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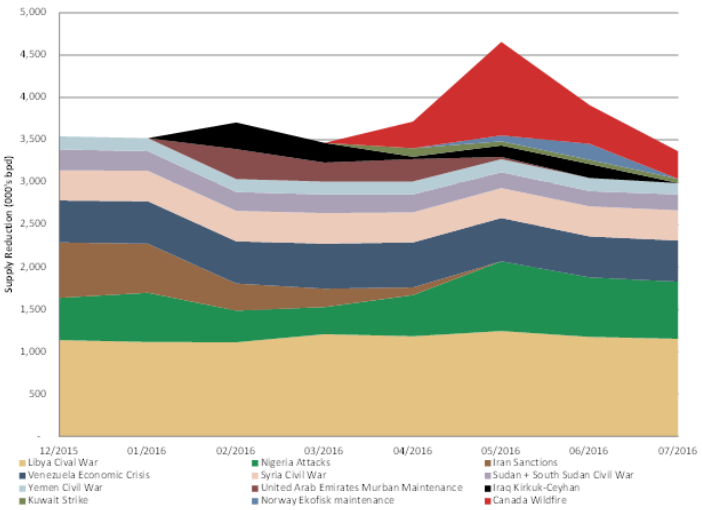
WHY IT MATTERS: NIGERIA'S GLOBAL OIL IMPACT

Oil production in Nigeria has been severely hampered in recent months as local militant group, the Niger Delta Avengers, have committed numerous attacks on oil pipelines in the region, materially lowering the country's oil production. Our Emerging Market (EM) debt team in London take a closer look the political situation in Nigeria, the origins of the conflict, prospects for its potential resolution and its impact on global oil prices.

Although the global level of oil production is currently at elevated levels, there are a number of major oil producing countries still suffering from production shortfalls, as we highlight below:

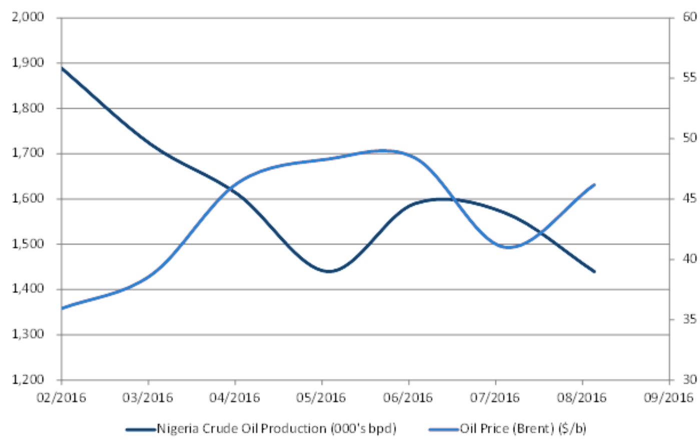
Figure 1: 2016 Crude Oil Supply Shortfalls in barrels per day (bpd)



Source: Bloomberg, Energy Intelligence Group

Nigeria accounts for a significant share of the shortfall, second only to Libya. Nigeria, in fact, accounts for nearly 3% of total oil production capacity according to the Energy Intelligence Group, so Nigerian production can have a material impact on the price of oil, as witnessed this year:

Figure 2: Nigerian Production and Brent Crude Oil prices



Source: Bloomberg

What is behind the various shortfalls?

Much of the global shortfall in production can be linked to longer running conflict zones, where an imminent end to disruption looks unlikely (such as Libya and Syria, which are included in our analysis as there still remains potential for upside surprise in production, no matter how unlikely such may seem). We have also seen one-off disruptions linked to natural events (Canada), industrial action (Kuwait) and technological maintenance (Norway), where production losses have been of much shorter duration.

Nigerian disruptions rank somewhere in the middle: with specific pipeline attacks resulting in temporary disruptions (as subsequent repairs are typically concluded within months), yet the longer running conflict has seen recurrent outages, this reduces the incentive for oil companies to repair damaged pipeline (if repeat attacks are to be expected) thus potentially turning temporary outages into semi-permanent ones. Will this be the case for Nigeria? In order to determine this, we must assess the prospect for peace in the region, and in order to do so we review the factors behind the current conflict.

Origins of Nigeria's oil conflict

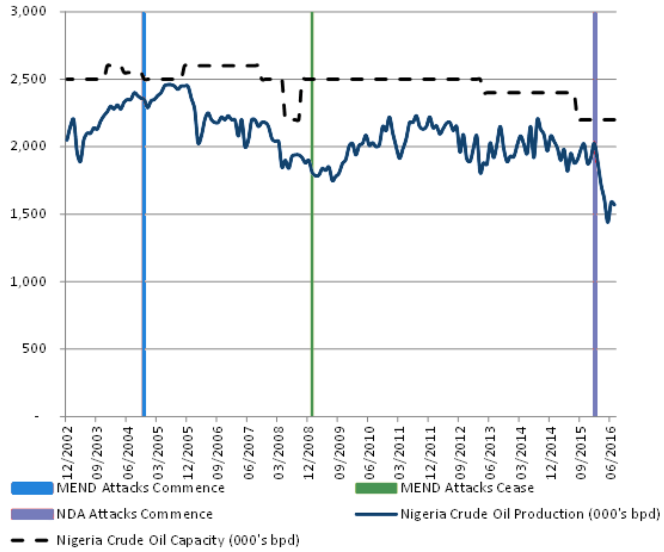
Disruption in the Niger Delta can be traced back to the discovery of commercially viable oil reserves in the region in the late 1950s. Following several decades of environmental destruction, displacement and suppression, with seemingly little of the socioeconomic benefits from oil revenues reaching the people, dissatisfaction turned into political protests. Violence originated in the 1990s as groups such as the Movement for the Survival of the Ogoni People threatened the Nigerian government and Shell with supply disruptions unless they received accumulated royalties, damages and compensation. The government response was uncompromising, with alleged repression and violence towards the Ogoni people. In 1998, protests by a similar, larger, indigenous group were met with violent retaliation from the military. In the early 2000s the Niger Delta Development Commission was created by the government to address the concerns of the local people, yet the tension quickly deteriorated into armed conflict.

The violence escalated to crisis levels in 2004 with government crackdowns countered with retaliatory rhetoric of "all-out war" against the state and oil corporations. 2005 saw the creation of the Movement for the Emancipation of the Niger Delta (MEND) as the Niger Delta militant groups united under one umbrella group demanding control of the region's oil wealth and threatening to destroy Nigeria's oil export capabilities. The violence finally subsided in 2009 with the introduction of the government amnesty program under President Umaru Musa Yar'Adua, and expanded under his successor Goodluck Jonathan. As well as training and rehabilitation, the amnesty deal also included monthly stipend payments to ex-militants and awarded lucrative pipeline security contracts to former commanders. Despite Yar'Adua being a northern Muslim the expansion of the scheme under Jonathan, a Niger Delta Christian, has embroiled religion into the debate ever since, with Muhammadu Buhari's 2015 general election victory, reigniting the issue (despite official backing from MEND) as he proposed to cut the amnesty budget by two-thirds.

Niger Delta Avengers

This year a new military presence emerged: the Niger Delta Avengers (NDA) who announced their presence with an attack of the Forcados pipeline in February. This forced the terminal offline, causing a ~250,000 bpd drop in production, which has yet to be recouped. The NDA's origins have not been fully verified, but are most likely a young splinter group of MEND, perhaps unhappy with the consolatory tone of the larger group, cut-off from stipend payments by internal corruption or a new band of militants keen to flex their military might in return for payments of their own. NDA attacks have been prevalent this year; they claimed responsibility for an attack on Chevron's Escravos facility and were likely behind explosions that caused the closure of Shell's Bonny Light export programme in May. The impact of these attacks on total production in Nigeria has been material, with August volumes at a mere 1.4 million bpd vs estimated capacity of 2.2 million bpd, eclipsing the losses during the era of MEND attacks (Figure 3).

Figure 3: Nigeria Crude Production



Source: Bloomberg, OPEC

Prospects for Peace?

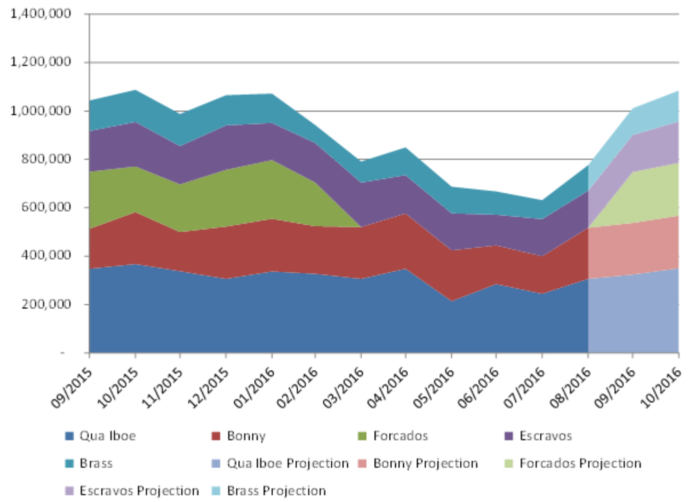
Recent events may have taken a turn for the better, as media reports circulate of a proposed ceasefire between the NDA and the government. The NDA have released a statement saying that they have laid down arms and appointed a seven-man negotiating committee to seek dialogue with the Nigerian government. There may well be legitimate concerns about the means the Nigerian government is pursuing, some commentators have likening the saga to Danegeld, a tax bribe paid by the English to the Vikings to prevent attack, yet one that simply encouraged profiteering Danes to extort further payments. However, the situation in Nigeria has become somewhat desperate with the economy now in recession, and in desperate need of oil revenue to fund much needed infrastructure projects and reforms. Any return to peace, even at increased financial cost, is likely to be welcomed.

The longevity of the ceasefire will depend on the government's stance; previous hawkish rhetoric from Buhari will need to soften in order to placate the militants, still aggrieved by the ongoing operations of government troops in the Delta region. This will be critical to the discussions, as will Emmanuel Kachikwu, Minister of State, Petroleum Resources, born in the Delta, and a former official of the Nigerian National Petroleum Corporation, who is seen as a placatory force. Therefore, while one cannot rule out rogue attacks reigniting the conflict, we see increased incentives for both sides to reach an agreement. This, coupled with the foundations of an appropriate negotiation platform, with the right people at the helm, lead us to be cautiously optimistic that the cease fire will hold.

Untapped Potential

It is clear that the recent loss of Nigerian output has impacted global oil supply and boosted prices, yet if the peace deal proves effective, Nigerian oil production could soon recover. For example, the Forcados stream could come back online as soon as this month, boosting production by over 200,000 bpd. There is also potential for production gains at the other major oil terminals (Figure 4) including Qua Iboe, which was running below capacity due to technical difficulties unrelated to the NDA.

Figure 4: Major Oil Terminal Loading Schedules



Source: Bloomberg, Nikko AM estimates

In total, we estimated that production should recover to ~1.8 million bpd within the next two months, bringing it close to, but still below levels prior to the NDA campaigns. We believe it should stabilise at these levels, leaving it still shy of the 2.2 million bpd fiscal target, which assumes production at full capacity (see Figure 3), yet a significant improvement over current levels. The additional revenues will help to fund infrastructure investment and pave the way for the government to tap international borrowing, of up to $4 billion, at reduced cost later this year. As for oil prices, a linear regression model predicts Brent prices will fall to $40-$42 per barrel, as this additional production comes on line, all else being equal. Volatility should also fall, as greater supply certainty returns to the market.

Conclusion

Nigerian supply disruptions have clearly contributed (along with other factors) to the oil price recovery this year, but a supply recovery is likely amid the cease fire in the Delta. This recovery, however, should be capped at ~350,000 barrels, still well short of the government's projections. Nevertheless, this will still be material for oil prices, given the market remains sceptical about Nigerian production gains; hence, we estimate Brent to decline ~$4-$6 in the coming months, assuming all else equal. Nevertheless, as we look ahead to 2017, limited additional OPEC supply and falling production from US shale producers, coupled with increasing global demand still point to a favourable outlook for the price of oil.

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