The Economics of Privatizing and Deregulating the Nigerian Downstream Oil Sector

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Introduction

Nigeria is blessed with vast quantities of oil and is the sixth largest oil exporter in the Organization of Petroleum Exporting Countries (OPEC). This has generated billions of dollars in revenues over the last forty years since oil was found in Nigeria.

As in most developing countries, this has not translated into an improved economy for the country. Instead through inefficiencies, corruption, abuse of natural monopoly powers, mismanagement, smuggling, bureaucratic bottlenecks and excessive subsidizing, the supply of refined crude oil (gas) in the country has virtually collapsed.

The Nigerian oil industry is divided into two sectors; the upstream sector (deals with Exploration and Production) and the downstream sector, which deals with refining of crude oil for domestic consumption. In this paper, I intend to focus on the downstream sector as it has a great impact on the lives of all Nigerians.

The government of Nigeria has decided to emulate other developing and developed nations by privatizing and liberalizing the country’s downstream sector which was hitherto managed by the Nigerian National Petroleum Corporation (NNPC) on behalf of the government.

Refineries in Crisis

The first oil refinery built in the country is located outside Port Harcourt in the southern part of the country known today as the south-south region, and it started operations in 1965 with a capacity of 38,000 barrels per day (bpd). Since the first refinery was built in the country three more refineries were built to cater for expanding domestic needs over the last thirty years.

In the 1990’s, with a fast growing population, the country was caught in the situation with domestic demand for gas far outweighing supply, and with corruption, smuggling and mismanagement, the refineries were operating at less than optimal levels. Turn Around Maintenance (TAM) was done on the refineries to improve capacity but this was not getting the desired effect and NNPC (State Owned Enterprise) had to import heavily from abroad thereby cutting actual revenue derived from oil exports.

International financial institutions started lending excessively to oil producing countries and successive Nigerian governments in the 1980’s and 1990’s borrowed heavily to subsidize for rapidly declining income from oil exports. Unfortunately because of some periodical non-servicing of those loans by the then military regimes, Nigeria found itself in trouble and was heading for insolvency. By 1992 when Nigeria took its’ last loan things were looking bleak and the country asked OPEC for a larger export quota so as to generate more revenue.

The current democratically elected government of President Olusegun Obasanjo on assumption of office in 1999 found a near comatose economy and a heavy debt burden.
Funding government expenditure in the last five years became a real issue since a substantial part of the country’s revenue from oil exports is used for debt servicing. The balance of which being used primarily for recurrent budget needs of the government due to an over bloated civil and public service, leaving very little funds for capital budget needs and investments in other critical areas of the economy such as that of welfare, educational and healthcare needs.

After analyzing the problem; where international oil prices were rising and actual refined production in the country was dropping. The government decided that it could not afford the continued subsidies in the pump price of gas at the pumps as it was buying refined gas at huge international prices only to sell at a heavily subsidized rate. Currently, 1 liter of gas in Nigeria is sold at the government rate of 70 Naira, which is 50 cents ($1 = N140) and this is with price increases made by the current government over the last five years.

The government realized that it would be necessary to boost production levels of the refineries but at a huge cost, and decided to invite local marketers to apply for licenses to build private refineries. This approach failed, as the marketers who are solely driven by profit maximization were not interested while government still controlled the pump price of gas. Government decided that it was necessary to deregulate and privatize the downstream sector in the country. The government owned refineries are being overhauled and maintenance carried out on them to make them attractive for private acquisition in 2006.

**Government Rationale and Issues Arising**

Gas prices affect all Nigerians, both the wealthy and the poor, and the CIA World factbook estimates that as at 2000, 60% of Nigerians live on less than a dollar a day. This is a huge number considering that the World Bank estimates that Nigeria has a population of 135.6 million as at 2003.

“Disruptions in the Nigerian downstream sector have deeper and more immediate domestic political implications for the country than those that may occur in the upstream sector” (Khan, 1994, p. 127).

Nigerians believe that low gas prices are a given right and have protested vigorously through strikes each time the price of gas was increased in the last few years and are bitterly against the privatization and deregulation of the downstream sector. As noted by Khan above, these disruptions have widespread political implications, for example there is a constant fear that the military may use the opportunity to seize power again as it has done over the decades since independence.

The goal of the Nigerian government in adhering to the principles of privatization and liberalization is influenced by the successes of other countries in doing the same. Kupolokun (2004) the Group Managing Director of NNPC noted that the intended goals are;

- Dismantle the natural monopoly of the stat owned enterprise by privatizing and deregulating price controls.
- Creation of competition in the downstream sector by encouraging more companies to get involved and eventually supplying the market at competitive pricing levels.
- Reduce the cost government spends on subsidizing the sector which runs as high as $1.5 billion annually, and can consequently used the resources freed up to handle the socio-economic and welfare needs of the Nigerian people.
- Boost in Foreign Direct Investment to the Nigerian economy.
- Reduction in transportation costs of products and people.

Possible Unintended Outcomes

The Nigerian government is aware that it cannot face the problems of the downstream sector in isolation and is well aware of the potential effects on the labor market.

It is possible that in the short term unemployment may arise due to price increases and the attendant problem of potential job losses by workers in the refinery, this will be done by investors who aim to maximize efficiency, once they acquire control.

Schipke (2001) notes, “Countries in which government was a dominant player in terms of both ownership and intervention are also likely to have highly regulated labor markets. Hence, a reduction in government ownership without the simultaneous liberalization of the labor market will lead to increases not only in temporary but also permanent unemployment.” (p. 67)

Using the social process model of analyzing possible effects of a new government policy, government could be prepared for potential outcomes. It is in this regard that the Nigerian agency charged with privatization; the Bureau of Public Enterprises (BPE) undertook a study of such effects and have come up with possible solutions such as rather than divest 100% to a core investor, 49% will be sold on the Nigerian Stock Exchange for ordinary citizens and part of that amount will be kept for current employees to acquire. Employees are also given the option of severance packages if they agree to resign before the actual sale takes place.

An abrupt removal of subsidy may cause dislocation to price of gas because with high demand, and not enough supply the price would sky rocket leading as mentioned earlier to labor strikes and chaos. This would encourage the military to try and take over governance using the threat of insecurity to justify their actions.

Impact of Privatization and Deregulation

The Nigerian government has decided to go ahead with the policy even against widespread disapproval on the part of ordinary citizens. The government though is taking note of other countries that have privatized, particularly those in South America.

It is worth noting that the biggest gain will be in savings generated from divesting in the sector. As mentioned earlier in the paper, this will free up government funds for other activities.

“Potential savings in the downstream sector are defined as the difference between the actual cost of supplying petroleum products to consumers (either through imports or by refining crude) and a benchmark cost corresponding to the procurement of these products from world markets under competitive conditions; and are subdivided into three categories: procurement, refining and distribution” (World Bank, Africa Technical Department, Industry and Energy, Division Note No. 14, 1992, p. 3-5).
The question that arises is how does government stimulate competition? Well that is the challenge because since the refineries to be privatized are natural monopolies. Government must effectively make sure that collusion does not happen once the refineries are sold; government also must still be able influence price mechanism without actually fixing price ceilings otherwise the exercise of privatization would have been in futility.

The approach government has chosen to do this is quite interesting because it is novel in the third world. The Government has created a policy that affects the upstream sector; government has sent a bill to the Nigerian senate for approval. This bill which is receiving accelerated hearing makes it mandatory for major oil companies operating in Nigeria, i.e. Shell, ExxonMobil, Chevron and Elf to refine at least 50% of their crude oil in the country. What this means is that there will be many suppliers in the Nigerian market, thereby encouraging competition and attendant lower costs. The oil majors are not too thrilled about this but it is a price they have to pay if they want to remain in the Nigerian market.

**Conclusion**

Nigeria is heading on the right track and is potentially going to be better off in the long run with the current intended plans on privatization. Already the benefits of maintaining a good fiscal policy is coming to bear, government has moved away from over dependence on oil revenues and is diversifying into other areas.

The international community has seen that and Nigeria is the first beneficiary of the G8 meeting at Gleneagles, Scotland where world leaders accepted to write off debt of the least developed nations. Though it is not considered in that category, the backing of certain governments including that of the United States, UK and Germany made it possible for the “Paris Club” to grant us a 60% debt relief. The condition being that the IMF approve of the home grown economic policy known as the National Economic Empowerment and Development Strategy (NEEDS), after it was scrutinized, the IMF approved the Policy Support Instrument (PSI), which is first because normally IMF dictates to the debtor country on what policies to implement.

The “Paris Club” approved an $18 billion debt write off and also agreed to let Nigeria buy back $6 billion. Though the government had to pay arrears of $6.4 billion within a specified time frame, which it has done. It is likely that for the first time since Independence, Nigeria may be out of debt by June 2006.

At the same time aggressive reforms are being undertaken in the country by the government in all sectors of the economy. The combined effects of savings from privatization and debt relief is going to free up huge resources to the Nigerian government and people.

The key issues in the impact of privatization when sold are those of profitability, efficiency, unemployment and capital market development.

- **Profitability**- This is likely to occur once the refineries are sold, but may be due more debt write off by government, in order to give the company a fresh start.
- **Efficiency**- Normally after privatization, state owned enterprises return to being efficient as costs are reduced and redundant employees are retrenched.
• Unemployment- This cannot be avoided, but as explained earlier government can create effective safety nets so as to handle welfare matters arising.
• Capital Market Development- As 49% will be sold through the stock exchange, this will strengthen the operations of the capital market and funds will be raised through the stock issue. Thus making government derive more revenue.

Source: http://www.florin.com/valore/fiokibanga.html