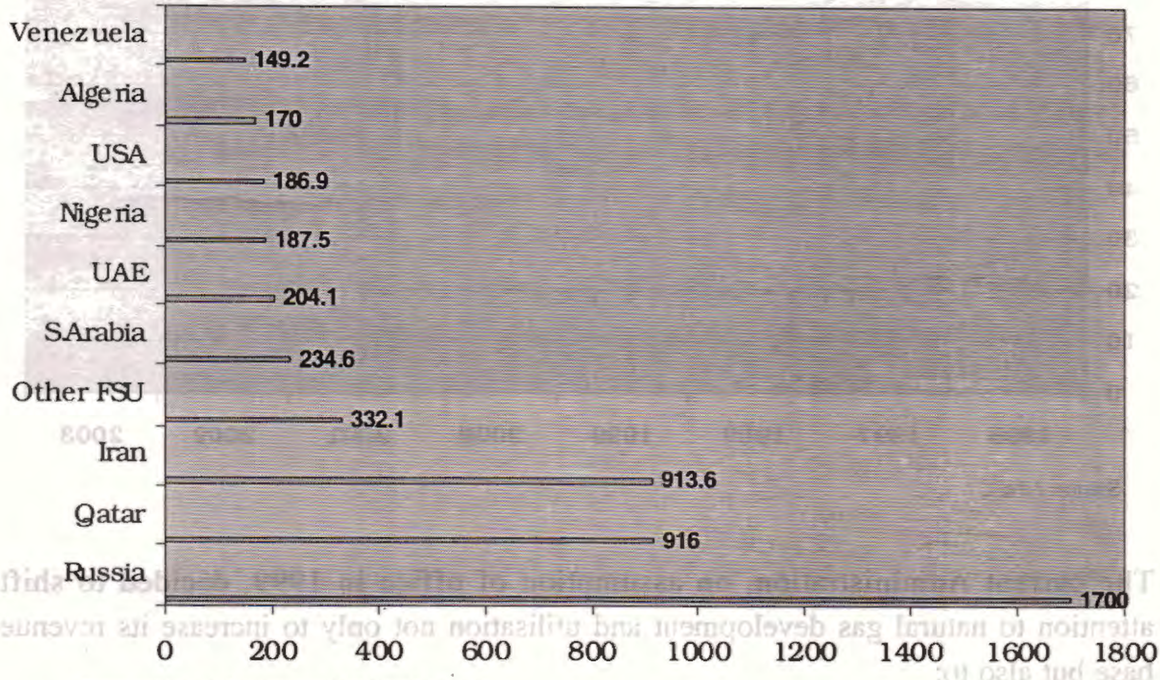


Source for Charts 3 & 4: International Energy Agency (IEA)

Gas Development in Nigeria

Nigeria is blessed with an array of energy resources principal among which are crude oil and natural gas. With a reserve of about 187.5 trillion cubic feet, the country ranks seventh in terms of global gas reserves and first in Africa (Chart 5)

Chart 5: Global Gas Reserves Ranking



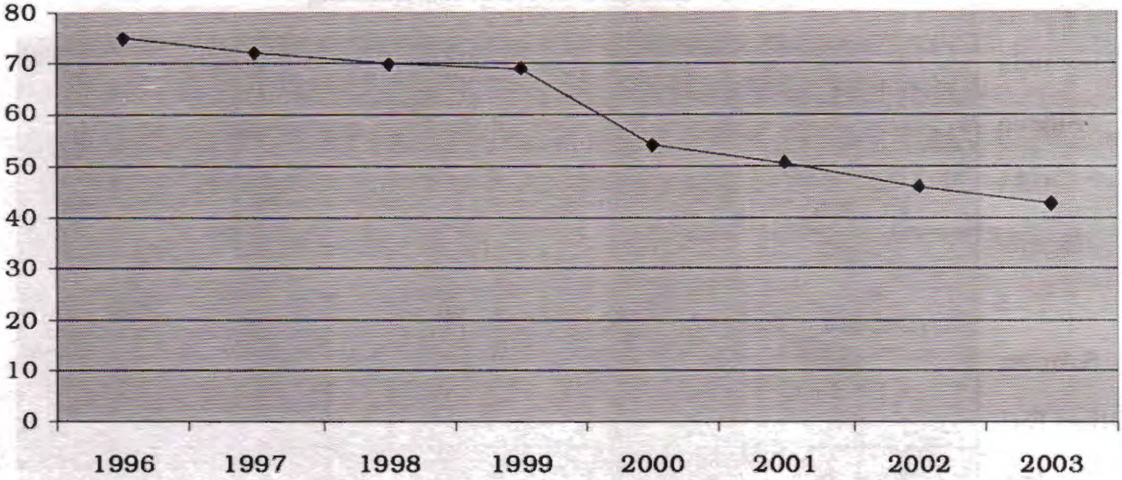
Source: World Oil August 2003 and NNPC

This is even expected to grow higher when deliberate efforts to explore for gas in the country commences as gas discoveries in the country to date are incidental to oil exploration. In energy terms our gas reserves translate to more than twice that of our proven crude oil reserves.

However, prior to the advent of the current Administration, natural gas development did not receive focused attention to the extent that as much as 75% of natural gas produced was being flared resulting in economic waste and environmental problems.

Nevertheless, the situation is changing for the better as gas flaring had reduced to about 42.6% as at the end of 2003 (Chart 6). Our aspiration is to achieve zero flare by 2008

Chart 6: Gas Flaring Reduction Efforts



Source: NNPC

The current Administration, on assumption of office in 1999, decided to shift attention to natural gas development and utilisation not only to increase its revenue base but also to:

- increase domestic energy availability;
- release more premium fuel for export;
- diversify government's export base for foreign exchange earnings;
- increase value-added to the petroleum sector;
- reduce level of gas flaring; and
- contribute to clean environment.

This Administration places much emphasis on gas development as a result of its global acceptance as an environment friendly form of energy. Its abundance, cleanliness and price have also led to its being called the global energy of the future. To this end, it is our belief that the gas industry must be transformed for the country to derive maximum benefit from it. In order to achieve this, we need to:

- Develop a natural gas policy document;
- Finalize the draft downstream gas legislation;
- Update and legislate a new fiscal regime for Gas projects;
- Establish Production Sharing Terms for Gas;
- Develop licenses, regulation and code;
- Unbundle NGC through the creation of a Natural Gas Transmission Company and a Gas Marketing Company; and
- Develop domestic Liquefied Petroleum Gas market.

Natural Gas Aspiration

Nigeria's natural gas aspiration can be summarized as follows:

- Elimination of natural gas flares by 2008;
- Facilitating development of domestic power sector through increased use of natural gas;
- Leveling the playing field between oil producers and other parties involved in the domestic gas business to encourage investment in gas;
- Increasing private sector participation to inject capital into the gas sector; and
- Ensuring that as much revenue is generated from gas as oil.

Opportunities for Gas Monetization

A lot of opportunities have been identified for monetizing gas. They include expansion of domestic utilization as well as gas export. In this respect, domestic demand for gas is expected to increase from its current level of 573 million cubic feet/day to about 1,699 mcf/d by 2010 through expansion in the power sector, and increased demand from other sundry users. In addition, export opportunities for monetizing gas include the NLNG, the Brass LNG, the West African Gas Pipeline, the Gas to Liquid project (GTL) the Natural gas liquids (NGLs), as well as, Liquefied Petroleum Gas (LPG).

The NLNG has been one of the fastest growing in the world since Trains 1 and 2 were commissioned in 1999. Train 3 was commissioned in November 2002, while Trains 4 and 5 are expected to be on stream in the second quarter in 2005. When Train 6 is added in 2007, LNG output will total 22 metric tons per annum.

The Memorandum of Understanding (MOU) for the feasibility studies of Brass LNG (a joint venture between NNPC, Agip, Phillips and Chevron/Texaco) was signed in August 2001. Final Investment Decision is expected in December 2005 and first LNG delivery in first quarter 2009.

The West African Gas Pipeline (WAGP) project is expected to supply about 580 mmscf/d of gas to countries in the West African sub-region on completion. The project which is of strategic importance, is to foster co-operation and economic development within the sub-region. It is estimated to provide between $75 and $100 million in local goods and services during construction within the sub-region.

Increased domestic gas utilization will stimulate the production of natural gas liquids and increase the supply of Liquefied Petroleum Gas (LPG) for the domestic market. The objective is to improve Nigeria's low per capita LPG consumption (0.5kg/yr.) compared to the West African average of (3.7 kg/yr.), discourage deforestation and minimize environmental pollution.

Huge investment will be required to execute these projects. The private sector will have to be more involved if the zero-flared target of 2008 will be met.

Even then, the gas sector is still under developed as a result of certain impediments which are being addressed by Government. They include funding, pricing, fiscal reforms, institutionalised arrangements, legal/regulatory framework.

Conclusion

A major problem to the downstream reform has been that of the perception of the people about these reforms. On two occasions NNPC had to reverse increases in its ex-depot prices.

Distinguished Ladies and Gentlemen, the downstream reforms introduced by this Administration are necessary for the survival of the sector particularly in this era of globalization which encourages flow of capital and technology to areas where returns are highest and unhindered. To do otherwise is to return to the era of acute petroleum products scarcity and gas flaring with attendant economic and social consequences.

The private sector will no doubt play a prominent role in the on- going reforms in the downstream sector of the oil and gas industry. The firm commitment of the current administration to economic and fiscal reforms will stand the country in good stead in no distant time.

I thank you for your attention.