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Deregulation and Inflation: Preventing a Petroleum Industry Act's Paradox

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Abstract

This paper seeks to expatiate on the impact of Petroleum Industry Act 2020, given its provision authorizing the Federal Government to withdraw subsidy payment at the downstream sector and deregulate same. Without necessarily antagonizing this initiative, given that it would rid government's expenditure from the massive the cost that goes with the maintaining subsidy payment, and enable the government focus on other sectors of the economy that could thrive better with increased funding, I attempt to show that the initiative without more could engineer a grim impact on the economy from a pricing standpoint, and ultimately proffering solutions across various timelines to manage the deregulation plans.

Keywords: Petrol; Petroleum industry; Deregulation; Subsidy; Inflation; Investment production; Diversification

Introduction

On August 16, 2021, the long anticipated Petroleum Industry Bill (PIB) was signed into law, as an Act seeking to streamline the legal, political, regulatory and fiscal framework of the Nigerian oil and gas sector.

The passage of the said enactment, which came over 20 years after the conception of the law, has been heralded as a watershed moment in the Nigeria oil and gas sector, and has been met with rave reviews on account of its ubiquitous innovations touching administration of the industry. This is not to mention its prospect to upend the current stagnation in the sector, significantly drive investment in the sector, and improve benefits to host communities, among others.

In spite of these, the monumental regulation has been unable to allay discontentment among some stakeholders in the industry, this is largely due to some of its fiscal related provisions, such as stipulated levy for host communities fund, ownership of the restructured Nigeria National Petroleum Corporation (NNPC), and the crux of this article, deregulation of the downstream sector.

It is seemingly an ingenious approach by the government, through the Petroleum Industry Act (PIA), to deregulate, and position the oil and gas industry for larger revenue, but not all cadres of the populace are financially equipped to survive this impact.

Provision of Petroleum Industry Act Installing Deregulation

Although the Petroleum Industry Act is quite intricate, and dissecting many of its content isn't a Tea party, what is clear is the impact of deregulation on fuel subsidy.

Under the Act [1], pricing of petroleum products in the downstream product sector shall be deregulated to ensure market related pricing, adequate supply and removal of economic distortions and creation of a fair market value for petroleum products in Nigeria's economy. To contextualize this, under the PIA regime, petrol will be sold at the same value as the international oil price. In other words, the government will cease to pay subsidy, and local consumers will purchase petrol at international price.

Further, to ensure effectual accomplishment of the Act, including the foregoing provision, a steering committee tasked for timely implementation of the Act, over a 12 months deadline was constituted on August 18, 2021 [2].

The Paradox

There are myriads of externalities that follows deregulation of an industry. The most obvious is that it will enhance proficiency in the concerned sector as a result of the government restricted activities, and will give a level playing field to private enterprise. Of course, It will also promote investment in that industry's value chain. Specific to Nigeria, deregulation will curb the fiscal deficit that stems from subsidy payment, which has left the country incapable of adequately funding other sectors. For context, petrol subsidy payments gulped N1.43 trillion in 2021, shrinking revenue accrued to the federation account to N542 billion [3]. Owing to this, deregulation is a welcomed policy shift in the oil industry.

However, it should be noted this deregulation would not is not happening during the oil dip that occurred within 2015 and 2016. Then, the global average price of oil as quoted by statistical in both years were $49.49 & $40.76 [4] ($56.91 & $46.87 adjusted to inflation) per barrel, respectively. Add to the fact that the naira had significantly more bargaining power.

In more recent times, oil prices at the international market are beginning to spiral out of control, putting upward pressures on unregulated local retail price. At the time of writing, the price of Brent crude oil and West Texas Intermediate (WTI) (2 Major international crude oil price benchmark) has surpassed the $90 mark [5]. Flowing from the volatile upward trend of the commodity, analysts forecast over $100 per barrel in succeeding months [6]. An unfavorable circumstance to this possibility for Nigerians is that value of the Naira has further depleted.

Economic Concerns

There is a silver lining in oil deregulation, which is that the impact would not be felt immediately as mechanisms have been put in place by the administration to cushion the impact of deregulation on the average consumer. The most notable of these mechanisms being government's desire to include N900 billion [7], in the 2022 budget to fund subsidy payment. An estimate subsequently increased to N3 trillion [8].

However, with the imminent volatility in oil prices (influenced by a demand hike as economies begin to ease back into full operation from the pandemic), and subsidy payment likely surge beyond the budgeted figure, subsidy may be serviced at the expense of other capital project. In extreme circumstances, the government may cease subsidizing fuel altogether if its continuity becomes unsustainable as a result of further hike in international crude oil price.

In such scenario, expecting the average consumer to afford petrol at the projected rate is not feasible if the weak power of naira to the dollar, and the income level of the major household is considered. Not only that, an inflated fuel price in Nigeria, being a fuel dependent economy would trigger an inflation on other commodities, and services. Thus, it is not in doubt, the contagious effect this would bear on other sectors if all variables are not properly managed when PIA becomes fully operational.

What can be done

There is not a single approach, conclusive enough to manage the impact of deregulation, and fuel subsidy removal. As such, a multi-prong measure in phases would be essential to effectively manage impact of deregulation, and inflation of petrol.

Temporary Policies

With Nigeria currently being a net importer of petrol, in the immediate, it is encouraged that the country's policy makers maintain expansionary sentiment over fiscal matters that bear significant nexus with Petrol importation, including tax and foreign exchange (forex). This bespoke policy will not be farfetched considering that these financial products will determine how affordable consumers find deregulated petrol price in the short term.

It is worthy of note that the Expected open market price EOMP (oil retail price) is measured as the sum of landing costs (all costs incurred up until sale to final consumers, including refining of product, shipping and port charges), the cost of distribution in Nigeria and the profit margins of participants in the value chain, plus tax incidence through the production value chain [9].

That said, the deregulated price of petrol has been speculated to range within N380 [10] and N500 [11]. While no adequate financial analysis has been employed to arrive at this estimate, and even though is a far cry from the current price of N162-N165/ltr, this estimate is logical considering the makeup of cost that determine petrol retail price in Nigeria. Hence, why a short term policy should be activated to reduce the extra cost anticipated on consumers.

First, on foreign exchange, despite crude oil being the biggest export from Nigeria, there's still much to hope for on accessibility of foreign exchange by exploration & production companies. There is generally shortage of foreign exchange in the economy, which has been referenced as a factor for inflationary effect on the price of petroleum already [12]. The Central Bank of Nigeria (CBN) does not intervene in ensuring companies (including those in the oil industry) access foreign exchange seamlessly [13]. With petrol being an inelastic commodity, it is logical that scarcity of foreign exchange will force oil companies to source foreign exchange at the parallel rate. The impact of premium paid to access forex at parallel market is currently non-existent, owing to government's regulation of the commodity, and the fact of the NNPC currently being the major importer of refined petroleum products [14]. Upon deregulation, in a bid to avoid oil importers obtaining forex bearing the parallel market premium, which will be passed through to consumers, effort of the CBN needs to be rallied to ensure oil companies access forex more frequently at the official rate.

Secondly, considering that deregulation grants a carte blanche to oil production (including importers) companies to determine and revise prices with more power, regulators should ensure certain levies having the effect of hiking petrol are temporarily relaxed.

There are several cost effect borne by oil companies under the Act, including royalties, leases, tax. Almost all of these levies are either deductible (i.e royalties, payments by license holders, contributions to host communities trust fund etc) or remitted after gross earnings by oil companies (i.e Income tax and Hydrocarbon tax). As such, the impact of their computation in the retail price is quite speculative.

However, VAT and customs duty may play out differently. This is owing to the tax incidence of VAT and the period in which payment of custom duty arise. In other words, since by its nature, the burden of VAT fall on the consumer, and custom duty is paid upon importation, before earnings of oil importers are accessed, both taxes will be a significant determinant on retail price during deregulation.

Although VAT has been exempted on petroleum products as per the Value Added Tax Act (Schedule Modification) Order 2020, if history is taken into account, VAT is usually levied during deregulation of retail price [15]. Exemption of VAT on petroleum product found basis in the 2005 policy of the Petroleum Product Pricing Regulatory Agency (PPPRA) [16], where the exemption of VAT on petrol was first set in motion, so as to coalesce its impact with the government's effort at keeping petrol price low through subsidy payment. Prior to that time VAT and custom duty were actively levied on petrol. Add to the fact that VAT is currently paid on Liquefied natural gas (LNG) [17], which is also a deregulated commodity [18], despite the 2020 VAT order exempting gas from being subject to VAT, perhaps the levy will be factored into a deregulated petrol price. Without doubt, not imposing VAT will be pivotal at keeping petrol price affordable upon deregulation.

As far as custom duty is concerned, there are plans in the works to levy same on imported petrol, although not currently levied. It is encouraged that the Nigeria customs service put a hold on the proposal to reintroduce the levy as planned [19].

Taking into account how forex, and tax are determinant factors of petrol retail price, an implementation of the foregoing will ensure deregulated price is not far off the current price of N165/Ltr, and the eventual price is easier for consumers to adjust to pending the activation of egalitarian policies, outlined subsequently.

Permanent Policies

For a far reaching effect, this article postulates two permanent policies namely, local production, and diversification of energy mix so as to manage deregulation, keeping make petrol price affordable, yet sustaining attractiveness of the oil industry.

Local Production

It has been stated that EOMP is comprised of the cost effect of the operations, and the attendant profit margin by players in the petrol value chain. It should be emphasized that this cost is amplified due to Nigeria being a net oil importer. Thus, the medium term of stakeholders in the Nigeria should be the preventing the brunt of an impending astronomical retail price for the average consumer, through pragmatic and concerted effort to ensure that exploration, production, and refining of petrol occur in Nigeria.

All attempts from private enterprises and government parastatals alike to ensure local production has been keenly observed. Notwithstanding, the desire to deregulate petrol should serve as a propellant to expedite said attempts as that will relieve retail price of some distribution cost including, but not limited to freight costs, which will then translate to lesser production costs for oil companies. To contextualize logistics cost, the net cost of importing refined petrol exceeded US$43.56 billion in 2020 [20], in addition to cost of export to various refining hubs outside the country, all factored in petrol price.

Consequently, local consumers could purchase petrol at considerably low price even after deregulation since distribution, and other price determining costs such as the Nigeria port authority and Nigerian Maritime Administration and Safety Agency charges, premium paid by oil companies to purchase of forex at parallel rate, among others will cease to be factored in retail price. Specifically, petrol prices upon deregulation will only be determined by global crude oil cost, refining costs, distribution costs, and federal & state taxes [21].

However, owing to the inefficiency of the Nigeria National Petroleum Corporation managed refineries to churn out quantity adequate for local consumption, and the perennial incapacity to match projected oil refining targets despite several financially dissipating attempts made to upend the headwind [22] it is encouraged that the Company's participation, as well as that of other government agencies in oil refining be restricted to regulations, and technical support to other players in the industry. For an optimal local production during the Petroleum industry Act operation, private enterprise in oil production, including refinery should be established.

Being that this will be new approach in the Nigerian oil value chain, getting the most out of the Petroleum Industry Act begets the need to maintain a free, yet perfectly competitive market. Competition from different private companies will be hugely beneficial to eliminate the tendencies of any one firm to unfavorably fix prices [23], and rather, it will galvanize competitive trading among the many oil refining companies, which will translate to fair price for consumers [24].

A knock on effect of this policy is that it will signify Nigeria's readiness for, and attract further investment into the oil industry.

Diversification of Energy Mix

A prognostication of oil price is not a straightforward task, but if the geopolitics in the global oil industry such as Opec+ production quota for members, supply disruption, restriction of funding to petroleum investment, among many more, could be taken as a guide, there exists a possibility of oil price surging higher than current projections.

For Nigeria specifically, considering the economy's over reliance on the fuel, there is the possibility that deregulated petrol price in Nigeria will translate to exorbitant pump price in the long term. Upending this possibility should include Nigeria diversifying some of the sectors that rely on petrol for operation to other energy source. To accomplish this, there is need to turn the tide on the country's ailing power supply. Similarly, pragmatic steps should be taken to include gas in surplus quantity to the country's energy mix for utility by household, and industries beyond its current utility as largely a cooking fuel, leaving petrol as transport fuel. In such circumstances, the impact of an unfavorable international oil price will only be felt by few sectors in the economy.

However, it is instructive to note that presently, Nigeria is faced with a Gas infrastructure deficit [25]. This can be attributed to a shortage of investment in vital infrastructure [26] by the government, which is the dominant gas player [27]. As such, similar to the suggested model for local oil production, there should be a free gas market enabling Private companies to optimize infrastructure, and develop the gas industry.

Further, the condition of the country's power sector can be improved by simply increasing power sector. Since Nigeria is deeply rich in Gas [28], it is advised that - in addition to putting adequate infrastructure in place - the country substitute its hydro thermal power infrastructure, which has always been seasonal and dictated by the water level in the country [29] and completely utilize Gas as power fuel.

Undoubtedly, this shift in energy policy will drastically reduce the country's oil production-to- consumption ratio, and without an alternative plan for utility of its large oil reserve to avoid an oil glut, further investment into the industry may be discouraged, not to mention the consequential drop in the country's revenue from the oil industry, contrary to the PIA's intendment. An alternative plan should then see the country redirect its course to becoming a net exporter of oil rather than the present over- reliance on local consumption.

Conclusion

The new Petroleum Industry Act entails provisions which if adequately implemented could drive foreign investment into the Nigerian petroleum industry. On the other hand, putting its deregulation provisions into action is likely to inflate commodity prices. With particular interest on the latter impact, this paper has suggested policies that could be simultaneously implemented with deregulation policy to steer the economy favorably for its populace.

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