# The Twin Shocks and the Nigerian Energy & Natural Resources Industry

## An Analysis of the Challenges, Consequences and Cure

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KPMG in Nigeria

# Foreword

The Twin Shocks, which resulted in a further collapse of crude oil prices, and a crash in the price of futures, has continued to weigh heavily on the fortunes of the global Oil and Gas Industry. Increasingly, industry players are beginning to report lower than planned profitability and liquidity positions and consequently, some plan to shut in production, declare force majeure on ongoing contracts, slash costs, suspend evaluation of future projects, profile assets for sale, etc. The public and private companies operating in Nigeria's Oil and Gas Industry are not insulated from this unprecedented crisis, mainly because most of the hydrocarbons produced in the country are exported. This is especially a challenge for Nigeria considering the Nation's dependence on proceeds from the sale of crude oil and gas for a significant portion of its foreign exchange earnings.

Similarly, the Power and Mining industries have been negatively impacted by the Twin Shocks.

Fortunately, the Twin Shocks present a unique opportunity for stakeholders in the Nigerian Oil and Gas sector to transform the industry as the severity of the shocks on the Nigerian Oil and Gas industry may not have been as high as experienced if certain foundational practices and principles were in place. In this publication, we discuss stopgap measures to support companies to survive the immediate difficulty. In addition, we share our thoughts on some other medium to long term measures, which if implemented will enhance the competitiveness of the companies as soon as the health and economic conditions imposed by the Twin Shocks improve.

The will to faithfully implement well-reasoned and relevant ideas is required to restore and reposition the upstream, downstream, midstream and services sectors of the Oil and Gas industry and the Power and Mining industries for the immediate and longer-term benefits of all stakeholders. The time is now!

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# Content

# The Twin Shocks and Energy & Natural Resources Industry - Introduction

## The Crisis is a combination of: The COVID-19 Pandemic and the Crude Oil Price War

The current pandemic has created an unprecedented and global crisis that will cause regions, countries, sectors, companies and individuals to experience a reaction, resilience, recovery and adjustment for a "new reality." On the 31st of December 2019, a pneumonia of unknown cause was reported to the WHO from Wuhan, China. This phenomenon has gone on to be widely known as the COVID-19 virus which was declared as a public health emergency by the WHO on the 30th of January 2020, and a Pandemic on the 11th of March 2020. As at the 22nd of June 2020, the pandemic has spread to at least 188 countries infecting over 9.051m people and resulting in the deaths of more than 470 thousand people around the world. As part of efforts to stem the spread of the virus, major economies have instituted lockdowns aimed at minimising human-to-human interactions, but this has in turn resulted in economic challenges and while a cure/vaccine for the virus is still being developed, countries currently have to find a way to balance the economic shocks of these extended lockdowns/restrictions with the associated public health risks.

Over the last 6 months, global crude oil prices have seen one of the sharpest drops in history (69%+) from a peak of $60.94/bbl in December 2019 to $18.84/bbl in April 2020. This was triggered by Russia and Saudi Arabia, both of whom were unable to agree on oil price cuts to match the fall in demand due to reduced economic activity by the COVID-19 pandemic. Subsequently, both countries have taken steps to maintain their market dominance against US shale producers who are unable to compete effectively at lower prices. With economic activity slowly resuming, oil prices have started to rebound and as at June 2020, prices have risen up to $43.71/bbl indicating a healthy recovery trend.

## Global Impact

### Human Life

- As at the 22nd of June 2020, there have been 9,051,949 confirmed COVID-19 cases across 188 countries.
- Antibody tests by the WHO in April suggested that up to 230m people around the world may have caught the virus but survived.
- Globally, 470,822 people have died from the pandemic.

### Economic Growth

- In light of the current macroeconomic challenges, the global economy is projected to contract by 3% in 2020.
- This economic impact is expected to be felt more by commodity-rich exporting countries who are projected to face a drop of USD2tn – USD3tn in their economies.
- The relatively more advanced countries will likely be able to better manage this impact through their instituted fiscal stimuli initiatives.
- In response to these challenges, countries have deployed stimulus and intervention packages to cushion the economic impacts. These have come in the form of loan restructuring, buying back of private and public securities, and the provision of credit and liquidity guarantees, amongst others.

### Oil & Gas

- As a result of the pandemic, global oil demand dropped sharply by about 9.07mb/d (Y-o-Y), and as a result of OPEC+'s inability to reach an agreement on production cuts, there was a resultant oversupply in the market which triggered subsequent price drops.
- Drops in oil demand is projected to be more intense.
- The OPEC+ alliance which was started to stabilize oil prices between OPEC producers and non-OPEC producers became ineffective as Russia and Saudi Arabia were unable to agree on how to dictate policy to tackle the huge drops in demand.

**Sources:** Johns Hopkins; IMF; The Economic Times; NCDC; Business Week; Statista

- The excess supply of oil as a result of declining demand by manufacturing and transportation industries further triggered a decline in crude price to unprecedented levels in decades.

### Power

- Due to the pandemic and milder weather conditions, global electricity demand declined by 2.5% in Q12020. Electricity demand in China declined by 6.5% while in France, India, the UK and Spain among others, this demand drop was as high as 15%. As a result, global wholesale electricity prices have remained low.
- Most non-hydropower renewable projects across the globe will face an increased risk of delays, as they rely heavily on imported components whose supply chains have slowed down or even stopped completely.

### Mining

- Most mines in key mining jurisdictions such as copper mines in Chile, iron mines in South Africa, coal mines in Australia, and gold mines in Peru, Mexico and across Europe have had to shut down or operate with a much smaller workforce in line with lockdown protocols and this has made a huge impact on production and exports for most countries.
- Although the demand for most metals have fallen modestly, there has been an increase in the demand for Gold. This is because whenever the economy spirals, investors tend to buy and hold on to gold.
- The price of gold has risen from about 1519.50USD/oz in December 2019 to 1764.08USD/oz in June 2020.

## Country Impact

### Human Life

- As at the 22nd of June 2020, there have been 20,919 confirmed COVID-19 cases in Nigeria resulting in 525 deaths.
- Lagos, Nigeria's economic center, remains the epicenter of the pandemic with 42% of confirmed cases in the country followed closely by FCT and Kano.

### Economic Growth

- With Nigeria being a largely commodity-dependent economy, the impact of the twin shocks are expected to be intense in the country.
- The IMF recently reviewed Nigeria's economic growth projections from 2.5% for 2020 downwards to – 3.4% due to the impacts of this crisis.
- About 50% drop in government revenue from about N880bn to about N440bn.

### Oil & Gas

- Over the last two months, there were reports that Nigeria had over 50 stranded cargoes of crude oil and 12 of LNG that were unable to find buyers due to low demand. This had negatively impacted the revenue profile of Government.
- Upstream projects are expected to be significantly delayed as a result of the current pandemic restrictions and scaled back government investments.
- Major downstream projects under construction could potentially experience some delays in execution due to the disruption in supply chains.
- Travel restrictions, together with state lockdowns has impacted negatively on the use of jet fuel, petrol etc. This has direct effects on oil consumption, and expected earnings of the downstream companies.

### Power

- An obvious impact of the current situation on electricity distribution companies in Nigeria arises from the loss of revenues due to reduction of demand from the commercial and industrial customers. This affects the ability of the tariff to effectively provide cross-subsidies to the lower-tariff paying consumers.
- The Twin Shocks are expected to result in revenue decline for power sector players as consumers, many of whom have lost their jobs or suffered some financial loss due to the pandemic may be unable to sustain electricity payments. These will potentially make it harder to finance new projects, and may draw public infrastructure funding away from the Power sector to other sectors such as healthcare.
- There is increased uncertainty in the industry as evidenced by the shelving of an initially planned April tariff hike for another three months.

### Mining

- Outbreaks of COVID-19 in mining regions in Nigeria and the resulting restrictions imposed on mining companies have resulted in production shutdowns and the unavailability of skilled technicians.

# Oil & Gas: Upstream Sector

## Challenge

**Global constraints and conditions (oil price wars and COVID-19 pandemic outbreak) further reveal the weaknesses in the local oil and gas upstream industry operations**

The upstream sector of the oil and gas industry has been plagued over the years by uncompetitive production costs occasioned by insecurity, uncertainty of applicable fiscal terms and prolonged contracting cycle, amongst others. This has now been exacerbated by the decline in demand for, and price of crude oil due to economic slowdown resulting from factory closures in buyer nations of Asia and Europe, as these nations take measures to curb the spread of the COVID-19 pandemic.

With Nigeria's crude oil exports accounting for over 90% of the nation's total exports and foreign exchange revenue, the current context reflects poorly on the sustainability of the industry with significant ricochet impact on other aspects of the Nigerian economy. The build-up of crude inventories and the reduced margins (owing to low prices) provides significant cause for concern.

Crude oil trading below zero in some quarters in April 2020, and just recovering late May/early June 2020 has resulted in dwindling revenue from crude oil sales whilst contractual/debt obligations fall due.

## Consequence

**Declining exports and resultant revenue shortfalls**

Historically, a decline in crude oil revenue has led to a dip in Federation revenue and consequently all the federating units – Federal, State and Local Governments. This trend often has a direct impact on the government's ability to meet its obligations and pursue growth and development initiatives.

## Cure

### Short Term

- Oil companies especially the indigenous players need to engage lenders to renegotiate the terms of existing loan obligations and deferral of maturing loan obligations, while also taking advantage of the Central Bank of Nigeria (CBN's) instructions to Nigerian banks to restructure loans with entities in the oil and gas sector in order to help mitigate the impact of COVID-19.
- Operators need to be intentional about reducing operating costs. They also need to consider reducing dividend pay-out to cushion the effects of declining operating cashflows.

### Medium Term

- Quick passage of the Petroleum Industry Fiscal Bill to remove the uncertainties and encourage investments in the sector.
- Deployment of technological solutions to support remote and digitized management of operations; to ensure that business continues beyond the period of lockdown and the pandemic, and support the optimisation of operational costs.
- Enter into strategic relationships with leading institutions to ensure the steady offtake of the nation's hydrocarbons produced for sale.
- It has become paramount for the government and oil producing companies to make sustainable adjustments to cater for the challenges bedeviling the upstream sector with the recently launched marginal field bid round and efforts at improving Nigerian Content in this industry is seen as steps in the right direction.

### Long Term

- Stakeholders in the sector need to:
  - i. make significant investments to increase in-country storage capacity for crude oil.
  - ii. focus on exploiting the country's abundant gas reserves and in-country consumption
  - iii. sell down FG's interest in the current JV operations and/or convert them to IJV model with FG holding minority shareholding interest.

# Oil & Gas: Downstream Sector

## Challenge

**Demand shortfall and risk of disruption to fuel importation**

The downstream sector of the Nigerian Oil & Gas industry is especially hit by the COVID-19 induced lockdown which has resulted in a sudden demand shortfall.

Given the importance of Petroleum Motor Spirit (PMS) and its impact on the social welfare of Nigerian citizens, the Federal Government of Nigeria (FGN) had historically taken measures to ensure that there are no disruptions to PMS importation and supply. Given the sub-optimal refining capacity in-country and the continued closure of international borders the country runs the risk of disruption to PMS importation and availability.

Nigeria currently has low refining capacity and arguably comparatively lower strategic reserves of oil/petroleum products.

## Consequence

**Supply shortfall/Declining revenues**

In June 2020, as a fallout of the drop in crude oil prices and in a bid to address the associated impact on government's liquidity whilst also ensuring adequate supply of PMS, the FGN through the Petroleum Products Pricing and Regulatory Agency (PPPRA) removed the cap on the pump price of PMS which had previously been reduced from ₦145/litre to ₦125/litre in March 2020. The PPPRA however maintains that it will continue to advise oil marketers on the pump price of PMS.

Earlier in May 2020, Oil Marketers had been granted approval to import PMS directly.

Restricted access to foreign exchange for imports particularly due to the drop in crude oil prices and the slow-down in Port operations as a result of the continued lockdown globally may however hamper the ability of oil marketers to import PMS directly.

The NNPC had assured of 60 day's supply which indicates that the country may be prone to a supply shortfall if the global lockdown and shutting of borders continues for a much longer period. The interplay of demand and supply of PMS may see operators in the downstream sector experience significant decline in revenues whilst grappling with fixed costs and the resultant operational losses.

## Cure

**Short Term**

- Companies need to engage lenders to seek extension of terms of existing loan obligations and deferral of maturing loan obligations, while also taking advantage of CBN's instructions to Nigerian banks to restructure loans with entities in the oil and gas sector.
- The Government should fully deregulate the sector to attract more investments and engender competition.
- The Government should evaluate in-country refining capabilities and implement policies that will ensure orderly growth and development.

**Medium Term**

- The Government should implement policies that will enhance the rehabilitation and capacity utilization of government-owned refineries.
- Other options including privatization (full or partial) should be prioritized.
- Enter into strategic relationships with leading institutions to ensure the steady offtake of petroleum products refined in the country for export.

**Long Term**

- Stakeholders in the oil & gas industry (Upstream & Downstream) should invest in modular refineries to improve in-country refining capacity and eliminate dependence on importation of refined products.

# Oil & Gas: Midstream/Oilfield Services Sector

## Challenge

### Drop in demand for services

The midstream and oilfield service companies are probably the hardest hit by the twin shocks. Due to the sudden drop in demand in both the upstream and downstream sectors, midstream/oilfield service companies have witnessed a drop in demand for their services.

## Consequence

### Declining revenues/Threat to business continuity

With a barrel of crude oil selling below, or close to, its production cost, producers have been forced to cut down on exploration and production activities. As the situation deteriorates, many industry participants are taking advantage of the force majeure provisions in their key contracts to excuse failure to perform or to exit. A major partner on the projects executed by the oil producers is believed to have also mandated an intentional drive to reduce contract costs by as much as 40%, while some projects and contracts are being cancelled outrightly.

The significant slow-down being experienced in the oil & gas industry supply chain may also lead to staff redundancy in the short to medium term.

The foregoing poses a long-term existential threat to businesses in the midstream/oilfield services sector as a number of the participants in the sector have seen their contracts terminated.

## Cure

### Short Term

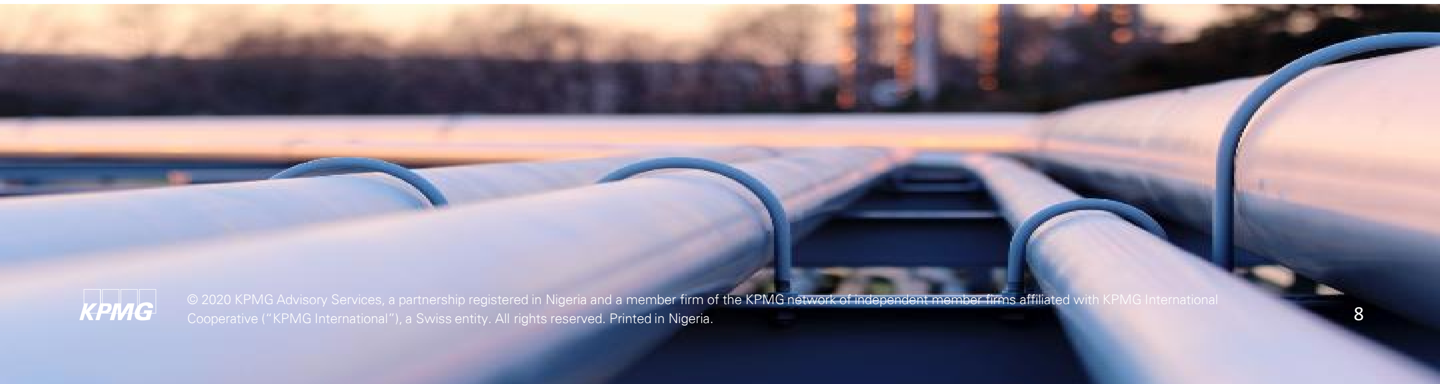
- Companies need to engage lenders to seek extension of terms of existing loan obligations and deferral of maturing loan obligations, while also taking advantage of the CBN's instructions to Nigerian banks to restructure loans with entities in the oil and gas sector.
- Operators need to adopt cost optimization initiatives, focusing on only essential expenditures.

### Medium Term

- The Government should implement policies that will ensure:
  - i. provision and maintenance of critical infrastructure such as pipelines and storage facilities.
  - ii. sustainable improvement in Nigerian Content in all aspects of work done in the midstream/oilfield services sector.
  - iii. strengthening of relevant institutions of learning and development.
- Deployment of technological solutions to manage operations and ensure business continues beyond the period of lockdown and the pandemic.

### Long Term

- Stakeholders in the sector need to form alliances to take advantage of synergies to be derived from collaboration between participants in the sector.
- Service providers should also explore the possibility of mergers and acquisition, to remain relevant in the industry.



# Power

## Challenge

- **Revenue:**
  A significant proportion of the energy generated during this period may be distributed to the residential class and very little to Commercial and Industrial customers whose tariffs are higher. This may put a strain on the sector revenue and may be lower than the cost of power at the wholesale electricity market.

  This situation may have improved post-total lockdown. However, a number of Commercial and Industrial customers are still either working from home or not fully operational at the moment.

- **Liquidity/ Collection:**
  The availability of resources to settle electricity bills is also a significant issue as this may not be the priority for a population that may already be struggling with the harsh economic realities brought about by the pandemic and the actions instituted to control it.

- **Policy and Sustainability of the sector:**
  The proposed adjustment in electricity tariff by the DisCos, which was slated to come into effect in April 2020, has now been delayed till July 2020. It should be noted that the tariff adjustment was initially slated for January before it was moved to April 2020 to allow for public and stakeholder consultations.

  Further, there is a lack of an effective legislation for renewables that codifies all the available policies and incentives to help attract investments in the renewable energy sector.

- **Foreign Exchange**
  The dwindling Government revenue from crude oil and gas sales may impact foreign exchange reserves and consequently lead to a devaluation of the currency. This may impact the Sector's ability to meet their foreign denominated obligations.

- **Infrastructure:**
  The Nigerian Electrification Road Map and the Siemens Agreement anticipate that the country would have a generation capacity of 25,000 MW of electricity by 2025. This increase is scheduled to take place over three phases starting from 2021 with an additional 7000MW and 11,000MW by 2021 and 2023 respectively. Nigeria was billed to spend over a trillion Naira over the course of the project with about 61 billion Naira committed this year. The government has already released the funds for the pre-operational phase. Notwithstanding, funding may still be a challenge given government's reduced financial capacity.

## Consequence

- Insufficient cashflow to meet immediate financial and capital obligations.
- Increase in debt portfolios as a result of potential defaults on existing obligations.
- Increase in finance costs.
- Difficulty in raising additional capital or debt.
- Increase in technical losses due to poor/decaying infrastructure.
- Increased dependence on government subsidy/ interventions.
- Decreased viability for external investment in the sector.
- Poor overall industrial competitiveness for the country as a result of sustained poor power supply.
- Inability to meet the targets set for generation, transmission and distribution sub-sectors.

# Power

## Cure

| Duration | Focus Area | Comments |
|---|---|---|
| **Short Term** | Revenue | Government may need to continue to provide financial support to businesses in this sector. However, this support must be administered in a manner that guarantees improvement in power infrastructure across the country. |
| **Medium Term** | | The move to cost reflective tariffs is long overdue. The industry should look to achieve this in the mid-term. |
| **Short Term** | Liquidity/ Collection | Government should consider deducting MDAs bills upfront and paying same to the Discos directly. |
| **Medium Term** | | Discos may consider the introduction of bulk payment incentives to encourage consumers invest in significant pre-payment and ease the cash flow challenges. This may however not be possible in the short term until a cost reflective tariff or price deregulation is achieved; and<br><br>Discos should be allowed to engage any Meter Asset Provider available, anywhere in the country, without any restrictions (other than quality review and approval by NERC). This would encourage the mass deployment of meters to consumers. |
| **Short/Mid/Long Terms** | Policy | Government should ensure consistency and clarity of policies as this will encourage investments in the Sector;<br><br>Criminalize energy theft and enforce penalties against offenders.<br><br>Codify coherent fiscal policy that encourages the production of renewables, mini-grids and solar home systems to the market. |
| **Mid Term** | Foreign Exchange | Government should continue to consider diversification of the economy and its source of foreign exchange in order to limit its over-dependence on oil. |
| **Short/ Mid Terms** | Infrastructure | The Government should remain committed to the Siemens Agreement and the Nigerian Electrification Roadmap. |

# Mining

## Challenge

- Limited access to exploration financing.
- Unregulated minerals market.
- Worsening inflation and unemployment rates, fluctuating forex rates and other macro-economic indices, including current physical restrictions, would further affect mining negatively.
- Illegal mining is becoming more and more sophisticated and organised, coupled with a depleted mining police force.
- Lack of active and regulated market for exchange of commodities.
- The infrastructure to support effective and cost efficient mining operations in Nigeria is insufficient, for example, on-grid power and efficient transport infrastructure to convey minerals from exploration site to the market/export terminal.
- Most mining operations are artisanal and ancestral in nature which hinders exponential growth of the sector.
- A significant number of mining licenses issued are yet to progress beyond exploration stage, due to limited access to exploration financing.
- Current fiscal incentives for mining companies are not aligned with gestation period of mining projects, and thereby, unattractive to mining majors.

## Consequence

- Further delay in project evaluation and delivery.
- Further loss in sector data and government revenues.
- Unattractiveness of Nigeria as a mining hub.
- With projected fall in global exploration spend due to the current crisis, we expect a depressed interest from junior and major mining companies in new exploration.
- Weak macro-economic indices would negatively impact project evaluations resulting in the delay/suspension of some projects . Some ongoing projects may also be suspended due to the restriction of movement of personnel, equipment and materials across states.
- Illegal mining and unregulated minerals markets, if not properly tackled, will continue to result in the loss of revenue for the government and other stakeholders.
- The ancestral and artisanal nature of mining operations results in environmental and social challenges.

## Cure

**Government:**

- Encourage exploratory and related activities to establish and communicate the resource and reserve capability of the Nigerian mining sector.
- Incentivise local financial institutions to lend to the sector.
- Intensify fight against illegal mining who have no permission to access mining sites.
- Formalise commodities market.
- Consider alternative models to provide support infrastructure.

**Operators:**

- Review short to medium term liquidity and operating position.
- Take advantage of all fiscal and monetary incentives provided by Government, particularly, COVID-19-related palliatives.
- Review operating model and consider growth options.

## Short Term

**Operators:**

- Scale operations for efficient cost management.
- Renegotiate facilities from local banks based on CBN regulatory forbearance.
- Take advantage of all fiscal incentives /reliefs provided by the Government.
- Rejig CSR strategy to focus on employees and host communities affected by the crisis.

# Mining

**Government:**

- Communicate the resource and reserve potential of the sector, using up to date reports by reputable experts.
- Extend the CBN intervention funds and other incentives provided to critical sectors to the mining sector, and improve access to exploration financing.

## Medium Term

**Operators:**

- Employ industry advocacy with Government to obtain additional incentives and reliefs, e.g., reduction in applicable royalty rates for up to one year.
- Consider potential mergers or joint ventures to improve economies of scale and operating efficiencies.

**Government:**

- Intensify current clamp down on illegal miners – revamp and empower the mines police and other relevant security agencies and fast-track establishment of the planned special offences court.
- Take steps to formalise supply chain, for example, by introducing registered buying centers.

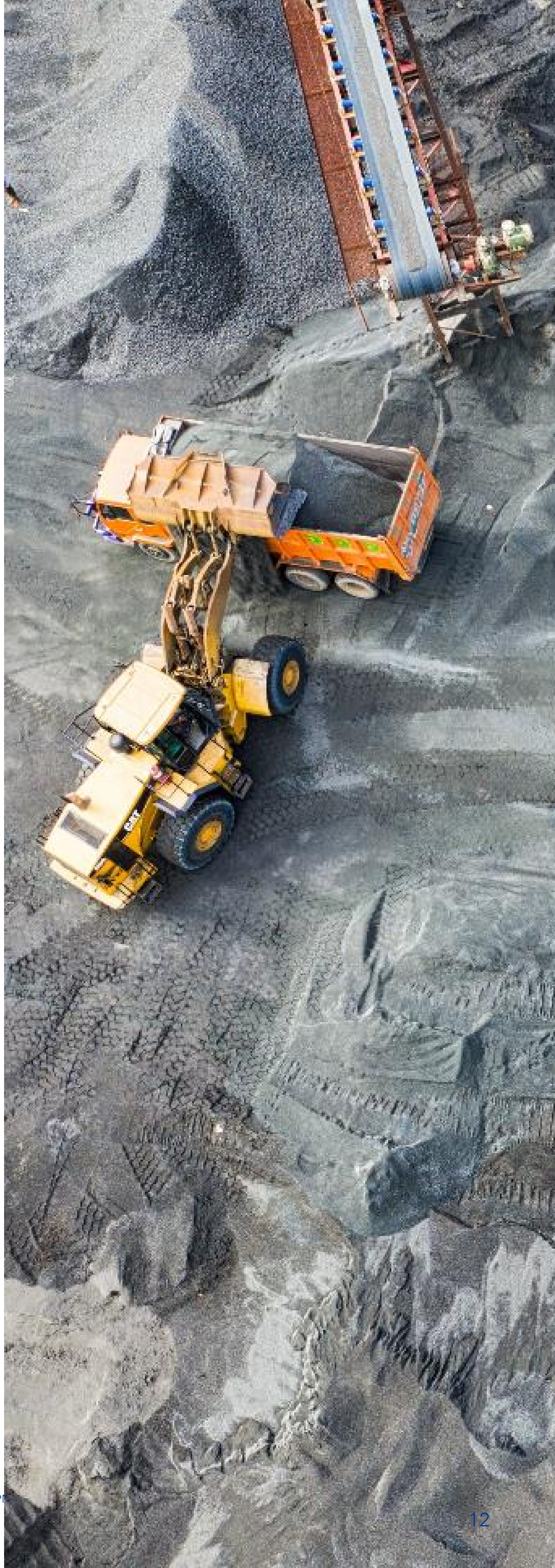
## Long Term

**Operators:**

- Diversification of minerals portfolio to minimise shock from economic crisis.

**Government:**

- Actively promote the use of public-private partnerships to develop the mid-stream, downstream and ancillary services sub-sectors, and to provide required infrastructure.
- Ensure the holistic execution of the recommendations in the roadmap for development of the sector which was issued in 2016. For example, the need to implement a targeted fiscal incentive scheme for the long-term development of the sector.



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