

Infrastructure Financing

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Options for Nigeria



The availability of sound infrastructure is critical to the economic, industrial, technological and social development of any country.

Infrastructure stock in Nigeria remains well below the international benchmark of 70% of GDP (Nigeria's core infrastructure stock is about 35% - 40% of GDP). Increasing infrastructure shortages are exacerbated by the rising demands of a growing population and urbanization.

To bridge this infrastructure gap, the Governor of the Central Bank of Nigeria has stated that Nigeria requires an annual investment of over US\$ 10 billion over the next ten years.

CURRENT APPROACH TO INFRASTRUCTURE FINANCING

The current model for financing of infrastructure in Nigeria relies primarily on

federal and state government funding through a combination of budgetary allocations, loans from international development finance institutions and grants or aid from foreign governments or international development agencies. Governments have also tapped into the capital markets by issuing sovereign and sub-sovereign bonds to finance large projects.

Reliance on usual sources of government revenues such as taxes or grants has proven insufficient to achieve even modest infrastructure development goals.

Accordingly, in recent times, there has been an emphasis on private financing of infrastructure projects via the public-private partnership model to deliver value for money in public service procurement and operations.

It is pertinent to consider the

sources of financing for these public or privately financed projects.

SOURCES OF INFRASTRUCTURE FINANCING

The following are the primary sources of financing for both government and private-sector funded projects.

Term Loans

Commercial banks are currently the largest providers of debt capital in Nigeria to both corporate and government bodies for infrastructure projects.

Loans from Nigerian Commercial banks are somewhat unsuited to infrastructure needs, due to their relatively short tenures (3 to 7 years), high Naira interest rates (up to 25% per annum) and preference for

Abuja Airport Road

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tangible collateral.

These characteristics are in turn due to a number of factors, including the nature of banks' deposit liabilities (largely short-term), high costs of own borrowings, a higher share of gross loan portfolio that is described as non-performing and single-obligor constraints. In addition, the difficulties encountered in enforcing creditors' rights in Nigeria makes the banks focus on a small number of corporate, sovereign or sub-sovereign clients perceived to be creditworthy.

Bonds

All tiers of government (including their agencies) and corporate bodies have the opportunity to finance infrastructure projects through the issuance of bonds. Bonds can be structured in different ways to suit project peculiarities and investors' expectations. The bond market is critical for long term fund mobilization and provides a variety of financing instruments and investor categories which can lead to a larger pool of funds than other financing options.

The different types of bonds currently available in the Nigerian capital market that can be used to fund infrastructure include:

Sovereign bonds, which are issued by the Federal Government of Nigeria with tenors between 3 to 10 years. Nigeria currently has a Ba3 rating from Moody's and a BB- rating from S&P and Fitch. Its domestic issuances are however perceived as credit risk free assets.

Sub-sovereign bonds are issued by entities below the federal government and include state governments, government agencies etc. Sub-sovereign bonds issuance in Nigeria is currently dominated by state governments.

Infrastructure bonds

Infrastructure bonds could be a)

project bonds that rely on cash flows from a project, b) corporate bonds issued by an infrastructure company or c) sovereign or sub-sovereign bonds branded as such because their proceeds are for particular projects.

Islamic bonds or sukuku which are financial certificates compliant with the Islamic Sharia law. The basic principle of sukuk issuance is that an ownership share in the underlying asset entitles the sukuk holder to a proportionate share of the returns generated by the asset.

Recently, the Osun State Government participated in the fast-growing global Islamic market by issuing a US\$62 million sharia-compliant bond to be used for the construction of 24 Millennium Model schools.

Infrastructure Funds

Infrastructure funds usually do not have fixed investment cycles, as the tenure of their investments is dependent on the nature of the infrastructure. They seek to generate returns from investment in various infrastructure and related assets. These funds are most often used as source of early-stage capital for infrastructure projects.

A number of infrastructure funds have been established in Africa and they include the African Infrastructure Investment Fund (AIIF) and AIIF 2 managed by Macquarie, the Emerging Africa Infrastructure Fund managed by Frontier Markets Fund Managers Limited and the local infrastructure fund established by ARM: the ARM Infrastructure Fund, a US\$250 Million closed end fund.

Grants from foreign governments or development financial institutions

Development Finance Institutions (DFIs), Export Credit Agencies (ECAs) and foreign Sovereign Wealth Funds (SWFs) are able to provide relatively cheap long-term funding to projects (mostly denominated in US dollars, with margins below 7% and tenors of up to 15 years). However, DFIs usually have cumbersome due diligence requirements and long processing

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periods. These organisations usually prefer projects guaranteed by government, although some institutions actively finance well-structured private sector projects.

Two key initiatives by DFIs with respect to infrastructure development in Nigeria are:

The World Bank Public/Private Partnership Program for Nigeria: this program is aimed at increasing private investments in core infrastructure sectors in Nigeria via PPP projects (as defined in the National PPP Policy). The program is set to provide a total of \$315 million in two phases. Phase I involves the establishment of institutional mechanisms and instruments for effective origination and development of PPP projects while Phase II will provide \$200 million for direct financing of PPP projects identified in the National Infrastructure Plan.

A Viability Gap Facility will be provided to the public sector for upfront capital contributions to projects; while a Financial Intermediary Loan (FIL) will be available to eligible intermediaries for the provision of long-term debt to private sector infrastructure developers. The program's Project Implementation Unit is currently supporting the development of Outline Business Case reports for three PPP projects: Kiri Kiri Light Terminals I & II, Kuje Waterworks and the Onitsha Inland Waterway Port.

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Facility (NIAF) is financed by a £47.31 million grant from the UK Department for International Development (DFID), and provides targeted technical assistance to federal and state government institutions. NIAF is working with ICRC and some federal MDAs to improve the processes for project costing, procurement, financial management, implementation and monitoring of PPP Projects.

Private Equity (PE)

PE funds typically have 5 to 8 year investment cycles and seek equity returns above 20%. This source of funding would be unsuitable as a conventional financing source for infrastructure projects, due to long gestation of the projects coupled with limited options for exit of such investments. Nonetheless, these funds could be suitable as a source of early-stage capital for infrastructure projects, especially where a secondary refinancing market for infrastructure assets exists.

A good example of the potential for private equity funds in infrastructure development is the Private Infrastructure Development Group which has subsidiaries such as Infracore Africa (which provided Project Development support on the 180MW Aba Power project), GuarantCo (a lenders' guarantee facility) and the Emerging Africa Infrastructure Fund (EAIF, which has provided debt facilities of about US\$120 million to various companies/projects including MTN Nigeria, Helios Towers Nigeria and African Foundries Limited).

CURRENT DEVELOPMENTS IN INFRASTRUCTURE FINANCING

Certain recent initiatives that may encourage private investment in infrastructure, enlarge the pool of viable, bankable projects and provide a blueprint for infrastructure development have been proffered by government and regulatory authorities. These initiatives include:

A National Infrastructure Financing Policy has been prepared by a

consortium comprising Africa Finance Corporation, UBA Capital Plc, Detail Commercial Solicitors and others. The draft Policy was commissioned by the Central Bank of Nigeria and policy contains recommendations, which if implemented, would enhance the availability of suitably tailored financing at the various stages of the implementation of infrastructure projects in Nigeria.

The National Integrated Infrastructure Master Plan (NIIMP) (presently being finalized) is a framework that identifies the required investment to bring infrastructure in Nigeria to a desirable

“A diversified approach is therefore required to increase the overall funding available for infrastructure and to match the timing of funds when needed.”

state. The plan has a 30 year outlook i.e. 2013 – 2043 made up of three 10 year strategic plans and six 5 year operational plans. The key objective of the NIIMP is to ensure a coordinated approach to infrastructure development in Nigeria.

A Securitization Bill has been submitted to the National Assembly, whilst the Securities and Exchange Commission has issued proposed Regulations on Securitisation. The creation of a legal framework for securitization would have the effect of encouraging infrastructure financing by providing a reliable refinancing window for projects.

RECOMMENDATIONS

It is imperative that Nigeria develops a new model whereby government and private financiers of infrastructure can

access a broader and varied mix of financing options for infrastructure.

Some areas that ought to be addressed to maximize infrastructure financing include:-

Effective use of the Sovereign Wealth Fund, most especially the statutorily provided Nigerian Infrastructure Fund for direct investments in infrastructure projects. The Nigerian Sovereign Investment Authority must ensure that these funds can be used as leverage for resources from other sources as long term financing options.

Utilizing Pension Funds

Models should be devised to maximize the investment of pension assets in Infrastructure. Such models may include the creation of super funds which pool pension assets for investment.

CONCLUSION

There are presently not enough resources available to government to expand urban infrastructure at a pace that keeps up with rapid urban growth. A diversified approach is therefore required to increase the overall funding available for infrastructure and to match the timing of funds when needed.

A mixed approach strategically utilizes own source revenue, grants, borrowing (loans and bonds) as well as private finance initiatives. By leveraging on these varied sources, all three levels of government will be in a better position to fully finance their priority projects.

It is important to understand that there is no single solution to Nigeria's infrastructure needs. The most effective approach lies in creating initiatives that will drive an effective collaboration between a broad spectrum of players, both public and private in the financial markets.

Principles for Risk Allocation in PPP Projects

Risks can be defined as the likelihood of occurrence of an event and the probable consequence of such event. Risks in PPPs may affect the legal or commercial viability of the project.

IMPORTANCE OF RISK ALLOCATION

Risks can have a significant impact on project structure and costs, therefore consideration and allocation of risk is a central feature of PPP transactions. Risk allocation is an iterative process that involves systematic consideration of possible outcomes and procedures to accept, avoid, or minimize the impact of project risks.

“One of the main reasons PPP Projects fail is poor risk identification and allocation.”

One of the main reasons PPP Projects fail is poor risk identification and allocation. For example, the parties fail to realize that stakeholder management will be a significant challenge during the project and; or too much risk is placed on the public party, which often happens when the public party does not secure external advisers.

The effect is usually that the parties are unable to fulfill their obligations and the project is terminated prematurely.

KEY PRINCIPLES

Utilize the right process. The process of risk allocation broadly includes:

- P identification of project risks;
- P assessment of the likelihood of occurrence;
- P allocation of risks to parties; and
- P consideration of suitable mitigation measures.

Allocate risks to the right party. The underlying principle of risk allocation is that risks should be allocated to the party best able to bear the risks. For example, land acquisition, political and regulatory risks are more appropriate for the public sector, while construction, operating and commercial risks are more suited to the private sector. However, this can be varied for project specific reasons - for example, sharing of commercial risks may be considered to attract private investors in an untested or volatile market.

Avoid concentration of risks in the Project SPV. In public circles, PPPs are often considered as a means of transferring project risks to the private sector. However, a wholesale transfer of risks to the private sector does not produce an optimal outcome, as the private partner would ultimately face difficulties in securing financing if the risk being borne by the project proponent are deemed too high.

Develop a Risk Matrix. It is best practice to develop a risk matrix (also known as risk register), which identifies project risks throughout all phases of the project. At the minimum, a risk matrix should also assess the probability of occurrence and allocate identified risks. A risk matrix may proffer risk mitigation measures and show the results of risk valuation.

Consider Bankability. From a lender's perspective, the risk of default by the private entity should be minimized. Lenders are not keen on the borrower taking on more risk in the pursuit of better value for money outcomes, if this will increase the risk of default in loan repayment. Even if such projects achieve financial close, higher risk premiums may be charged based on assessed/perceived project risks.

Risks must be matched with Reward. A risk of loss should be matched with an opportunity for higher gains. The private sector may be willing to take on more risks with the knowledge that it stands to gain a higher return on investment. Thus, the additional return on investment acts as a risk premium.

“The underlying principle of risk allocation is that risks must be allocated to the Party that is best able to bear those risks”

Minimise likelihood of occurrence. Eliminate or reduce to the extent possible the chances of occurrence of a risk. For example, when possible, borrow in local currency to avoid exchange rate risk. Consider insurance, hedging arrangements or development finance institution guarantee to deal with risks which neither party is able to manage.

Allow for Flexibility. Risk allocation may be flexible and allow for allocation to third parties for example, toll road users by way of charging higher tariffs.

Prepare for Contingencies. in the event of occurrence of a risk, termination of a project should be the last resort, and Parties should allow for compensation or extension of time to enable parties address the issues and restore balance to the Project.

Conclusion

PPPs are structured based on risk and reward trade-offs and a balanced risk/reward profile. Lack of reasonable risk equilibrium will ultimately result in increased costs and a project in danger.

Good to know:

Ensuring Optimal Service Delivery in PPP Projects

One of the main reasons for executing projects on a PPP basis is to use available resources more effectively to ensure services are provided to users at a higher standard.

There are various ways to ensure that the delivery and performance of PPP projects meet parties' objectives and specifications. These principles are best addressed in the agreement governing the project to ensure clarity of deliverables and output specifications.

METHODS FOR ENSURING OPTIMAL PERFORMANCE

Methods include the following:

Performance Standards

Private Partners should have clear and measurable performance standards by which the delivery and quality of their services will be judged. Such standards should be verifiable, simple and easily monitored and reviewed to ensure there are clear ways of ascertaining levels of performance.

Step-in rights

The PPP Agreement should place an obligation on the private party to rectify any defects in the infrastructure or service, especially those discovered during an inspection. Failure to rectify should allow the public authority to step into the project and rectify such defects at the expense of the private party.

Establishing adequate monitoring, reporting and inspection methods:

The public authority will need to establish effective monitoring and reporting methods to enable it check performance. Authorities may however need to build internal capacity to carry out this responsibility effectively. Importantly, the approach should be a collaborative one towards optimal project performance, which requires a balance of understanding of project challenges and constraints and the

underlying need for excellent service delivery.

“Private Partners should have clear and measurable performance standards by which the delivery and quality of their services will be judged. .”

Liquidated damages provisions

The PPP Agreement may include substantial liquidated damages provisions to ensure services are delivered on time and to specifications. Failure to comply would trigger payment of compensation to the Public Authority in the form of damages.

Performance Bond

The procuring authority may require a performance bond which would be called on if service levels are not met. Typically, a series of actions must have preceded calling on the performance bond such as notifying the private operator of the non-compliance and allowing for a period of time within which to correct the non-compliance issue and the accumulation of default or non-compliance points resulting from several occasions of falling below agreed standards.

COMMON PITFALLS IN PERFORMANCE OPTIMIZATION

There are certain challenges that may hinder parties from ensuring that performance standards are met and sustained.

Setting unrealistic standards

Setting high standards can be desirable, but if such standards are unrealistic, the

project would be more expensive, especially since the private partner would seek to pass on costs to users.

For example, setting a standard that a bridge be free of litter in order to enhance driver experience is commendable, however, requiring that litter be removed from the bridge every hour may not result in enough benefit to offset the additional cost that will arise.

Inflexibility

Standards must strike a balance between fixed expectations and room for innovation. Very flexible standards involve a risk that the highest possible level of performance will not be obtained, whilst inflexible standards may limit adaptation to changing technologies.

Complexity of performance measurements

Measuring some performance standards can be complex. For example, stating that a portion of an area within the project scope be “neatly manicured” or stating that an ancillary work be “aesthetically appealing” allows for various interpretations which leads to difficulties in ascertaining whether standards have been met.

Inadequate resources for performance monitoring

In order to ensure that performance standards are being met, the activities of the private operator have to be consistently monitored. The public

“The level of camaraderie developed in the course of project development and negotiations can have a negative effect.”

Ensuring Optimum Service in PPP Projects *contd.*

authority is responsible for monitoring the performance of the private operator and may do this through procedures like self-reporting, independent audits, regular meetings and reports and automatic data collection and reporting processes. However, a lack of staff capacity and resources might hinder the agency in carrying out this responsibility which might in turn result in the project not meeting the objectives envisaged by the parties.

Conflict of Interests

The level of camaraderie developed in the course of project development and negotiations can have a negative effect. Close ties may result in the public party being unwilling to enforce certain rights it might have against the

private partner either because it may have some adverse effect on the already established relationship or for some other less altruistic reasons like securing a contract variation in its favour.

CONCLUSION

To ensure the successful implementation of projects embarked on, the PPP Agreement must be clear

about performance levels which must be adequate, comprehensive and realistic. Where possible, third party monitors should be empowered to review and regulate the performance of projects, serving as a check on both the public authority and the private partner.

“Performance levels must be adequate, comprehensive and realistic .”



Lagos Light Rail Works
Credit: www.nanngroonline.com

Industry News

- .. **Pension Fund assets to hit N10 Trillion by December.** The exponential increase of the size of pension fund assets is followed by continuous cries of capital market operators to ensure the deployment of these funds in infrastructure and urban development.
- .. **Lekki-Epe Expressway Concession Buy-Back.** The Lagos state has indicated that it intends to buy-back the rights bestowed to the Lekki Concession Company in the 2006 Concession Agreement. The reasons why the Lagos State Government decided to buy out include the request by the LCC to raise the tolling rate on the first toll plaza by 20 per cent from a minimum of N120 to N166 for a car at the minimum.
- .. **Abuja FCT Rail Mass Transit Services.** Request for proposals and Terms of Reference for transaction advisers for the Abuja for the Abuja Light Rail have been advertised by the Infrastructure Regulatory Commission. Originally proposed in 2006, Abuja's light railway aims to provide an affordable way for the city's workers to commute from the satellite towns surrounding the FCT.
- .. **Kogi State PPP Bureau and Law.** The Governor of Kogi State recently said that the state intends to establish a Public Private Partnership (PPP) Bureau as well as promulgate a PPP Law to attract private investors to contribute to infrastructure deficiency. The bureau is to be devoid of bureaucratic delays and facilitate coordination between project initiating ministries and private sector investors.

National Integrated Infrastructure Master Plan (NIIMP). The Minister of Nation Planning stated that the NIIMP is ready for submission. The NIIMP, prepared by the National Planning Commission, identifies the required investment to bring infrastructure in Nigeria to a desirable state. The plan has a 30 year outlook i.e. 2013 – 2043 made up of three 10 year strategic plans and six 5 year operational plans.



Niger Bridge

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Nigeria PPP Review is a publication of Detail Commercial Solicitors, a commercial law firm based in Lagos, Nigeria. DETAIL has a leading Infrastructure and Public-Private Partnerships practice in Nigeria and is committed to driving the growth and establishment of the PPP sector in the Nation.

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