



POWER POINTS:

PROJECT FINANCE ISSUES IN DEVELOPING POWER PROJECTS IN NIGERIA

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ENERGY INVESTMENT
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Despite obvious challenges, Nigeria continues to aspire to be Africa's premier investment destination. In 2010, the Federal Government (FG)'s *Roadmap for Power Sector Reform (RPSR)*¹ declared that at least US\$3.5 billion annual investment is required in power generating capacity alone, in order to meet Nigeria's Vision 20:2020 target of 40,000 megawatts (MW). Notwithstanding that similarly large investments are necessary in other parts of the value chain, the sum total

of investment in power generation over the years has, at best, been paltry. Unsurprisingly, Nigeria is currently very far off its target, having an installed capacity of about 12,522 MW and actual generation of less than 6,000 MW.²

The FG's power sector reform efforts which envisioned transformational capacity development has, almost two decades on, yielded underwhelming results due to the insufficiency of investments to meet the suppressed and ever increasing demand for power.³ The need to maximize every avenue to attract investment to Nigeria's power sector has never been greater; and the imperative of a de-risked



¹ Presidential Action Committee on Power, *Roadmap for Power Sector Reform 2010*, p.4.; <https://www.nigeriaelectricityhub.com/download/roadmap-for-power-sector-reform-2010/> (accessed 26.04.2019).

² The United States Agency for International Development (USAID), '*Nigeria Power Africa Fact Sheet*', November 2018: <https://www.usaid.gov/powerafrica/south-africa>, (accessed 07.08.2018).

³ The FG began systematic work on reforming the power sector in the early 2000s, starting with the National Electric Power Policy (NEPP) 2001 before the enactment of the *Electric Power Sector Reform Act 2005 (EPSRA)* and EPSRA's subsequent phased implementation.

project finance option is as compelling as ever. This article highlights the key steps and considerations in power sector project finance in Nigeria.

Imperatives of Project Finance for Nigeria's Power Sector

Energy investment requires huge, long-term capital. The insufficiency of this (due to a myriad of factors) has unarguably been the biggest set-back for Nigeria's power sector. Unfortunately, the government has been financially constrained to fund power projects, given the inherent challenges (not the least bureaucratic budgetary procedures) of public sector led funding.⁴ The foregoing is exemplified by recent news reports of President Buhari seeking the support of the Chinese government for the funding of the Mambilla hydropower project.⁵

All things considered, private sector led project finance is the long term sustainable financing model for provision of power infrastructure. The massive gap in the power sector confirms Nigeria's potential to absorb

significant investments at all levels of the sector's value chain and provide commensurate returns on these investments. Execution of projects via project finance also aid technology transfer and provide employment opportunities. The 'limited' financial exposure that project finance offers makes it attractive to both investors and the government (by 'lightening the burden' of the latter) and the huge financial outlay admits capital efficiency structuring opportunities, leveraging a mixture of debt and equity.

Furthermore, project finance offers the opportunity for collaboration between the public and private sectors. The government usually supports or contribute to projects by granting concessions, making land available or granting approvals/licenses especially in respect of greenfield projects. Also, specialized agencies are sometimes set up to support projects development.⁶

Harnessing Project Finance for Power Project Development

A typical project finance structure involves a number of equity

investors (sponsors), as well as a syndicate⁷ of banks as debt providers. The loans are most commonly non-recourse loans which are secured by the project assets including revenue-producing contracts and are paid entirely from project cash flow, rather than from the general assets or creditworthiness of the project sponsors. The pertinent question therefore is: *what steps are usually taken to deploy a typical project finance arrangement?*

a. Choosing Project Finance

The author's view is that raising large capital for a project and the attendant risks are the biggest consideration in choosing project finance. Capital intensive but 'bankable' projects are best suited for project finance because they pose an awful amount of risk to sponsors. The balance sheet and tax implications are enormous regardless of whether the project eventually succeeds. Of course, the implications are worst when projects fail. Thus, a corporate promoter may conceptualize a project and reach out to other prospective investors with similar interest,

⁴ By virtue of **Section 80, Constitution of the Federal Republic of Nigeria 1999 as amended (1999 Constitution)**, revenues raised or received by the Federation are paid into the Consolidated Revenue Fund of the Federation and requires appropriation by the National Assembly in line with procedure for budgeting and appropriation, to spend for any projects. Similarly, the various States' Houses of Assembly appropriate funds for their respective States. The implication of the aforesaid on funding for infrastructural development is further compounded by the sheer volume of capital investment required across various sectors.

⁵ Johnbosco Agbakwuru, **'Buhari Seeks China's Support on Mambilla Power Project'**, *Vanguard*, 06.09.2018: <https://www.vanguardngr.com/2018/09/buhari-seeks-chinas-support-on-mambilla-power-project/amp/>, (accessed 05.04.2019).

⁶ An example is the Rural Electrification Agency (REA) which supports power project developments under its **Energising Economies Initiatives**. See Rural Electrification Agency, **'Energising Economies Initiative'**: <http://rea.gov.ng/energizing-economies/>, (accessed 05.04.2019).

⁷ Syndication is a mechanism utilized by lenders to limit their exposure on loan advanced. It allows two or more banks to agree on advancing loans to a borrower on common terms governed by a single agreement between all parties. Large loans lend themselves to syndication amongst a number of banks since a single bank may not on its own be willing or able to advance the whole amount. See Philip R. Wood, **'International Loans, Bonds, Guarantee, Legal Opinions'**, (2nd ed. (2007)), p. 3. Covenants in the loan agreement may help to mitigate intra-syndicate disagreements where such arises.

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having considered that collaboration rather than going solo especially because of the required capital outlay, was prescient.

The decision to deploy project finance for such project is usually premised on in-depth due diligence/feasibility studies. Legal and other professional experts are typically required for this purpose. After requisite due diligence is carried out, those signing up to carry out the project including sovereign or subnational (if applicable), all become the project sponsors.

b. Setting Up a Special Purpose Vehicle

Once the decision to adopt project finance is made, the next step is the setting up of a special purpose vehicle (SPV) as the project company. The essence is to shield non-project assets from the detrimental effects of a project failure.⁸ As an SPV, typically the project company has no assets other than the project.

The shares in the SPV would be allotted to the project sponsors relative to their respective equity stakes, as they also enter into a Shareholders' Agreement (SHA) or

Joint Venture Agreement (JVA) to govern their rights and duties as shareholders. These will include capital commitments by the project sponsors which is critical to ensure financial stability of the project. The SHA or JVA signed by project sponsors usually carries with it the right to nominate a number of directors to the Board of the SPV.

During the power sector privatisation exercise, many prospective investors bid for electricity assets using SPVs. For example, Sahara Group successfully acquired majority shareholding stakes in two (2) of the assets of the erstwhile Power Holding Company of Nigeria (PHCN) that were sold by the Nigerian Government, namely Egbin Power Station and Ikeja Electricity Distribution Company.⁹ Similarly, the Ariaria Independent Energy Distribution Network Limited (AIEDNL) was set up by a group of investors spearheaded by Ariaria Market Energy Solutions Limited (AMESL), as an SPV for the purpose of generating and distributing off-grid power to 32,000 shops in Ariaria.¹⁰

c. Allocation of Risks

Once the SPV is set-up, the next step is usually the identification,

analysis and allocation of the risks the project may entail. Attendant risks in power projects may include environmental risk,¹¹ price risk,¹² political risk,¹³ legal risk,¹⁴ completion risk,¹⁵ operating risk,¹⁶ interest rate risk¹⁷ amongst others.

The essence of project finance is identifying risks, developing risk mitigating mechanisms in addition to determining who should bear them; thus, there is a clear need to employ adequate risk management methodologies. This requires extensive consultation with technical experts.

The report obtained after the above stated analysis will inform the choice of the other project partners such as the lenders, contractors, operators and the off-takers. It will also inform the nature and the quantum of risk that will be passed to the said partners. It is presumed that a business plan or entry strategy that leverages legal and commercial advice and thorough appreciation of the Nigerian power sector regulatory landscape would have been crafted much earlier to provide a sort of 'reference manual' to guide project development activities.

⁸ Sometimes project sponsors elect to have a parent SPV abroad that will wholly own the Nigerian SPV, so the parent can better raise finance. This may be resident in a country with bilateral investment treaty (BIT) with Nigeria for investment protection reasons etc.

⁹ Sahara Group, 'Sahara Acquires Power Sector Assets': www.sahara-group.com/2014/05/31/test-news-1/, (accessed 28.04.2019).

¹⁰ Emmanuel Uzodinma, 'Power Distribution: EEDC, AMESL Battle for Ariaria Market', *Daily Posts*, 07.06.2018: <http://dailypost.ng/2018/06/07/power-distribution-eedc-amesl-battle-ariaria-market/>, (accessed 05.04.2019).

¹¹ Strict and other legal liability for environmental damage and degradation under statute and common law are vital issues that crop up in project finance, particularly given the growing sensitivity to sustainable development and good corporate citizenship. See for example: **Section 2, Environmental Impact Assessment Act, Cap. E12, LFN 2004; section 7, National Environmental Standards and Regulations Enforcement Agency (Establishment), Act, Cap. N164, LFN 2004.**

¹² This refers to the risk of volatile markets or government price controls. In the Nigerian power sector, the price of power is regulated by the Multi Year Tariffs Order (MYTO) pursuant to **section 76 EPSRA.**

¹³ This class of risk underscore the need to ensure adequate host government participation, political commitment, social acceptability, stakeholder involvement and if possible, the added comfort of an enabling law or a transparent and stable regulatory regime.

¹⁴ This refers to the need to ensure that the transactions is compliant with the relevant laws of Nigeria (as the host country) to avoid risks from non-compliance.

¹⁵ This is the risk that the project will not be completed on time or at all, e.g. because of technology failures, costs overruns, *force majeure* or necessary variations.

¹⁶ This covers, for example, manpower costs, maintenance costs, technology, operating supply costs and the likes.

¹⁷ This is the risk of higher interest rates than expected.

d. Sourcing Project Lenders

Generally, the SPV possess all the powers of a natural person of full capacity pursuant to **section 38(1) Companies and Allied Matters Act (CAMA)**,¹⁸ including power to borrow money;¹⁹ and can borrow locally or from abroad like other Nigerian companies subject to compliance with regulatory requirements on capital importation, amongst others.²⁰

Project lenders typically advance loan directly to the project company and will take security over all its assets. Thus, they are able to assume control of a project if the project company has difficulties complying with the loan terms.²¹ Also, lenders usually put control measures in place to ensure financial health and discipline of the SPV project company. Care must be taken to ensure that such measures do not unduly constrict the project company's operations. Lenders must also ensure that the funds advanced to the project company are adequately protected in the event of meltdown.

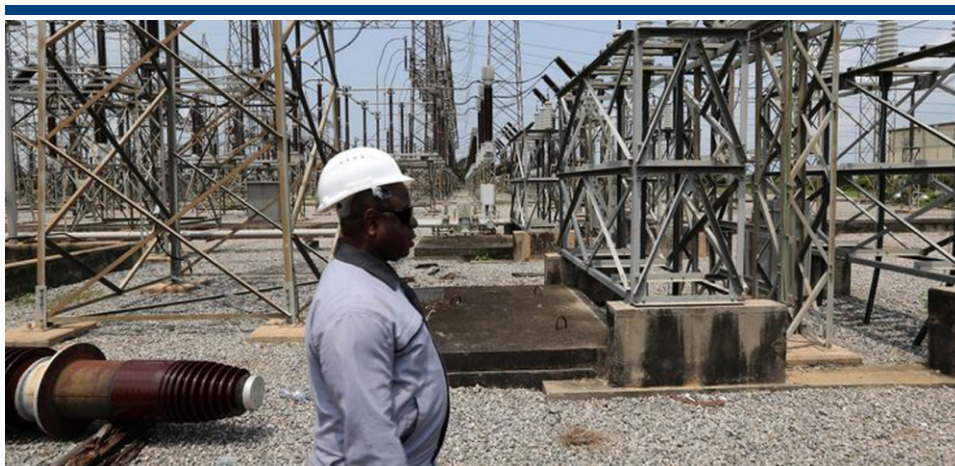
Additionally, lenders often require

project sponsors to provide a guarantee or undertaking which may be supported by a bank guarantee or a parent company guarantee, in order to give the lenders further comfort as to the extent of their commitment to the project.²² They may also ask that the guarantee be supported by a letter of credit.

Moreover, investors themselves often need to obtain loan from banks to provide additional funding to projects. It is noteworthy that consideration is usually given by financial institutions to the reputation and financial strength of project sponsors before advancing loans. A notable source of funding for power projects are multilateral,

regional and bilateral developmental financial institutions. For instance, the International Finance Corporation (IFC), is active in the Nigerian market.²³ This is also the case with the African Development Bank and the African Export Import Bank.²⁴ These institutions provide funding for projects at prices that allow for returns as their lending rates is lower than regular commercial banks.²⁵

With respect to credit support, World Bank Group's partial risk guarantees have sometimes been available to appropriate projects in the power sector. This has afforded investors some additional credit support that can



¹⁸ Cap. C20, Laws of the Federation of Nigerian (LFN) 2004.

¹⁹ Section 166 CAMA.

²⁰ See Afolabi Elebiju and Daniel Odupe, 'Doing Business in Nigeria: An Aide Memoire to Regulatory Compliance and Optimal Entry Strategy for Foreign Investors', LeLaw Thought Leadership Insights, December 2018: <http://lelawlegal.com/blog-details.php?title=doing-business-in-nigeria>, (accessed 05.04.2019).

²¹ Banani Dinesh, 'International Arbitration and Project Finance in Developing Countries: Blurring the Public/Private Distinction': <https://lawdigitalcommons.bc.edu/cgi/viewcontent.cgi?article=1155&context=iclr>, (accessed 05.04.2019).

²² A Guarantee is an instrument of security that affords the lender personal rights enforceable in court against the guarantor in the event of default by the debtor. The recent action by the United Bank for Africa for the winding up of Sahara Energy Resources Limited (alleged Guarantor) on the default by KEPCO Energy Resources Limited (KEPCO) pertaining to the loan advanced to it to finance the acquisition of the Egbin Power Plant, demonstrates how a guarantee transaction/relationship can sometimes pan out. See Davidson Iriekpen, 'UBA Asks Court to Wind Up Sahara Energy over \$15bn Loan', Sahara Reporters, 13.04.2019: <http://saharareporters.com/2019/04/13/uba-asks-court-close-down-sahara-energy-over-kepcos-15bn-loan>, (accessed 01.05.2019).

²³ IFC, in 2015, signed a Joint Development Agreement with Alten's Middle Band Solar One Limited, a Nigerian solar power project company, to co-develop a 120 MW peak photovoltaic solar power project with a consortium of developers. The project was to provide renewable energy supply to about 175,000 people and nearby industrial clusters, support job creation, and boost economic growth in the country. The project is based in Lokoja, Kogi State and benefits from the support of the host state government. See International Finance Corporation, 'Alten and IFC Boost Renewable Energy Supply and Energy Security in Nigeria', 08.12.2015: <https://ifcextapps.ifc.org/ifcext%5Cpressroom%5Cifcpressroom.nsf%5Co%5Cd8062E42B4B966085257F1600240411>, (accessed 30.04.2019).

²⁴ The African Development Bank's Sustainable Energy Fund for Africa (SEFA) is yet another notable initiative by a multilateral financial institution. It is a US\$60 million multi-donor fund, which supports small and medium scale renewable energy and energy efficiency projects in Africa. See African Development Bank Group, 'Sustainable Energy Fund for Africa: Unlocking Africa's clean energy potential for employment and economic growth': <https://www.afdb.org/en/topics-and-sectors/initiatives-partnerships/sustainable-energy-fund-for-africa/>, (accessed 08.09.2018).

²⁵ In February 2018, the World Bank approved an International Development Association (IDA) credit and an IDA scale up facility credit totalling \$486 million for rehabilitation and upgrading of electricity transmission substations and lines in Nigeria. World Bank, 'Nigeria: World Bank Approves \$486 Million to Improve Nigeria Electricity Transmission Network and Infrastructure', 15.02.2018: <https://www.worldbank.org/en/news/press-release/2018/02/15/nigeria-world-bank-approves-486-million-to-improve-nigeria-electricity-transmission-network-and-infrastructure>, (accessed 30.04.2019).

underpin the country's risk and in turn influence investors' final investment decision. The Azura-Edo Independent Power Project (Azura-Edo IPP) was the first power generation project in Nigeria to receive guarantee support from the International Bank for Reconstruction and Development (IBRD) and the Multilateral Investment Guarantee Agency (MIGA).²⁶

A major attraction for these institutions to be included as part of the syndicate of lenders is their preferred creditor status. This allows them to benefit from multilateral tax waivers or exemptions.²⁷ Receiving funding for a project from a multilateral institution could assure greater co-operation from government. Involvement of multilateral institutions also minimize the chances of the government acting in a manner prejudicial to the project. Where the project involves the importation of technological equipment from other countries, Export Credit Agencies (ECA) from such countries may also increase



source of funding and provide guarantees in order to help lenders avoid country issues and make the projects more viable.

e. Obtaining License and Concessions

Once sufficient funding is secured, the project company will proceed to obtain requisite license and concessions. Licensing is undoubtedly a regulatory prerequisite to undertaking project in the Nigeria's power sector. **Section 62 EPSRA** forbids the construction and operation without license of any power project for generating electricity exceeding 1 MW in aggregate at a site or an undertaking for distribution for electricity with a capacity exceeding 100 kilowatts (KW) in aggregate at a site, or such other capacity as the Nigerian Electricity Regulatory Commission (NERC) may determine from time to time.

In **Petadis v. HFP Properties**,²⁸ NERC declared, amongst other things, that the electricity distribution arrangement at the Ikota

Shopping Complex, Lagos, was illegal as the Respondent was essentially engaging in regulated activity by generating above 1MW without license and distributing same on the basis of a delegation of power from the Eko Electricity Distribution Company (EEDC).

Thus, **EPSRA** empowers **NERC** to issue licenses²⁹ for an aggregate period of 15 years, which is renewable. As long as licensees comply with the terms and conditions of their current licenses, such licenses are eligible for renewal at the expiration of the existing term. Some of the licenses NERC issues includes: *Generation License*;³⁰ *Transmission License*;³¹ *System Operations License*;³² *Distribution License*;³³ and *Trading License*.³⁴ Where a licensee for any of the services contemplated by **EPSRA** requires land in connection with its obligations under the licence, such licensee is required to apply to the Commission, in such form as the Commission may prescribe, for a declaration that the land is required for purposes of generation, transmission or distribution of electricity.³⁵

²⁶ World Bank Group, 'Financial Solutions Brief: Nigeria Azura-Edo IPP', January 2018: , (accessed 30.04.2019).

²⁷ The multilateral tax waivers and exemptions is made possible by the accession treaties signed by member States.

²⁸ Case No: NERC/10/0011/08 : http://www.nercng.org/index.php/library/documents/NERC-Decisions-and-Rulings/Petadis-Enterprises-and-HFP-Properties-Ltd_Decision/ (accessed 30.08.2018).

²⁹ An application for license is required to be submitted in the form and manner approved by the Commission as contained in the *Nigerian Electricity Regulatory Commission Application for Licences (Generation, Transmission, System Operations, Distribution & Trading) Regulations, 2010 (NERCALR)*.

³⁰ Section 62 EPSRA.

³¹ Section 65 EPSRA.

³² Section 66(1) EPSRA.

³³ Section 67 EPSRA.

³⁴ Section 68 EPSRA.

³⁵ Section 77(1) EPSRA.

f. Securing Off-takers

Since the means of the loan repayment is based on the project's income stream, it is crucial for the sponsors as well as the lenders, that such income stream is assured and protected as much as possible. This is usually done by signing offtake agreements with the prospective purchasers of the project's output. The Azura-Edo IPP is a landmark power generation project which demonstrated the significance of off-takers in a project finance transaction. The project benefited from a long-term take-or-pay power-purchase agreement (PPA) with the Nigerian Bulk Electricity Trading Plc. (NBET) and a put-call option agreement (PCOA) with the Ministry of Finance that provides termination payment assurances, while mitigating the impact of such assurances to the balance sheet of the FG.³⁶

In essence, off-takers help to assure loan repayment by ensuring that payments is made to the project company to cover the scheduled principal and interest payments under the financing documentation so long as the Independent Power Project (IPP) will be available to generate electricity.³⁷

g. Kick-starting Project Development

Once the required capital is raised and requisite licensed obtained,



the project company will engage contractors and sub-contractors to construct the project. During the construction period, the project is at its highest risk because it is not earning any money but instead 'consuming' it. The sponsors are often required to give the banks a completion guarantee since the risks are not managed by the lenders.


Supply agreement are sometimes entered into contemporaneously with project development. These are agreements for the supply of raw materials, fuel or other product to the project company for its operations.³⁸ Also, the operations and management of the project is usually taken care of via an agreement between the operator and the project company. The operator may be an outside third party or one of the project sponsors with special expertise in the area.

Conclusion

It is crystal clear that a typical project finance is a complex transaction of a unified series of agreement and projects. Some

project are dependent on other projects. Without doubt, things must be brought to a seamless whole. Thus, parties must play their role effectively to ensure the overall realization of the project objective.

The project sponsors must ensure the elimination of as much commitment and financial risk as possible to support the project company. Their aim must be to ensure that the project is viable. Lenders, especially commercial banks typically seeks to ensure that: the project is bankable; repayment of their loan is secure; and as many commercial risk as possible are passed to someone else.

Government however, seeks to harness project finance to attract foreign finance, to protect the national interest, to ensure the efficient exploitation of the country's resources and the provision of fine infrastructure. Government often also seek to have no financial exposure to the project and to ensure that the financing of the project is not on its balance sheet. Project finance provide the rare opportunity for these key players to achieve their goals 

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³⁶ *Ibid*, footnote 26.

³⁷ The liquidity challenges in Nigeria occasioned by costs unreflective tariffs and huge collection losses has however made loan repayment difficult.

³⁸ The security of raw materials or fuel supply is critical to power plants. This is why it is prudent to locate power plants close to a reliable and secure source of fuel.