GEPLAW Focus

COVID-19 Special Edition

GEORGE ETOMI & PARTNERS

COVID-19 IN THE OIL SECTOR: EFFECT AND MITIGATION STRATEGIES

1.0. INTRODUCTION

The global oil market is presently facing an unprecedented financial crisis with oil prices currently hovering around $26.44 per barrel as at the time of this report. Global oil demand has reduced by 30 million bpd which has hit an 18-year low, thus propelling talks about production cuts by the Organisation of Petroleum Exporting Countries (OPEC) member countries and other non-OPEC countries to reduce global supplies. This crisis currently being faced is due to the outbreak of the Corona Virus (COVID-19) pandemic which called for a shutdown of business activities causing economic slowdown across the world and Nigeria in particular. This report seeks to evaluate the causes and effects of the dip in oil prices on the Nigerian economy and proffer possible mitigation strategies.

2.0. CAUSES OF THE FALL IN OIL PRICE

Generally, oil demand is determined by various factors such as: OPEC's influence on oil prices, supply and demand impact, production costs, storage and interest rate impact, and also natural disasters. A combination of fall in oil demand and oversupply of oil results in a dip in oil price. The recent fall in oil price is based on the ripple effects of lockdown measures occasioned by the COVID-19 pandemic. A summary of three key factors are discussed below.

i. **Restriction of the Movement of Persons and Commercial Activities in Nigeria**

The World Health Organisation (WHO) declared COVID-19 a public health emergency of international concern on 30 January 2020, and subsequently declared it a pandemic on the 11 March 2020. In line with this, the Federal Government of Nigeria (FGN) enacted the COVID-19 Regulations 2020 pursuant to the Quarantine Act, which directed the total restriction of movement of persons and the closure of all businesses and offices in Lagos, Ogun and FCT. Subsequently, other States replicated the Regulations wholly or partially. Furthermore, the lockdown resulted in the closure of airports, workplaces, factories, and non-essential businesses which ultimately slowed down economic activities and lowered the demand for oil products such as aviation fuel, gasoline and premium motor spirit, thereby causing a drop in oil price. The effect of this on the Nigerian economy is enormous since the economy is largely dependent on oil revenue as an oil-producing State. The inability to sell crude oil at a competitive rate results in low revenue and the inability to fund the country's budget.

ii. **Delay in Oil Production Cuts**

OPEC+, which includes non-members, controls over 50% of global oil supplies and about 90% of proven oil reserves, significantly influencing global oil production and price. As an organisation, the OPEC+ collectively agree on how much oil to produce, which directly influences the price of crude oil on the global market at any given time. However, due to drop in demand, it became imperative to effect production cuts. In March 2020, during its extraordinary meetings held in order to deliberate on the possibility of stabilizing oil price by reducing output beyond cuts that were initially approved, Russia and OPEC+ failed to reach an agreement as to the cuts.

As a result of their failure to reach a consensus, an oil price war ensued. Saudi Arabia released an extra 1million bpd in order to grab a greater share of the market, resulting in an oversupply of oil to the market. Russia was unwilling to go along with a take-it-or-leave-it offer and threatened to unleash a gusher of oil on world markets. This resulted in an oversupply of oil for a market with reduced demand. The international benchmark for crude oil dropped by 10% after the meeting was adjourned.

However, OPEC+ later agreed on production cuts which would commence on 1 May 2020, prior to which the oil glut continued; leaving the crisis to linger further. The failure of the oil producing countries to arrive at a consensus on time is a contributory factor to the oil price dip.

iii. Low Storage Capacity

The world has about 7.2 billion barrels of crude and products in storage, including 1.3billion to 1.4billion barrels onboard oil tankers. The sharp decline in demand globally has forced producers to shut down some production because of the decline in storage space, given the oil glut.

Oil producing companies around the world are fast running out of storage capacity and Nigeria with a total storage capacity of 87.70 million litres, may soon run out of space leading to a forced sale. Nevertheless, the OPEC+ meeting appears to be at least a start at tackling the most serious problem the oil industry has encountered in decades – ensuring production cuts. The decision to cut might go some way toward assuaging growing tensions between members of the organization.

3.0. EFFECTS OF THE FALL IN OIL PRICE ON THE ECONOMY

I. Unemployment

It is impossible to project at this point the number of layoffs that will occur, in the nearest future if this economic crisis lingers. Estimated 2,500 oil and gas workers lost their jobs in Texas in a 10-day span with more to come.

Unemployment report released by the National Bureau of Statistics (NBS) ranks Nigeria 21st among 181 countries with an unemployment rate of about 23.1%. If this situation persists, more workers would be laid off not only in the oil sector but in other sectors that are directly connected to the oil sector and this will result in increased hardship in the country.

ii. Economic Downturn

The sectors of an economy are interrelated. Other sectors, apart from the oil sector, would experience the grave impact of the oil price drop; some of which include the banking and investment sectors, and service providers to oil producing companies, etc. Instances of non-performing loans, stringent debt capital requirements, stiffer project finance terms, currency circulation and lower purchasing power of consumers are expected direct effects from the pandemic and lockdown.

iii. Revenue Loss

Nigeria is a country that depends on oil sales for around 60% of its revenue and 90% of its foreign exchange earnings, though it only accounts for 9% of GDP (gross domestic product). The Nigerian budget for the 2020 fiscal year was prepared with projections of huge revenue from the oil sector. The approved budget had projected revenue collections at N8.24 trillion which is an increase of about 20% from 2019 figure. The revenue assumptions were premised on expected increase in global oil demand, stable market and oil price benchmark of $57 per barrel and output of 2.18 Million bpd.

The emergence of COVID-19 pandemic and its effects on the Nigerian economy has called for drastic review and changes in the earlier revenue expectations and fiscal projections. On 27th April 2020, the Senate approved the President's proposal to acquire a N850 billion loan; in addition, the International Monetary Fund (IMF) has approved a $3.4billion emergency fund for Nigeria. All these measures were undertaken in a bid to create buffers against the present financial crisis arising due to loss of revenue in the oil sector. Compared to events that led to recession in 2016, the current state of the economy poses more difficulties ahead as the oil price is currently below $27.

4.0. MITIGATION STRATEGIES

i. Transition/Economic Diversification

Transition and economic diversification has remained a difficult path to tread for successive Nigerian governments although, the current government had begun implementing pragmatic diversification plans for investments in other sectors. As this is progressively achieved, this will reduce the over-dependence on the oil sector for revenue and the focus would be on alternative sectors such as agriculture, solid minerals, manufacturing and services sectors.

Diversification of Nigeria's economy is believed to be the only viable way to survive future risks of economic breakdown in view of the uncertainty of oil prices. This will result in ensuring economic stability, security and confidence in the system. Diversification ensures economic security and reliability along with sustainability.

ii. Production Cuts

OPEC+, of which Nigeria is a member-State, has agreed to a downward adjustment of their overall crude oil production by 10 million bpd - about 23 percent of their production levels - starting on 1 May 2020. This would be for an initial period of two months and for the subsequent period of 6 months, the total adjustment agreed will be 8 million bpd. It will be followed by a 6million bpd adjustment for a period of 16 months. The cut in oil supply will bring the market to a proper balance, as supply would be reduced thereby propelling demand. Hence, the demand curve will project upwards while the supply curve will go lower and oil price will increase steadily. As Nigeria complies with the production cuts, a gradual rebound of the oil price can be expected, alongside other fiscal mitigation measures. It is however clear that the oil producing companies would not operate at optimal levels, although a return to business operations is imperative.

iii. Phased Easing of Lockdown

The lockdown has proved to be a viable measure for curbing the spread of the Corona virus. However, the lockdown has resulted in gross levels of hardship across economic sectors which were not initially contemplated. Given the situation, Nigeria has implemented a phased approach towards a gradual easing of the lockdown restrictions. WHO had published key considerations for countries in implementing lockdowns and noted that challenges and circumstances vary from country to country and there is no one-size-fits-all approach. It is vital that countries clearly communicate this information to the public to build trust and ensure that people observe restrictions specific to their situation. It appears that there would always be the challenge of ensuring full compliance by citizens with the precautionary measures during this phase. However, it is also necessary that business operations in non-oil sectors reopen and recalibrate the wheels of the economy in order for society to slowly return to normalcy.

4.0. CONCLUSION

The rise and fall in oil prices remain inevitable as it is a necessary effect of market forces interplay. The direct impact of OPEC+ production cuts on oil price is expected to positively rebalance the market. The Nigerian economy is one of the worst hit by the pandemic and lockdown directives given its over-dependence on oil revenue and lack of strategic savings from previous years of abundance of oil revenue which has inevitably led to large borrowings. However, the economy can eventually rebound from its dire state if the mitigation strategies of implementing an internal diversification plan, gradual easing of lockdown and production cuts are implemented.