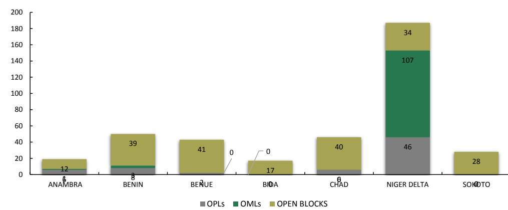
OPEC Advocates Sturdier Cords, as Nigeria seeks to Recoup Revenue Arrears from Oil Majors

DOMESTIC MARKETS

Oil Exploration Breakthrough in Gongola Opens up New Frontiers

On October 10, the NNPC drilling crew working at Kolmani River-II in Gongola Basin encountered hydrocarbon outflow to the wellhead while testing. Preliminary evidence from the exploration area revealed that the hydrocarbon deposits consist of gas, condensate and light, sweet crude of API gravity between 38 and 41 degrees. While the bulk of Nigeria's energy wealth is concentrated in the prolific Niger Delta, exploration for oil in the North East (Gongola and Chad basins) picked up recently, and this particular find is a major victory for NNPC in its quest to identify new hydrocarbon basins outside of the South South region. The exploration team is yet to provide estimates of hydrocarbon quantities, but should the find be significant, Nigeria's Reserve : Production ratio just got a major boost. Besides, this event is expected to spur concerted exploration in and around the region for more hydrocarbon deposits. New, commercially viable finds can coincide with the complete overhaul of the four national refineries (including Kaduna) scheduled for completion around 2023. Crude and Gas feedstock can come from that area to the Kaduna refinery, rather than transporting via pipelines from the South-South. This find is also significant because it opens up opportunities for new Oil and Gas infrastructure (including pipelines, terminals & gas processing facilities) to reduce Nigeria's deficit and underdeveloped value chain within the sector. We also expect that investors will tap the potential of modular refineries to process crude and facilitate development of the regional value chain. Meanwhile, new retail stations will open up a nascent export market in neighboring Chad and Niger. Thermal power stations in and around the North-East/North-West will also benefit of gas (Associated/Non-Associated) from the discoveries. However, the key investment risk that regulators including NNPC, DPR (and others enabled by the upcoming PIGB) have to mitigate, is the security conundrum in the region. There are indications that this discovery might open up conversations around resource control and a review of the derivation formula.

Chart 1: Distribution of Production Licenses & Oil Blocks in Nigeria (2018)

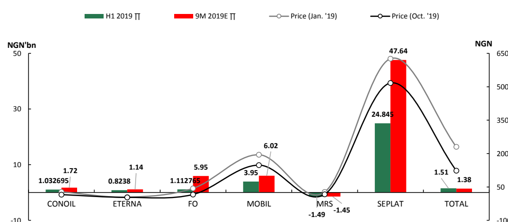


Source: NBS, Meristem Research

Ahead of the release of Q3 Scorecards

9-months earnings scorecards are already streaming in on the Nigerian equities bourse. So far, the NSE Oil and Gas Index has mirrored the general bearish market sentiment, with 24.98% losses YtD. At a -63.20% YtD return (NGN16.00), FO is the worst-hit, which is rather peculiar, given that the company posted a 1,059.13% uptick in earnings in H1:2019 (exclusive of the one-off NGN3.95bn income recognized on subsidy and foreign exchange differentials from PPMC). JAPAULOIL (-60.00%) has also lost more than half of its value, and now sits at the very base of the pricing spectrum for NSE-listed equities. For us, this is justified, given the company's long-drawn struggle with losses and negative retained earnings. TOTAL (-46.42%; NGN123.20), CONOIL (-45.00%; NGN15.40) and OANDO (-41.57%; NGN3.50%) have similarly shed more than 40% of their beginning values for mixed reasons, but largely due to the pervasive risk-off sentiments on downstream oil and gas stocks ocassioned by softer revenue growth, escalating costs and thinner margins. MRS (-38.27%; NGN16.95), MOBIL (-24.00%; NGN147.90) and ETERNA (-22.41%; NGN3.15) have also disappointed investors so far, as they similarly contend with lower sales, higher costs and compressed earnings respectively. Our assessment of the downstream segment remains downbeat - at least until a permanent answer to the question of high landing costs (from importation) is available. Not even lower oil prices will force down landing costs in the near-term, as freight costs for oil tankers have also gone over the roof due to higher "war premiums", in reference to tensions in the Middle East. Already, data from the last 5 years (2014 - 2018) points to Q3 as the worst quarter for downstream businesses on the average. SEPLAT (-17.44%; NGN517.00) remains the outperformer in the sector, and rightly so, with sustained investments in gas capture and processing to diversify and stabilize its revenue mix. The E&P company historically posts its best performance in Q3, and fundamental evidence suggests that the trend might be sustained this year.

Chart 2: NSE Oil & Gas Index Constituents' Performance (Market & Earnings)



Source: Company Financials, NSE, Meristem Research

PSC Act Amendment: FG In Dire Search of Revenue

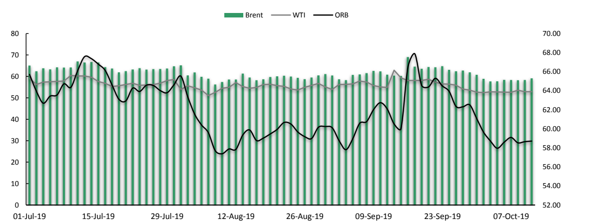
On October 15, 2019, the Bill to amend the Deep Offshore and Inland Basin Production Sharing Contract (PSC) Act was passed by the Nigerian Senate. The Bill, which is the most important fiscal legislation applying to Upstream Oil and Gas companies in Nigeria (principally those operating in the Shallow Water and Deep Offshore) makes provisions for taxes, royalties and an operational framework for companies operating in such areas. The Act was initially enacted in 1993, and included a clause for a review after the first 15 years, and every 5 years thereafter. The essence of the review was to align the Act with extant circumstances in the global and domestic oil and gas space; to ensure that Federal Government revenue from such licences was fair, and the environment for upstream companies in the country remained competitive. The PSC provides a tax rate of 50% of chargeable profit (as against the 65.75% and 85% stipulated by Joint Venture agreements). It also ensures that the licence is retained by the government which is absolved of any cash call requirements, while the entire risk of exploration and production lies with the technical partner (typically an IOC). For their efforts, the technical partner would share in the *Profit Oil,* after deducting *Cost Oil, Royalty Oil and Tax Oil* from the proceeds of its endeavour. An key proviso in the Act which necessitated its speedy amendment was the requirement that Royalty rates be stepped up, if the oil price benchmark moved above USD20pb. Oil prices have since moved well above USD20pb, and incidentally, the first review period should have coincided with the peak of oil prices (USD146.08pb) in 2018. Nigeria is now seeking USD62b in delayed royalty payments from oil majors operating in the country, vide the instrumentality of a Supreme court ruling in 2018. At a time when oil prices are dwindling, and the country is unable to increase its production due to the output cap set by OPEC, it remains to be seen whether the payments will eventually be received. Looking into the future however, the amended Bill should ensure a boost to the Federal Government's strained revenue outlook.

GLOBAL MARKETS

Oil prices risk lower support levels, as geopolitical risk premiums fade off

The previous edition of the oil market monitor dwelt extensively on the September 14 drone strikes on key Saudi Aramco oil facilities. The quest for regional dominance in the Persian Gulf has seen ocassional sparring for decades, but the attacks on the *Abqaiq* crude processing facility and the *Khurais* oil field were unprecedented due to their scale - it was the single biggest shut-in of crude experienced in history, with 5.7MMbpd (c. 5.7% of global supply) immediately cut off. Oil markets responded immediately with a 20% surge in prices to USD71.95pb on September 16. Speculation was rife that Aramco might be unable to restore output as quickly as possible, and the implication for short-term global supply seemed depressing. More importantly, market participants bared concerns about the sanctity of Saudi's defence structure for oil installations, despite having the world's largest millitary budget. There were also insinuations that OPEC might have to relax its production cuts for the rest of 2019 to accomodate Saudi's production slump and keep market share within the group. However, the euphoria was short-lived; to assuage the impact of the supply shut-in, President Trump announced a plan to authorise release of oil from the US Strategic Petroleum Reserve, and Aramco worked extra time on its restoration efforts such that full production was restored barely 2 weeks after the incident. Expectedly, oil prices came back down to earth - by October 2nd, Brent was sub-USD58pb, the lowest since August 7th as the narrative shifts back to waning global demand. The near (and long)-term implications of this reversal are far-reaching. If the oil market could recover from a 5.7MMbod shut-in in a matter of 13 days with as minimal fuss as possible, then it will become harder to justify the price premiums for future supply disruptions due to geopolitical crises in the Middle East or elsewhere in Africa or South America. With the value of this key oil price fundamental undermined, and global demand-supply balance increasingly pointing towards a glut in 2020, Brent could conveniently stay sub-USD60pb in the next few months. This assertion however assumes that the ever-dynamic oil markets throw up no new surprises within this period. A critical ingredient for market balance and oil price support is expected from OPEC+ when the coalition meets for the final time in December 2019. If the status quo is maintained, we envisage that the group might take the direction of a bigger production cut agreement going into the new year.

Chart 3: Trajectory of Benchmark Oil prices (Jul. '19 - Oct. '19)

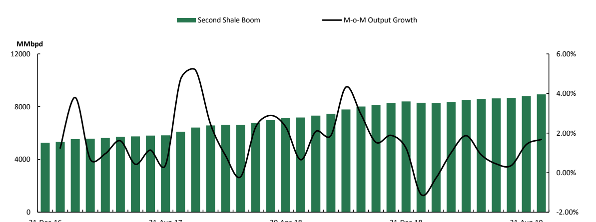


Source: OPEC, Bloomberg, Meristem Research

Is the Second US Shale Boom Coming to an End?

The period between 2012 and 2014 will go down in history books as a turning point for the American oil and gas industry, as it marked the first Shale boom. Wildly celebrated amongst heavy users of crude oil, Shale was heralded as the solution to high oil prices, and signalled the death-knell for OPEC and its golden years of oil market management. This was not to be. In a sharp departure from its perpetual production-cut strategy, OPEC decided to turn on its taps and increase supply, causing oil prices to reach a 12-year low of USD27.88pb in January 2016, with production hitting an all-time high of 34.14MMbpd in November 2016. In December 2016, OPEC+ held its first Joint Ministerial Meeting, where the first production-cut agreement was reached - a decision that sustained the oil price recovery. Up till this point, shale output had been declining - the result of unwieldy costs and a soft oil price outlook. Bankers had become unwilling to stake their money in the money-losing shale companies, and this was evident in negative production growth. OPEC's masterstroke with the Declaration of Cooperation supported oil prices, and emboldened shale producers to make further investments into their drilling programmes. Between 2016-end and September 2019, production from America's shale plays (principally the Permian basin, the Bakken and Eagle Ford) have seen a 69.53% uptick in output, from 5.27MMbpd to 8.93MMbpd. However, output growth has largely slowed in 2019, with a 7.64% (+634,220bpd) YtD increase (initial 2019F: +1.5MMbpd) and 11.48% (+920,080bpd) Y-o-Y. While production growth is not yet negative, it has stalled for much the same reason as the previous collapse. Feelers from the market suggest that bankers are increasingly unwilling to advance debt to shale producers, as oil price outlook weakens and global demand wanes. More disturbing is the admission that tight oil producers are still losing money; cost of production for the average shale play remains above USD60pb, while WTI is sub-USD55pb. Further down the line is the fact that output from the most-prolific basin (the Permian) is nearing its peak, after which a decline is expected to kick in, with a consequent loss in market share. However, this is premised on the base-case assumption that no new plays are discovered, and the existing assets are not sweated as much as possible.

Chart 4: Global Oil Supply and potential impact of the outage



Source: Bloomberg, Meristem Research

Ecuador is Leaving: Can OPEC Keep its House Together?

On 1st January, 2019, Qatar officially left OPEC, citing a need to refocus strategy on its vast gas deposits and deemphasize crude production cum supply. By far, the Middle East nation is the world's largest LNG exporter with 81.0MTPA in 2017 (c. 28%) market share. For context, Australia trails in second place and supplied only 56.2MTPA (19.2%) of global LNG requirements. In the crude supply market however, it's contributions are relatively miniscule - only 0.62MMbpd (1.87%) in its final month as an OPEC member. Qatar's exit brought OPEC's membership number down to 14, and the combined reserves down by 1.69%. In October 2019, Ecuador informed the OPEC secretariat that it was leaving the coalition as well, as it sought avenues to increase its export revenue and combat a fiscal crisis. Like Qatar, the Latin American nation is only a small part of the grand scheme of things within OPEC. In September, Ecuador pumped 547,000bpd, 1.92% of OPEC's gross production and 7.68% higher than its quota for the year. It's reserves are also only 0.70% of OPEC and 0.55% of the World Total - evidence that its exit does little to dent the control that OPEC wields over the global oil market. Nonetheless, the withdrawal could not have come at a more injurious time for the coalition, with lower oil prices, waning demand and the growing influence of US shale forcing severe production cuts. OPEC has cut 7.51% (2.32MMbpd) of its production since the turn of the year - a figure which is 2.82 times what it initially intended to cut. The exit of a member (however insignificant) at this critical time when it is planning to ramp up its efforts to manage the softening oil price outlook is damaging for its objectives. Perhaps, this withdrawal is also evidence of growing discontent with the coalition's long-term production cut strategy, and if unchecked, could trigger a further exodus, with 3 members having left in the last 3 years (Indonesia, Qatar and now, Ecuador). Overall, the influence of the group appears to be waning, as evidenced by the market's reaction to the Saudi mega-disruption in September. OPEC appears to recognize this, and has called for greater cooperation by inviting all 97 oil producing nations of the world and the Gas Exporting Countries Forum to join up forces with it.

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