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Nigeria Strategy Report – H2 2017 Excerpts

Key Developments in Domestic Economic and Policy Environment

Economic Snapshot			
June 2017 Inflation Data/Indices			
	MoM	YoY	Prev YoY
Headline	1.6%	16.1%	16.25%
Food	2.0%	19.9%	19.3%
All Items Less Farm	1.3%	12.5%	13.0%
Imported food	1.6%	14.2%	14.9%
Energy	0.75%	14.2%	16.3%
Currency Markets			
	Latest	Daily Chg	YTD
USDNGN	305.4	0.0%	0.0%
EURNGN	352.4	0.3%	9.6%
GBPNGN	397.3	-0.1%	6.2%
JPYNGN	2.72	0.0%	4.7%
Monetary Aggregates – April 2017			
	(₦'bn)	MoM	YoY
M2	21,713	-1.4%	4.8%
CPS	21,943	-1.5%	13.2%
NCG	5,592	7.5%	42.2%
NFA	7,262	-4.1%	43.2%
NDC	27,535	0.2%	18.1%
External Position			
	Latest	QoQ	YoY
Trade Balance ($'mn)	185.73	-21.5%	N/A
External Reserves ($'mn)	30,323	0.95%	3.68%
Foreign Debt ($'mn)	13,808	21.1%	23.3%
Growth Data – Q1 2017			
	(₦'bn)	%of total	YoY
Real GDP	15,861	100%	-0.5%
Agriculture	3,385	21.3%	3.4%
Oil	1,411	8.9%	-11.6%
Services	5,975	37.7%	1.0%
Wholesale and Trade	2,819	17.8%	-3.1%
Manufacturing	1,543	9.7%	1.4%

POLICY AND REFORMS: GETTING DOWN TO BRASS TACKS

Power Sector: On Pins and Needles

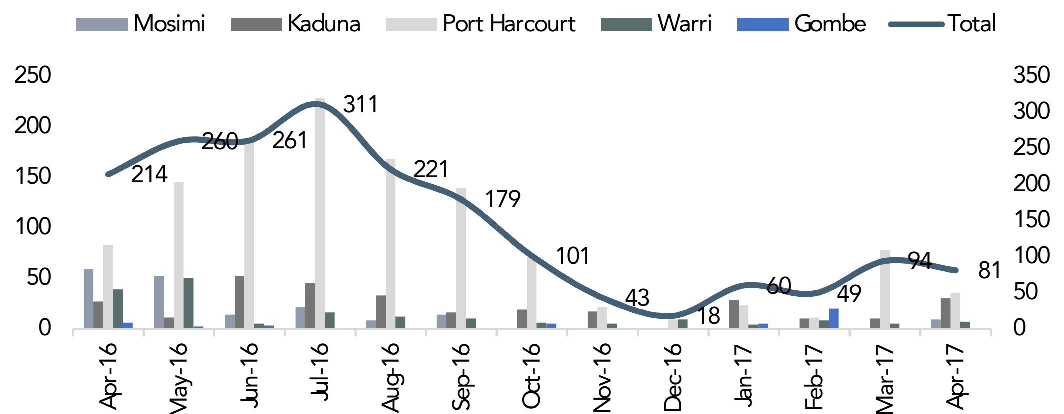
In H1 2017, though power generation improved from end of December by 20% to 4150MW, reflecting increase in gas supply to gas-fired power plants (+39% to 547mmscf/d), the sector continues to grapple with myriad of challenges that has resulted in financial distress for sector players. Infrastructure challenges stemming from gas supply constraints as well as inadequate electricity transmission and distributions mechanism has hampered loss reduction by Discos, and inherent cash shortfall and deficit that has bewildered the sector. Pertinently, out of circa 14,000MW installed generation capacity, just about 31% has been dispatched on average in the last two years.

To start with, the Multi-Year Tariff Order (MYTO), a tariff model to set cost-reflective tariffs has failed to keep to its path. Basically, the MYTO provides a 15-year tariff path with limited reviews each year in the light of changes in certain parameters (inflation, interest rates, exchange rates and generation capacity) and major review every 5 years. However, despite significant spikes in key parameters, inflation and exchange rate, tariff has remained sticky and has thus driven significant accumulation of cash deficit across the value chain. To emphasize the magnitude of the deficit, our analysis indicates current tariff of ₦28.8/kWh is about 43% discount to our estimated current cost reflective tariff of ₦50.5/kWh. According to NERC, between the period of February 2015 and December 2015, the

tariff shortfall[1] and market shortfall[2] are estimated at ₦460billion ($1.4billion) and ₦470billion ($1.5billion) respectively. The foregoing has led to under-performance by the DisCos and the rest of the sector. Aggregate Technical and Commercial Collection Losses (ATC&C) as reported by the DisCos have increased to 54% in 2016 (2015: 52%), a 22pps variance from the 32% in the MYTO estimates. Consequently, DisCos collection rate and DisCos settlement to NBET declined 4pps and 24pps to 57% (2015: 61%) and 29% (2015: 53%) respectively in 2016.

Furthermore, the sector has had to grapple with the debt profile of Ministries, Department, and Agencies (MDAs) in aggregate. NERC estimates aggregate debt owed to the electricity industry by the MDAs at ₦65billion ($206million) as at end of 2016 which contributes about 7% of the accumulated cash deficit. More so, currency concerns relating to debt repayment and expansion in debt have stifled profitability of power firms—largely due to currency mismatch and associated risks—from NGN denominated revenues to service a dollar-denominated loan facility. Total power sector loans following the sale of assets in 2013 stood at ₦219.7 billon (DisCos) and ₦287 billion (GenCos). However, the ~ 80% devaluation of the NGN from 2013 till date majorly expanded the debt profile by about one-fold—implying significant FX losses on financials.

Figure 1: DisCos Collection rate (2015 – 2016)

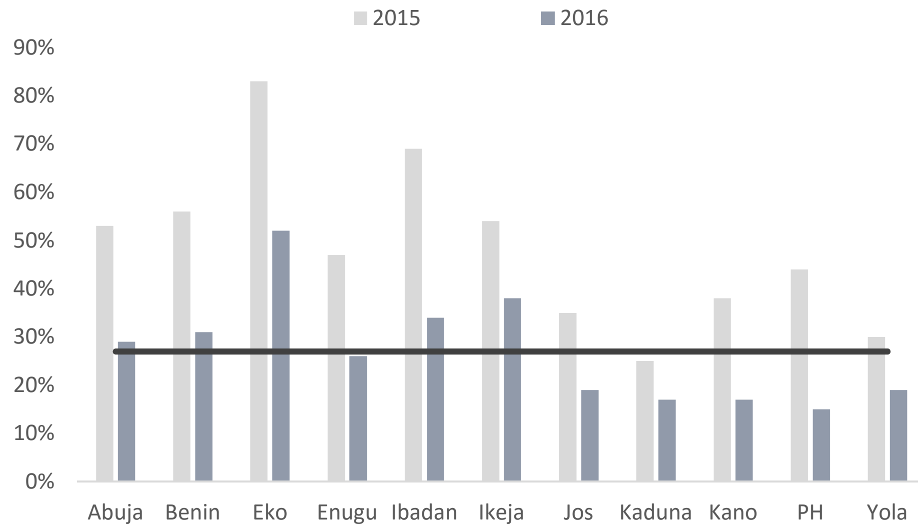


Source: NERC, NBET, ARM Research

[1]Amount owed by consumers in aggregate to the power sector

[2]Amount owed by DisCos to the rest of the market

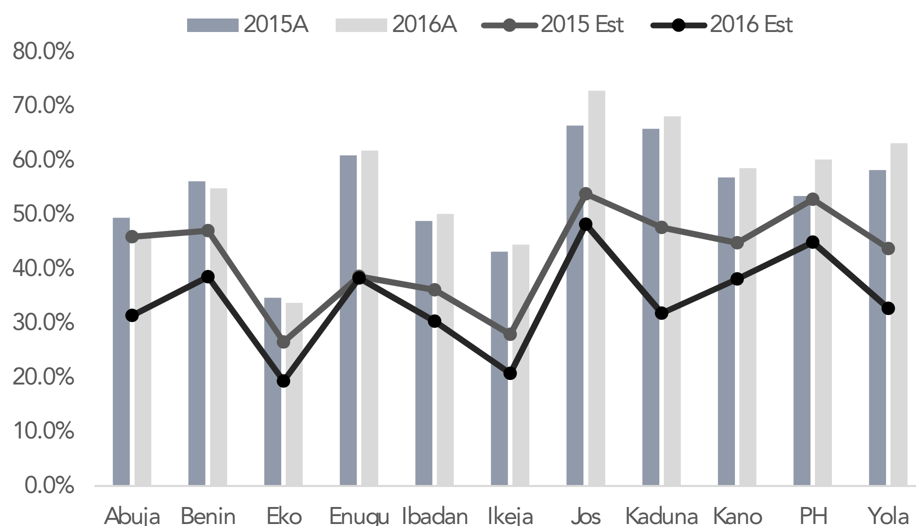
Figure 2: DisCos Settlement to NBET (2015 – 2016)



Source: NERC, NBET, ARM Research

Given the Economic and Recovery Growth Plan (ERGP), which recognizes the role of power to the development of all sectors of the economy, the FG sees power as one of its top priorities and aims to expand power sector infrastructure, increase power generation, address gas supply issues, optimize the existing installed capacity available for generation, and improve the commercial viability of the GenCos and DisCos. On this basis, the FG just recently designed a recovery program for the power sector, which in our view, cause for some optimism given a better understanding of the challenges, in contrast to prior plans, as well as a greater political will to save the sector.

Figure 3: ATC&C Losses Actual vs. MYTO Est (2015 – 2016)



Source: NERC, NBET, ARM Research

Power Sector Recovery Program: The devil is in the details

The Power Sector Recovery Program (PSRP), a series of carefully thought out policy actions, operational, governance and financial interventions, was launched in April 2017, in a bid to restore the financial viability and service delivery of the power sector. The program, which also aims to 'reset' the sector for future growth, was developed with the World Bank Group. The program aims to restore the sector's financial viability, improve power supply reliability to meet growing demand, strengthen the sector's institutional framework, establish a contract-based electricity market, and implement clear policies that promote and encourage investor's confidence. Central to the recovery plan is a ₦701billion payment assurance facility provided by the CBN to assist NBET in meeting its payment obligation within generation invoices and ease the liquidity challenges hurting the GenCos, even as the World Bank intends to fund the PRSP[3]. Other notable changes are the decision to eliminate the historical sector revenue deficit through December 2016 and clear the historical MDA debts even as plans aim to automate future MDA payment.

Elsewhere, the plan proposes to restore cost reflective end user tariffs over 5 years with immediate increase in non-residential categories of consumers effective from 1st of July.

[3] The World Bank Group has expressed its willingness to assist the FGN in preparing and supporting the power sector recovery program. The World Bank Group has indicated potential support for the Program totalling up to US$2.6 billion and support of IFC and MIGA to mobilize up to $2.7billion in potential private sector investment

Further down the program, other noteworthy points are among others, the financial restructuring and recapitalization of the DisCos, an FX intervention policy for the power sector, as with other critical sectors, and the starting off the contract based market (Transitional Electricity Market). Other functions of the program are encouraging private sector investment as well as governance and monitoring plans. In terms of private sector investment, the program seeks to clarify and review the terms and conditions of government support for private sector investment in GenCos, TCN and the DisCos including the timetable for transition to competitive procurement of generation;

Payment Assurance Guarantee: Bailout or Recovery facility?

As a first move towards unravelling the liquidity challenges in the sector, the FG approved a Payment Assurance Facility to NBET to enable it to meet its payment obligations to GenCos within generation invoices, and only meant for GenCos that have the contractual pact known as Power Purchase Agreement (PPA) with NBET. The facility, which is retrospective, effective from January 2017, is a ₦701billion facility (for 2 years) from the CBN to NBET, guaranteed by the FG (Ministry of Finance) to support NBET payment to GenCos and in turn to gas suppliers. From the details, NBET will pay for monthly obligations for energy produced that gets unto the grid as against total energy produced. Consequently, the percentage of energy delivered to total energy capacity will be the percentage of payment assured to GenCos creditors, majorly gas suppliers and banks. Therefore, the government bears the burden through NBET.

While this facility is laudable, as it helps reduces market shortfall by assuring GenCos performance, a key factor to its success will be hinged on the improvement on DisCos collections and ultimately settlement to NBET. Inefficiency and under-performance by the DisCos will create more burden beyond 2018 on how gas supplies to GenCos will be guaranteed, thus making it more of a bail-out than part of a recovery plan. However, juxtaposing this facility with the entirety of the PRSP suggests a plan that supports a credible move towards achieving an efficient and self-sustainable market. Pertinently, the aim to implement an electricity tariff trajectory that ensures cost reflective end-user tariffs in the next five (5) years, and, commit to fund future sector deficits (2017 – 2021) while also improving DisCos performance by designing balanced incentives to ensure aggressive ATC&C loss reduction will be key to the success of this facility. In our view, proper

implementation of this facility will help support the sector in the short term and meet liquidity challenges. However, eliminating historical deficit and debt will be key to its success even as the sustainability of funding future deficit and improving efficiency remains a cause for concern.

Electricity Market Support: Subsidy in another form

Given its plan to restore cost reflective end user tariffs over 5 years, the FG proposes a 50% tariff increase in July 2017 for all the Industrial, Consumer, and Special customer segments (i.e. all customer except class R1, R2 and C1). Furthermore, the R2 customer class will be disaggregated and the portion not requiring FGN support (approximated as half) will experience an increase by January 2018 while tariffs for R1, vulnerable former R2, and C1 will be increased by July 2019. Thus, in terms of funding future deficit, the PRSP proposes the 'Electricity Market Support' which we consider as another form of subsidy. FG has committed to making up the difference between the cost that the tariff allows market participants to recover and the full cost of supply.

Based on analysis, the estimated cost of this support is ₦2.3trillion ($5.9billion) over the five-year period. Funding for future shortfalls has been envisaged from the sale of government owned power plants, multilateral borrowings, and the national budget. While details remain sketchy, work is ongoing to elaborate in detail the mechanism for funding the shortfall taking account of fiscal space considerations as well as the detailed mechanisms on how the funding will be provided to market participants in tandem with regulator, governance, and institutional reforms under the PRSP to enforce market discipline.

Indeed, based on the current power sector model (2005), revenue shortfalls—were anticipated and modelled as high ATC&C losses embedded in the entire value chain—were to be funded by the FG through monthly subsidies. Precisely, the proposed rulemaking on transitional trading arrangement and financial settlement system published by NERC in July 2008 states that "…Given the revenue inadequacy which will now be funded by the subsidy in the first three years of the MYTO, the shortfall between the obligated payment and actual revenues collected, will be met by the Government monthly." That said, given fiscal revenue challenges and burdens associated with funding subsidies, we doubt the sustainability of the subsidy scheme post 2019 election.

Bringing it all together, the success of the PRSP and the long-term sustainability of the country's power sector is highly hinged to the performance of the DisCos; their ability to collect revenue from customers for electricity consumed and aggressively reduce the high ATC&C losses. This helps to boost energy efficiency—an important point missing in the PRSP. Thus, implementation of restructuring and recapitalization plans of the DisCos, improving DisCos technical competence and financial status will be key to the success of the plan and create a sustainable and viable electricity market. Hence, full implementation is key.

PIGB: The 'tip of the iceberg' garners optimism

Back and forth on the Petroleum Industry Bill (PIB) in the last 9 years has deterred investment in Nigeria's Oil and Gas sector. The PIB, which has gone through the past two administrations, is a wholesome bill which caters for every aspect of the industry and aims to increase petroleum exploration and production, boost domestic gas supply, deregulate the downstream sector of the Industry, establish a viable national oil company, create an efficient regulatory entity, and enhance transparency and accountability in the Industry. However, the extensive provision of the PIB that cuts across fiscal, governance and regulatory matters has sparked a lot of debate in the country and thus affected its passage. Central to the debate are fiscal issues that relates to increase deep-water and gas tax rates as well as introduction of the 10% host community fund. Pertinently, the current administration adopted a logical approach to allow for passage of the non-controversial section of the bill, thus splitting the PIB into four (4) bills – The Petroleum Industry Governance bill (PIGB), The Fiscal Regime bill, The Petroleum Revenue bill, and the Upstream and Midstream Administration bill.

Consequently, the senate, in May 2017, passed the PIGB which addresses the administrative aspect of the proposed PIB and provide for the governance and institutional framework for the petroleum industry and for other related matters. The PIGB seeks to establish a framework for the creation of commercial and profit oriented petroleum entities, which should ensure value addition and internationalization of the Nigerian oil & gas industry. Central to the provision of the bill is the plan to restructure the NNPC to a new regulatory agency, Nigeria Petroleum Regulatory Commission (NPRC). The commission would be the sole regulator and responsible for licensing, monitoring, supervising petroleum operations,

as well as enforcing Industry laws, regulations, and standards. Accordingly, the NPRC will be vested with the roles, rights, assets, liabilities, and obligations of the Petroleum Inspectorate, the Department of Petroleum Resources (DPR) and the Petroleum Products Pricing and Regulatory Agency (PPPRA). Furthermore, the regulatory functions of the Minister of Petroleum Resources, under the Petroleum Act and the Oil Pipelines Act, will also be transferred to the Commission, thus limiting the mammoth power of the Minister to only determine, formulate, and monitor government policy for the ministry as well as supervise the affairs and operations of the industry[4].

Elsewhere, the portfolio of the NNPC has been reorganized into 3 different entities – the Ministry of Petroleum Incorporated (MOPI), the National Petroleum Company (NPC) and the National Petroleum Asset Management Company (NPAMC). The MOPI, which is to be incorporated upon the presidential assent of the PIGB, will be solely for holding the FG's shares in successor commercial entities. In addition, the NPC is to be an integrated oil and gas company operating as a fully commercial entity across the energy value chain, and is meant to manage all the assets held by NNPC except the Production Sharing Contracts (PSC) and back-in Rights assets. On the other end, NNPC's assets under the PSC and back-in rights provision shall be managed by the NPAMC. Thus, the NPAMC shall be vested with about 25 oil and gas licenses which are mostly in the hands of the Nigerian Petroleum Development Corporation (NPDC) currently. Though the PIGB requires the FGN to privatize close to 40% of the NPC's and NPAMC shareholding within 10 years of its incorporation, the bill was vague with regards to terms of divestment, though listing on the stock exchange remains a viable means.

For us, the key positive of the PIGB include the creation of efficient and effective governing institutions with clear and separate roles for the petroleum industry. Also, we expect this bill to promote transparency and accountability in the petroleum industry as well as the creation of a conducive business environment for the operators. To add, given its role in facilitating the establishment of a framework for the creation[5] of commercially oriented and profit-driven entities that will ensure value-addition and internationalisation of the petroleum industry, we view this bill as the right step in the right direction towards the effective regulation and efficiency of the oil sector. That said, while the PIGB is historic for the sector

[4] Minister's powers to grant, amend, renew, extend, and revoke petroleum exploration and production licenses and lease are now transferred to the NPRC

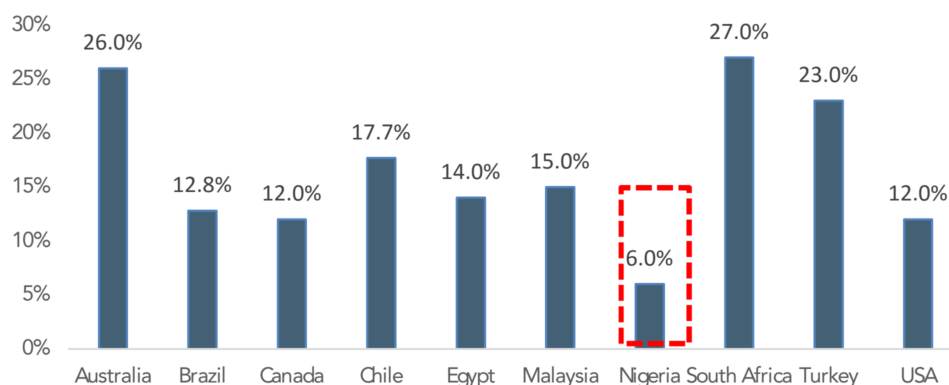
[5] out of existing government-owned entities

and creates optimism for passage of other bills, its impact with respect to investment in the sector, particularly the upstream sector remains limited. Importantly, the fiscal provisions which affects the upstream investment is not captured in the PIGB. Perhaps, the Petroleum Industry Fiscal Bill, which defines the revenue and tax structure of the sector, will be critical to scale up the level of investment in the sector. Overall, the PIGB creates optimism regarding the passage of the other bills that will unlock the investment opportunities in the industry even as the regulatory reforms in the PIGB bodes well in dealing with administrative issues that are central to the growth of the oil industry.

New National Tax Policy: Banking on implementation

The Federal Executive Council on February 2017 approved the new National Tax Policy—initially published in 2012. The document was bore out of the need to widen Nigeria's tax base, and urgency following the implications lower oil prices and production, in some instances, had on financial fortunes of all tiers of the government. The key objective of the revised policy is to increase Nigeria's non-oil tax revenue to GDP to 20% from current 6% and improve Nigeria's ranking on the global ease of paying taxes index to top 50 by 2020[6]. Parsing through the document, the revised policy sets five key objectives; the operations and review of the tax system; provide the basis for future tax legislation and administration; serve as a point of reference for all stakeholders on taxation; provide benchmark on which stakeholders shall be held accountable; and provide clarity on the roles and responsibilities of stakeholders in the tax system

Figure 5: Tax to GDP Ratio (2016) of Some Selected Countries



Source: World Bank, ARM Research

[6]Nigeria currently ranks 181 out of 189 economies in the global ease of paying taxes

Irrespective of the objectives and the potential of taxation as a major source of government revenue, Nigeria's tax system currently remains bewildered with challenges ranging from a lack of robust framework for the taxation of the informal sector and high network individuals (HNIs), fragmented data of taxpayers, insufficient capacity, obsolete tax laws, unorthodox tax collection system and poor accountability of tax revenue. This revised tax policy seeks to address these challenges and contains measures designed to address duplication of taxes and multiplicity of revenue agencies as well as reduce income tax rates and compliance burden for MSMEs.

Overall, the reviewed policy remains haughty but creditable, even as implementation and other recommendation for review will be key to the achievement of the said objective. In terms of the recommendation, one of the significant recommendation is the immediate repeal of the Value Added Tax (VAT) Act, and its replacement with an entirely new VAT Act to align with global best practices. Some major considerations include expansion of allowable input VAT, introduction of registration threshold as well as progressive VAT system which posit higher VAT rate for luxury items and increase in exemption majorly for basic items. Elsewhere, the policy advocates the removal of the Stamp Duty Act (SDA) and the presentation of a new SDA which will specify the specific instruments to be stamped and duty rate. Another key recommendation is the elimination of special rules in Companies Income Tax Act (CITA) which places needless compliance burden on tax payers and leads to multiple taxation[7]. Lastly, enactment of new laws to cover areas where no specific legislations exist, such as the taxation of Real Estate Investment Trusts (REITs) was recommended. On Implementation, the policy provides a framework to guide and monitor implementation.

[7] Modification of the minimum tax rule in section 33 of CITA to eliminate discriminatory provisions against Nigerian businesses and alleviation of punitive impact on loss-making businesses. Also, removal of the exemption from minimum tax of foreign companies with at least 25% imported equity capital on the basis that it is discriminatory against Nigerian companies.

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