

SPARC Briefing Note: Implications of Declining Oil Price for State Governments (February 2015)

Summary

A summary of the key issues facing states and the implications for the 2015 budget implementation and beyond are summarised below.

Key Issues:

1. All ten SPARC states over estimated their Federal Transfers in 2014 (to varying degrees). Performance varied from 70% at worst (Yobe) to 98% at best (Zamfara). Average (un-weighted) performance across the states was 79% performance or an NGN 8.7 billion short-fall compared to budget (see Figure 2).
2. Bonny Light Crude Oil Price has almost halved over the last six months – it has declined from average of almost \$110 per barrel in first half of 2014 to \$60 per barrel by the end of the year, and has seen further declines in the first half of January 2015. Based on this, the Benchmark Crude Oil Price for 2015 has been reduced to \$65 from \$77.50 in 2014. The production benchmark has also decreased by 5% to 2.25 million barrels per day (see Figure 1 and Figure 5).
3. The Excess Crude account is considerably depleted (currently US \$3 billion) and is unlikely to be accrued to in 2015 – states cannot rely on any excess beyond potential augmentations to Statutory Allocation to achieve the \$65 per barrel benchmark (see Figure 3).
4. There is a great disparity between states in terms of the level of recurrent expenditure (Personnel and Overheads) – it might be considered that some states' expenditure is too high (see Figure 4 and Figure 5) which may be an indication of the size of their workforce and cost administration.
5. Most states are still heavily dependent on mineral based revenue, which are finite, to fund their recurrent expenditure.

Implications / Recommendations:

1. In the short term, states could consider adjusting their 2015 budgets according to the above revenue issues (some SPARC states, including Niger and Zamfara, have done this, following advocacy from SPARC and SAVI) – adjustments could target prudent overhead expenditure and prioritisation of capital expenditure projects – finish existing projects first.
2. In the medium to long term, states must increase effort on improving IGR generation and seek a long term sustainable recurrent account balance that is not dependent on mineral revenues (both through increased IGR and rationalisation of recurrent expenditure).
3. The budgeting process needs to be more flexible to changes in the mineral sector and could utilise tools and processes developed by SPARC for resource estimation and

allocation. Furthermore, the ExCo and SHoAs must be sensitised to the issues faced by its administrative branch.

4. There needs to be a prioritisation of Capital Expenditure projects (both in terms of allocation of funds, and execution) and use of source of funds classification.
5. There could be more efficient procurement processes that yield more value for money spent. The SPARC supported procurement manual should facilitate this objective, and SPARC has supported several states to make significant VFM savings – such as Enugu.
6. Information needs to be more publically available, earlier in the budget cycle. DFID and FEPAR could have more robust engagement with the Federal Medium Term Fiscal Forecasts and Strategy, and with the Federation Account Allocation Committee (FAAC) in terms of transparent access to data. There needs to be similar improvement in transparency at state level.
7. Performance needs to be better monitored, and reported, so that as many people as possible know what is happening against the revenue and expenditure promises in state budgets – there is a major role for State Houses of Assembly, civil society and the media, facilitated by SAVI (as long as information is publically available).
8. DFID and its programmes need consistent messaging around fiscal issues – particularly ensuring that both governance and sector programmes are speaking with one voice.

Overview of the contribution of Nigeria's Mineral Sector to State Revenue

Statutory Allocation is a centrally pooled revenue stream from the Mineral Sector (predominantly crude oil) and Non-Mineral (Company Income Tax and Customs and Excise) that is then distributed, monthly, to the three tiers of government (Federal, State and Local). State governments collectively share 26.72% of the Statutory Allocation pool (after a deduction of 13% of mineral revenue which is channelled directly to oil producing states). Each state then receives a share based on 10 ratios dominated by equality and population.

The level of revenue distributed from Mineral Revenue depend on “benchmarks” for crude oil price, production and the NGN:USD exchange rate. Any mineral revenue that is accrued above that implied by the benchmark is held in the “Excess Crude” account which is then distributed ad hoc to augment in months where there is a short-fall of revenue compared to the benchmarks, or for other reasons.

Historically, Mineral Receipts have made up around 75% of Statutory Allocation, hence illustrating the impact of volatility of the production and price.

Non-Mineral receipts have been growing steadily (almost 20% per annum in nominal terms) over the last 6 years, largely due to sustained economic growth and inflation (which has been more than 10% per annum over the same period). Heading 3: Add your text here

What has been happening to Oil Prices and Why

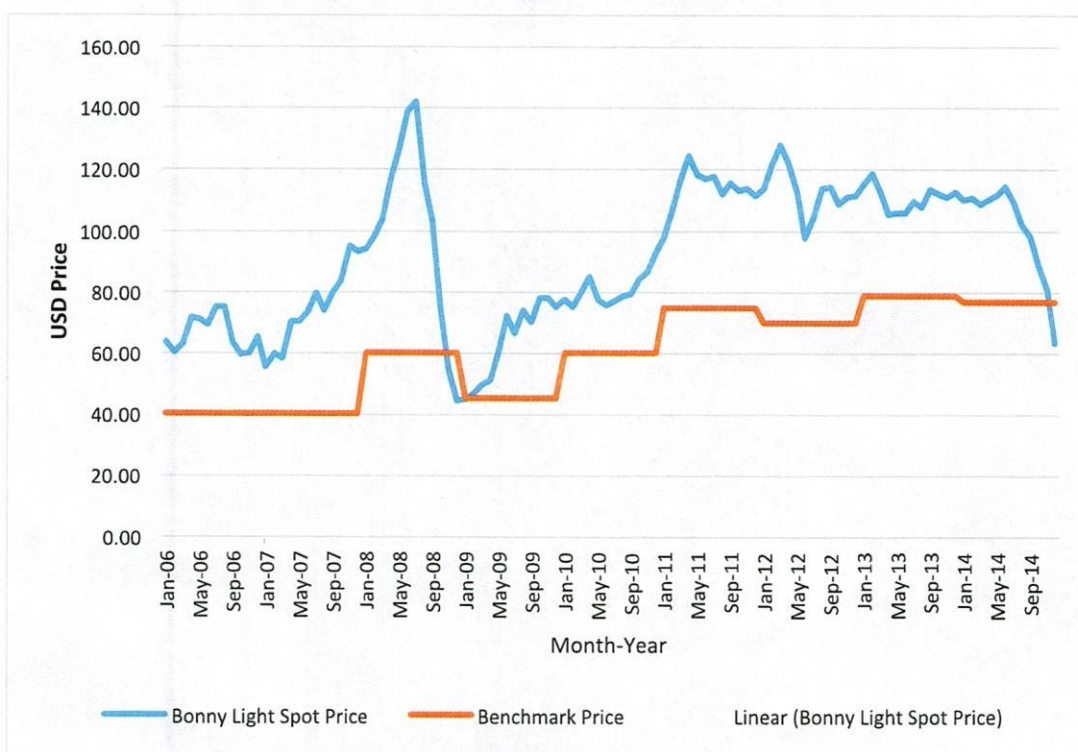
There has been plenty of news coverage on the reasons for the current oil price decline with both supply (increase) and demand (reduction) causing a decline in price. Supply has been

boosted by fracking activities, particularly in the USA. At the same time, economic growth rates in some of the world's dominant economies are falling (specifically, China and USA). OPEC has also taken the decision to maintain current production levels in the hope that the declining oil price will make some production financially unviable and hence drive competition out of the market.

The result has been a sharp decline in global oil prices over the second half of 2014 from a high of \$114 per barrel in June to \$63 per barrel in December (Bonny Light), and further declines in January 2015 (which as at January 20th was \$49.80 per barrel). This comes after three years of relatively stable price between around \$100 and \$120 per barrel.

The trend in price for Bonny Light crude and the benchmark (for budget purposes) is shown below.

Figure 1: Bonny Light Crude Oil Price and Benchmark (2006 to 2014)



(Note that the Bonny Light prices for October to December 2014 are estimates only).

2014 Federal Transfer Performance

Statutory Allocation – the level of Statutory Allocation for 2014 was entirely consistent (98% performance) with the figures anticipated using the 0.4 rule for mineral revenue and the benchmarks for price (\$77.50), production (2.3883) and NGN:USD Exchange rate (160), and elasticity based forecast for non-mineral revenue. It represented a small (around 1.5%) decline for receipts in 2013.

Some states clearly over anticipated Statutory Allocation – likely due to adoption of incremental budgeting based on previous growth rates (generated by increases to the oil price and production benchmarks) rather than elasticity based forecasts (as noted above, the benchmark price for 2014 was actually below that for 2013).

VAT - at the aggregate level, VAT receipts were static in 2014 compared to the previous year (in fact there was a very marginal decline). This is compared to average annual growth rates of almost 18% over the last seven years. It should be noted that this slow down only occurred in the second half of 2014. This is surprising and further analysis of this should be undertaken when forecasting for 2016 (particularly to see if there was a slow-down in economic growth which might have been caused by the oil price declines), and 2015 estimates should be carefully monitored.

It should also be noted that there was a re-basing of VAT allocation to states in October 2014. Anambra (8% reduction equivalent to around NGN 760 million annually), Kaduna (3% reduction, NGN 360m annually) and Katsina (3% reduction, NGN 310m annually) were the biggest losers, whereas Enugu (13% increase, NGN 990 million annually), Kano (2.5% increase, NGN 330m annual) and Yobe (2.5% increase, NGN 175m annual) saw increases.

This was likely due to collection levels by states which are remitted to FIRS.

Excess Crude – this includes all distributions above and beyond Statutory Allocation – these are usually classified as Augmentation (in theory these are to top up the Statutory Allocation in the months when it falls short compared to the budget, but in practice it is not as predictable), Excess Crude (usually exchange gains and other excesses based on price, production and FX rates above the benchmark – again distributed sporadically), Refunds (NPPC) and SURE-P (the fuel subsidy re-investment programme).

In 2014, SURE-P was distributed every month at the same rate (and at the same rate (approximately) as was distributed in 2013). The last three months of a three year programme of NNPC refunds were distributed in January to March 2014. There was no augmentation in 2015 (as above, Statutory Allocation was in line with budget). Excess crude was only distributed in five months (June, July, September, October and December).

The result was a decline of more than 50% in Excess Crude receipts in 2014 compared to 2013 and more than 35% below the average of the last 7 years.

Performance compared to State Budgets – as noted in the summary, all ten SPARC states over-estimated federal transfers for 2014. Yobe has the largest performance gap – they over budgeted across the board for Statutory Allocation, VAT and Excess Crude resulting in a 30% or NGN 21.6 billion short-fall. Yobe's IGR has also suffered in recent years due to the impact of Boko Haram on the economy. Niger state over-budgeted for Statutory Allocation by NGN 22 billion resulting in an overall 25% short-fall against budget (NGN 20.5 billion). Kaduna and Jigawa also over-budgeted, again for Statutory Allocation and Excess Crude, with their short-falls being 18% (NGN 14.7 billion) and 11% (NGN 7.6 billion) respectively

The remaining six states achieved between 90-100% performances with Zamfara achieving the highest accuracy at 98%.

As noted above, the key issue in over budgeting has been the use of increment (percentage increases) in estimates for Statutory Allocation (and Excess Crude). The previous growth in Statutory Allocation, which has grown by an average of 13% per annum between 2007 and 2013 (almost doubling over the period), has been the near doubling of the Benchmark Oil price (see Figure 1 above). As the benchmarks plateau (or fall as is the case for 2015), the growth will not continue. This has to be taken into account during the budgeting process.

A summary of state's federal transfers (Budget and Actual) is presented in the figure below.

Figure 2: FAAC Performance 2014

State	Item	2014 Budget	Full Year	Performance vs budget	Short-Fall / Surplus	Performance Graph				
						25%	50%	75%	100%	
Anambra										
	Statutory Allocation	56,600,000,000	38,265,371,963	67.6%						
	VAT	0	9,236,514,576							
	Excess Crude	0	5,614,503,969							
	Anambra Total	56,600,000,000	53,116,390,508	93.8%	-3,483,609,492					
Enugu										
	Statutory Allocation	48,300,000,000	38,703,395,604	80.1%						
	VAT	9,000,000,000	8,065,453,161	89.6%						
	Excess Crude	0	5,648,297,829							
	Enugu Total	57,300,000,000	52,417,146,594	91.5%	-4,882,853,406					
Jigawa										
	Statutory Allocation	46,000,000,000	43,038,352,389	93.6%						
	VAT	10,500,000,000	9,547,477,853	90.9%						
	Excess Crude	10,000,000,000	6,301,640,129	63.0%						
	Jigawa Total	66,500,000,000	58,887,470,371	88.6%	-7,612,529,629					
Kaduna										
	Statutory Allocation	71,790,000,000	50,424,435,633	70.2%						
	VAT	11,550,000,000	10,794,646,636	93.5%						
	Excess Crude	0	7,375,879,168							
	Kaduna Total	83,340,000,000	68,594,961,437	82.3%	-14,745,038,563					
Kano										
	Statutory Allocation	57,200,000,000	61,044,393,080	106.7%						
	VAT	12,600,000,000	14,360,418,116	114.0%						
	Excess Crude	16,832,268,100	8,940,542,461	53.1%						
	Kano Total	86,632,268,100	84,345,353,658	97.4%	-2,286,914,442					
Katsina										
	Statutory Allocation	48,010,832,155	47,307,667,317	98.5%						
	VAT	11,000,000,000	10,441,248,469	94.9%						
	Excess Crude	12,000,000,000	6,922,079,179	57.7%						
	Katsina Total	71,010,832,155	64,670,994,965	91.1%	-6,339,837,190					
Lagos										
	Statutory Allocation	74,000,000,000	51,555,950,084	69.7%						
	VAT	65,000,000,000	72,068,084,538	110.9%						
	Excess Crude	300,000,000	7,596,124,371	2532.0%						
	Lagos Total	139,300,000,000	131,220,158,994	94.2%	-8,079,841,006					
Niger										
	Statutory Allocation	69,699,539,654	45,586,679,657	65.4%						
	VAT	9,220,585,968	8,753,195,590	94.9%						
	Excess Crude	2,616,327,854	6,676,521,875	255.2%						
	Niger Total	81,536,453,476	61,016,397,122	74.8%	-20,520,056,354					
Yobe										
	Statutory Allocation	50,263,195,000	38,216,230,219	76.0%						
	VAT	10,029,723,000	7,399,094,039	73.8%						
	Excess Crude	12,520,406,000	5,589,998,276	44.6%						
	Yobe Total	72,813,324,000	51,205,322,534	70.3%	-21,608,001,466					
Zamfara										
	Statutory Allocation	45,121,821,455	38,297,619,630	84.9%						
	VAT	8,000,000,000	8,118,907,189	101.5%						
	Excess Crude	0	5,612,220,383							
	Zamfara Total	53,121,821,455	52,028,747,202	97.9%	-1,093,074,253					

90% or better performance
 85-90% performance
 Less than 85% performance
 Full Year Performance

Implications of the Oil Price, Macro-economic assumptions and 2014 Accounts for 2015 Budget

Oil Price Outlook – as with the analysis of why the price has dropped, there are many forecasts available for oil prices for 2015 and beyond. A simplistic comparison is to look at what happened in 2008 (Global Financial Crisis) when prices fell from over \$140 per barrel to \$45 in the space of six months (almost 70% decline) and the subsequent recovery (as per Figure 1 above) – however, the underlying factors were different (it was more due to demand than supply – supply being considered the major factor behind the current price reduction). Another analysis would be to look at the long term trend (again as is shown in Figure 1 above) and consider the rate at which the trend should be discounted for benchmarks – ideally at least 30% to account for short-term shocks.

In its latest Short-Term Energy Outlook,¹ the US Energy Information Agency (EIA) expects global oil inventories to continue to build in 2015, maintaining the current downward pressure on oil prices. The forecast Brent crude oil price averages \$58 per barrel in 2015 – Bonny Light is usually several dollars higher than Brent Crude so a price of marginally above \$60 per barrel can be anticipated.

Based on current market balances, EIA expects downward price pressures to be concentrated in the first half of 2015 when global inventory builds are expected to be particularly strong. By the fourth quarter, Bonny Light could be expected to break above \$70 per barrel. However, some short-term fluctuations may well take the price above \$65 in within the first six months of the year.

Statutory Allocation – assuming Nigerian economic growth (effecting customs and excise and corporate tax) is not severely impacted by the oil price decline, the benchmarks for 2015 suggest that states should anticipate Statutory Allocation to reduce by approximately 5-10% compared to 2014. The estimates for Statutory Allocation (SA) are shown in **Error! Reference source not found.** below and are disaggregated into the mineral and non-mineral components.

VAT – real GDP growth has been forecast down for 2015 from 6.35% to 5.5% - this is likely to have an impact on VAT. Also as noted above, 2014 receipts were lower than anticipated (zero growth from 2014), so 2015 receipts will be growing from a lower base. Receipts in the first few months should be monitored carefully.

Excess Crude Account - The excess crude account has also been depleted considerably – it currently (as at 31st January) has funds of around US \$2.3 billion – the value of this to each state is shown in the table below. Given that the current crude oil price is below the proposed benchmark for 2015 (and is likely to remain that way for the year), the excess crude is unlikely to be topped up during 2015. The US \$2.3 billion would be enough to augment statutory allocation for a year at a price short-fall of \$5 per barrel compared to the benchmark (i.e. \$60 per barrel compared to the \$65 benchmark) if it were to be fully depleted.

¹ <http://www.eia.gov/forecasts/steo/report/prices.cfm>

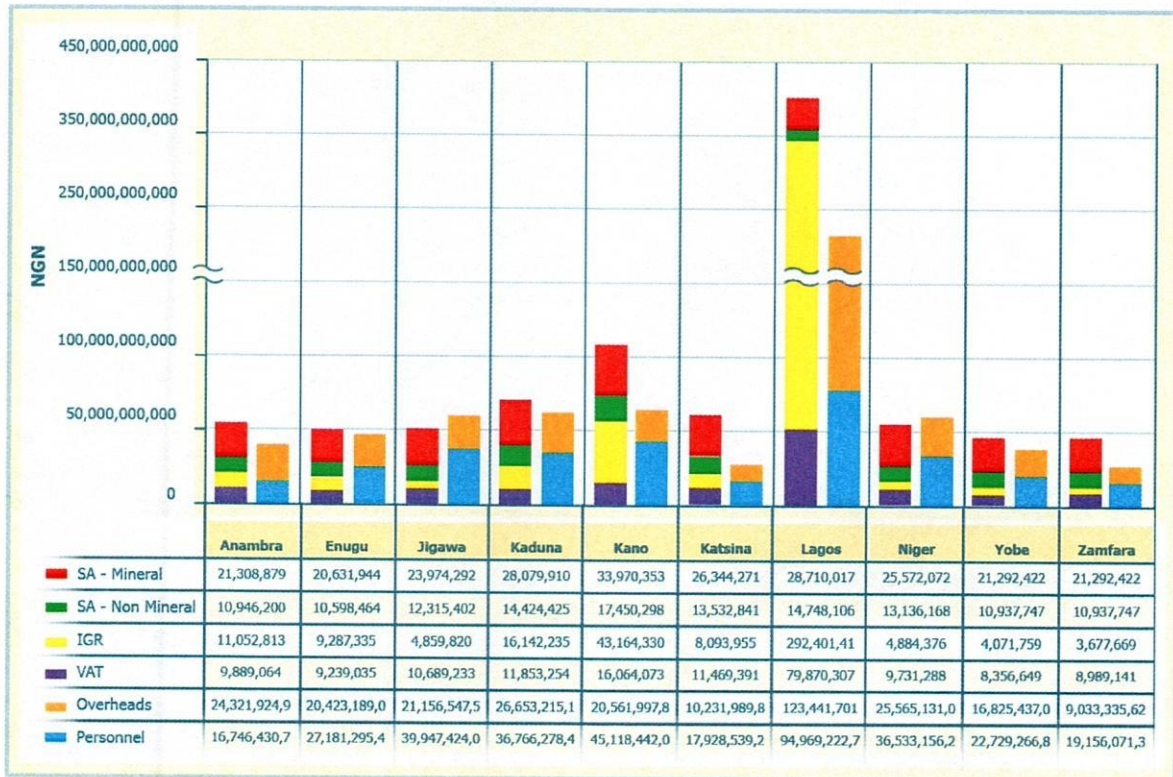
Figure 3: Excess Crude Funds by State

State	Anambra	Enugu	Jigawa	Kaduna	Kano
Average Annual EC since 2007	9,191,346,521	7,866,386,071	10,041,760,888	11,533,434,776	13,994,358,328
Value of EC Account to State at end 2014	2,313,152,722	2,239,669,111	2,602,492,596	3,048,171,612	3,687,599,678

State	Katsina	Lagos	Niger	Yobe	Zamfara
Average Annual EC since 2007	10,941,769,975	12,897,171,723	10,437,335,086	8,898,249,260	8,925,375,118
Value of EC Account to State at end 2014	2,859,762,073	3,116,571,986	2,775,937,096	2,311,366,306	2,311,366,306

A summary of estimated recurrent revenue (Statutory Allocation (SA), split into Mineral and Non-Mineral components), VAT and IGR) and recurrent expenditure (Personnel and Overheads) is provided in the graph below.

Figure 4: 2015 Recurrent Revenue (excluding Excess Crude) and Expenditure Estimates for SPARC States



Major Issues –In the absence of excess crude distributions, two states (Niger and Jigawa) are forecast to run a current account deficit – meaning there is insufficient recurrent revenue to pay salaries and overheads costs.

Enugu, Kaduna and Yobe will all have minor current account surpluses (although this may turn to deficit depending on debt servicing obligations). There remaining five SPARC states still have reasonable (or better) surpluses - Anambra (NGN13 billion), Kano (NGN46 billion), Katsina (NGN26 billion), Lagos (NGN235 billion) and Zamfara (NGN17 billion).

What is likely to happen if states run out of money – There is little chance of “bailout” or emergency lending from banks and IFI’s. Any international bailout would have to be backed by Federal Government which, based on the delays on approving DPO’s, will probably not be forthcoming quickly. Banks would charge a significant risk premium which for most states would result in very high interest rates.

In the absence of commitment controls and/or formal adjustment of the budget, there is likely to be a build-up of payment vouchers in treasury for which there is insufficient cash to service. In turn, without effective treasury management system, there will be no structured prioritisation of vouchers. This could lead to “favouritism” both to suppliers (overhead and capital vouchers) and even personnel. Ultimately there will be stricter rationing meaning assets will not be serviced, and service will not be delivered to civil society. Contractors will likely halt work or demand advance payment.

There will likely be significant pressure to distribute the remaining excess crude resources, but these have already been depleted from USD 3.3b to USD 2.3 billion in January 2015 (as noted above) leaving very little resource.

The IMF have recently published a Technical Note on expenditure arrears which identifies several economic and fiscal impacts²:

1. Reduced Economic Growth –as government is a core sector of the economy;
2. Increased cost of service provision – as suppliers increase the cost of providing good/services to government;
3. Reduced or interrupted service delivery – as suppliers withhold goods and services;
4. Increased rent-seeking – and collusion between government and suppliers;
5. Increased interest rates – as there is more demand for liquidity both on the part of government (potentially short-term borrowing) and suppliers (bridging);
6. Reduced confidence in Fiscal Policy – brings into doubt the budget process and the extent of government liabilities; and
7. Second round fiscal costs – as suppliers withhold tax and other social contributions.

² <http://www.imf.org/external/pubs/ft/tnm/2014/tnm1403.pdf>

Recurrent Account Break Even Oil Price

As noted above, although the Oil Price benchmark for 2015 has been set at \$65 per barrel, the spot price has been threatening to drop below \$50 per barrel in the first half of January 2015. Further to this, and as also noted above, there are limited funds in the Excess Crude account to augment the Statutory Allocation.

It is therefore appropriate to assess at what oil price states will effectively have a zero current account surplus / deficit. A zero balance implies no transfer to capital account. The calculations below are based on VAT, IGR and Recurrent Expenditure as above, and the oil production and macroeconomic assumptions (NGN:USD FX rate, national real GDP growth and inflation) as per the Federal Budget assumptions for 2015, then looking at oil price at which total recurrent expenditure = total recurrent revenue.

Three SPARC states, Kano, Katsina and Lagos, would still have a recurrent account surplus without the mineral component of Statutory Allocation in 2015. For Katsina, this is due to modest recurrent expenditure (forecast to be less than NGN 35 billion in 2015), whereas for Kano and Lagos, it is due to significant IGR collections (Lagos, VAT too).

Anambra and Zamfara are also relatively well protected from Oil Price shocks (needed oil prices of \$25 and \$14 respectively), again largely due to having modest recurrent expenditure.

Jigawa, Kaduna and Yobe all need an oil price benchmark of around \$45 to break even – the benchmark has been above this level since 2008.

At the current benchmark of \$65 per barrel, Enugu has a small recurrent account surplus of NGN 3.3 billion, and at an oil price of \$55, there would be zero balance. Although their recurrent expenditure is not necessarily excessive, IGR collections are weak as is their overall FAAC allocations. As noted above, since the oil price is now little over \$50 per barrel, there is cause for concern.

Finally, Niger state is likely to run a recurrent account deficit even at the \$65 benchmark price – in fact it will require \$85 per barrel (this excludes Excess Crude) to fund its recurrent expenditure. This is due to both large personnel and overhead costs as well as low IGR and a lower allocation from Federal Government than some of the other larger spending states.

Figure 5: 2015 Recurrent Account and Break Even Price

State	Scenarios based on 2013 Actual				
	Rec. Revenue	Personnel	Overheads	Surplus / Deficit	Break Even Price
Anambra	54,052,918,425	16,746,430,719	24,321,924,900	12,984,562,806	\$25
Enugu	50,732,134,980	27,181,295,472	20,423,189,016	3,127,650,493	\$55
Jigawa	52,983,153,170	39,947,424,000	21,156,547,500	7,312,181,670	\$45
Kaduna	71,896,028,796	36,766,278,415	26,653,215,171	8,476,535,210	\$45
Kano	111,637,667,889	45,118,442,057	20,561,997,884	45,957,227,949	\$0
Katsina	60,599,781,702	17,928,539,231	10,231,898,882	26,525,651,586	\$0
Lagos	416,282,613,432	94,969,222,743	123,441,701,210	235,611,533,465	\$0
Niger	54,151,322,960	36,533,156,232	25,565,131,007	- 7,946,964,279	\$85
Yobe	45,513,981,520	22,729,266,828	16,825,437,050	5,959,277,641	\$47
Zamfara	44,754,354,655	19,156,071,357	9,033,335,628	16,564,947,670	\$14

Benchmarks	Assumptions
Oil Price	\$65.00
Oil Production	2.2782
NGN:USD Rate	165
Real GDP Growth	5.50%
Inflation	7.90%
SURE-P % of 2014	38.19%

It should be noted that this analysis does not include Debt Servicing / Repayments costs or potential arrears that will need paying off in 2015 since the data is not immediately available.

Levels of Recurrent Expenditure and IGR

Within the context of trying to balance (at worst) the recurrent account and becoming less dependent on oil price, when assessing the level of recurrent expenditure and IGR by states, it would be useful to have analysis against the following:

Population – the higher the population, the higher the cost of providing public services (particularly Health and Education). However, the latest census data is from 2006 and is likely not reflective of current state populations.

State GDP – particularly in relation to IGR, the relative collections levels should be in part proportional to state GDP. State estimates are currently being prepared with support from NPC – once this is in place, such analysis would be useful.

State Owned Assets – the higher the level of state owned assets, the higher the cost of operating and maintaining them, hence overhead expenditure. This would rely on recent accurate valuation of state assets in the statutory accounts.

Recommendation for Long Term Recurrent Account Financing Target

It is typical in many states for VAT to be classified within the budget as a “Capital Receipt” insofar as states should use VAT to fund capital expenditure. This is a fallacy. It is more reasonable to suggest that States should look to cover their recurrent expenditure with VAT, IGR and the non-mineral element of Statutory Allocation (Company Income Tax and Customs and Excise) – these revenues are recurrent in nature (i.e. they will be collected in

perpetuity) whereas revenues flowing from crude oil production are finite and should be used for Capital Expenditure only.

Both Figure 4 and Figure 5 provide illustration of how close the SPARC states are to this. It is effectively saying states can run their recurrent accounts with a zero oil price (Figure 5, although this does include SURE-P), graphically it is equivalent to removing the red segment of the revenue bar in Figure 4 but still achieving balanced bars (i.e. the revenue bar is at least as high as the expenditure bar).

Notes on Assumptions and Data source

The following assumptions and sources of data were used in preparing this paper:

2013 state accounts (2011 in Katsina) were used to estimate recurrent expenditure and IGR receipts in 2015 using a 10% annual growth rate (this is largely in line with historical trend).

For mineral revenues, the mineral multiplier of 0.4 was used to assess the impact of the oil benchmarks, and elasticity (using Real GDP Growth and Inflation) based forecasts (5 year moving average excluding outliers) were used to forecast non-mineral receipts (Customs and Excise, Company Income Tax and VAT). Historical Real GDP and Inflation figures from IMF (www.imf.org), historical Customs and Excise data available up to December 2013 only (from State FAAC packs).

Bonny Light Crude Oil Price data up to September 2014 was sourced from Central Bank of Nigeria (www.cenbank.org). The prices for October – December 2014, which are not yet available from CBN but are of importance, are based on the average monthly price for Brent Crude over the period multiplied by the average historical (3 year) ratio Bonny Light to Brent Crude price.

Data on Federal Transfers are available from the Federal Ministry of Finance (www.fmf.gov.ng) up to and including October 2014. Figures for November and December 2014 were gained from external news sources (www.nigerianmuse.com and www.nigeria.gov.ng).

Finally – what we don't know

The above analysis does not take into consideration assets (opening balance) and liabilities (commitments, vouchers and arrears) of state governments that may have significant effect on their fiscal position. The reporting of the items is not always transparent and for 1st January 2015, not available. Obviously assets will lessen the short-term impact of the oil price fall whereas liabilities would increase the severity of the impact. We also have limited access to reconciled debt data.