Political Volatility & Funding Risks .

Presentation by
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What is Project Finance

"Raising of funds to finance an economically separable capital investment project in which the providers of funds look primarily to cash flow from the project to service their debt and provide returns on their equity"

Characteristics of Project Finance

- Complex contractual arrangements
- Limited or non-recourse financing
- Risk management strategies and techniques
- Changing perceptions, new innovations

The Emergence & Growth of Project Financing:

- Appropriate techniques for projects with high capital requirements and a complex risk profile
- Payouts are based only on the projects' own assets and cash flows stream
- Creditors rely on the ability of the project for repayment of related debt obligations, non-recourse debt
- Multi-source financing: syndicated commercial banks, bonds, multilaterals
- Tailor designed to suit the power industry

Key Issues and Challenges (to energy investment)

- **Liquidity** – currently a small number of Nigerian investors have the depth and capacity for fund power projects
- Also, the industry have no proven credit history
- **Standards** – need for standards and verification systems for measuring performance of funds injected & certainty of use of proceeds. Also need to establish standard terms and conditions for sectoral capital flow.
- **Policies & Government Support** – NESI infrastructural funding is dependent on policy instruments previously lacking & now being developed, with associated political risks which are now minimized
- **Transactional Risk** – higher technological risks associated with assembling & operating power plants in climes with dearth of technology
- **Risk and reward** – higher yields required to offset the present illiquidity of the NESI and any preconceptions of higher political or technical risk
- **Government backstop** –all the above lead to a state where investments inevitably require government guarantee + how deep and for how long (NBET, PRG, FMFInc)

Reported Constraints and Impediments to investment in NESI

- Unprofitable projects (e.g., too risky, insufficient profitability & scale, high upfront expense)
- Previous inadequate legal and regulatory frameworks, issues with local banking provisions for guarantees)
- Unacceptable risks & insufficient access to local funding (government crowding out, pension funds restrictions, government fiscal constraints)
- Weak local partners (e.g., operators, government)
- Unrealistic public expectations
- Difficulty/expensive coordination with multiple official donors

Clean energy funding in the NESI

- **Power demand currently outstrip supply** – Utility demand in Nigeria is expected to keep growing as a result of suppressed demand and population growth

- **Need to diversify feedstock** – gas rich nations have contracted-out gas output for near term and oil is most valuable as an export commodity; coal and biomass are being explored; good solar resources widely available in Nigeria

- **Projected feedstock shortages and bottlenecks** – major infrastructure development to develop new distribution networks to serve power generation

- **Strong infrastructure spending pipeline** – estimated at over $215 billion, significant portion of which is focused on power generation and related infrastructure
- **States pushing ahead** – most state governments have stated intent to devote resources to local renewable energy programs over the short and medium term

- **Knowledge transfer** – very limited local R&D and technology; developers are looking to import expertise and technology, while NERC quickens its local content regulations

Multilateral Level: Issues & Constraints

- Slow, bureaucratic & politicized procedures (rigidity of Board approval process, fear of innovation, politically-based decisions)
  - One-off deals
  - Lack of new programs/services (unresponsive to market requirements)
  - Politicization of work-outs & recovery processes

- Reduced faith in umbrella value (e.g., IFC default rate on B loans up from 1% pre-Asian crisis to 17% June 2003; Argentina deals)

- Lack of “coherence” with IMF fiscal policies (inadequate differentiation of expenditure vs. investment)

Impediments to Infrastructure Financing for Developing Countries

- Sponsors are reluctant to make new equity investments
- Commercial banks have retreated from project finance in both developed and developing countries
- International capital markets investors avoid developing country issues to finance infrastructure
- Local capital markets in developing countries are hesitant to bear both the commercial and financial risks of infrastructure
- Multilateral institutions have been unable to replace or attract new private funding

Sponsors Reluctance to Make New Developing Country Investments

- Previous developing country investments have produced disappointing returns because:
  - Regulatory risk had frequently reduced expected local currency cash flows
  - Devaluation had often reduced the US dollar value of local currency cash flows

- Difficult conditions in sponsors' home markets require that attention be given to sponsors'
  - Credit ratings
  - Balance sheet improvement
  - Share prices

- Sponsors' avoid new investments because:
  - They fear regulatory risk and devaluation will adversely affect new investments
  - They do not want to make decisions which appear to increase the risk profile of their firm to rating agencies or shareholders

Transformational Leadership

- Investor confidence boosted by
  - Executive Political-Will with policy stability and consistency
  - Rule of Law (sanctity of contracts)
  - Regulatory certainty (regulatory independence)
  - Institutional Capacity (Ministries, Departments and Agencies driving the change)
  - Proper project development (Proper feasibility/EIA Studies)
  - Ensuring credit worthiness of market participants (Bulk Trader)
  - Long-term planning

Enabling Environment

- The presence of a strong, independent regulator: **Nigerian Electricity Regulatory Commission**.
- Institution of a **cost reflective tariff** effective June 1st 2012 with Major reviews of Multi Year Tariff Order (MYTO) to occur after every 5 years
- Institutionalization of international best-practice commercial frameworks in Power Purchase Agreements (PPAs), Gas Supply Agreements (GSAs) and Gas Transport Agreements (GTAs)
- Presence of a credit—worthy off taker for power: **Nigeria Bulk Electricity Trading Company Plc** (also known as the Bulk Trader) backed by WB Partial Risk Guarantees

Next steps

From NERC's point of view

- ✓ **Be flexible enough to implement changes on rules and keep on running the system and the Market, in a delicate environment.**
- ✓ **Study and analyse scenarios to identify and anticipate risks, in order to help in the search of solutions.**

THANK YOU

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