



Aerial view of marina commercial business district, Lagos, Nigeria. Credit: Terver/Adobe

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Project financing and risk allocation for construction projects in Nigeria: legal aspects and mitigation strategies

Introduction

In countries across the world, construction projects are vital for infrastructure development, which in turn drives economic growth. Nigeria is no exception, with its infrastructure sector covering key amenities such as electricity, roads, railways, ports, airports, and oil and gas pipelines. These projects are typically large-scale and require significant funding, often sourced through debt, equity or a combination of both, along with alternative financing mechanisms. Project financing involves securing the necessary capital for these large-scale projects.

Given the scale of these projects, effective risk allocation is crucial. This involves assigning responsibilities for identified risks among project stakeholders, including contractors, sponsors and the government. Securing funding and executing these projects involves complexities, uncertainties and inherent risks. Therefore, understanding and managing these risks are essential for project success.

This article will explore the importance of effective project financing and risk allocation strategies in Nigerian construction projects. It will also provide recommendations for enhancing project financing and risk management practices to improve project success and stakeholder satisfaction.

Legal framework for the financing of construction projects in Nigeria

The financing of construction projects in Nigeria operates within an intricate network of regulations and oversight by numerous regulatory bodies, with the goal of promoting effective project development within the infrastructure sector. We shall examine some of these important regulations and regulators.

Infrastructure Concession Regulatory Commission (Establishment) Act 2005

The Infrastructure Concession Regulatory Commission (Establishment) Act established its commission, the Infrastructure Concession Regulatory Commission (ICRC), which plays an important role in regulating project financing in Nigeria, particularly in the context of infrastructure concessions, which involves a contractual agreement between a public authority and private company. As the agency responsible for overseeing public-private partnership (PPP) projects and concessions, the ICRC’s role in regulating project financing involves several key aspects, which includes the approval and regulation of PPP projects; developing and issuing guidelines, standards and best practices that PPP projects should adapt to; and conducting the financial viability assessment of PPP projects to evaluate their feasibility and sustainability. Furthermore, the ICRC plays a role in facilitating risk allocation and minimising these risks in PPP projects. The commission ensures that these risks are appropriately allocated among the project stakeholders, including government agencies, private investors and lenders.

National Policy on Public-Private Partnership

The National Policy on Public-Private Partnership provides a framework for regulating project financing in Nigeria by outlining guidelines and principles for engaging private sector participation in infrastructure development. This policy aims to ensure transparency, efficiency and accountability in PPP projects, while promoting sustainable financing arrangements. The policy outlines procedures for identifying, screening and approving PPP projects based on their

feasibility, strategic importance and alignment with national development priorities. This is pursuant to the fact that projects must undergo rigorous assessment to determine their suitability for private sector involvement and financing. It sets out the steps that the government will take to ensure that private investment is used, where appropriate, to address the infrastructure deficit and improve public services in a sustainable way.¹ By so doing, the policy provides guidelines for structuring PPP projects to attract private sector investment and financing.

National Environmental Standards and Regulations Enforcement Agency (NESREA) Act 2018

The NESREA Act indirectly regulates construction and project financing in Nigeria by establishing environmental standards and requirements that construction projects must adhere to. While the NESREA Act primarily focuses on environmental protection and sustainability, its provisions can impact project financing as it provides for environmental compliance requirements, which mandates that construction projects comply with environmental standards and regulations in order to mitigate the impacts of these projects on the environment.

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The enforcement agency undertakes this objective by conducting environmental impact assessment (EIA) tests to assess the potential effects the construction projects can cause to the environment and develop measures to mitigate them. The agency also grants approvals and permits, and the cost of obtaining these permits are factored into the project’s financing plan. It is pertinent to state that environmental safety standards are important and, as such, compliance is non-negotiable. As a result of this, the NESREA Act imposes sanctions for non-compliance with environmental regulations. This implies that construction projects found to be in violation of environmental standards may face fines, remediation costs or legal liabilities, which can impact project budgets and financing arrangements.

Public Procurement Act (PPA)

Enacted in 2007, the PPA serves as the cornerstone for transparent and accountable public procurement in Nigeria. It applies to the procurement of goods, works and services by all federal government ministries, departments and agencies. The PPA plays a significant role in setting the framework for how public funds are used in construction projects financed through project financing. Here's how:

- ensures a fair and transparent process:
 - the PPA establishes a fair and open bidding process for selecting contractors, which reduces the risk of favouritism or corruption in awarding contracts for project financing; and
 - publicly funded projects often rely on private investment alongside public funds and the PPA's transparency helps build trust with private investors;
- defines requirements and standards:
 - the PPA outlines specific requirements for project documentation, qualifications for bidders and contract terms, which ensures a baseline quality standard for construction and protects public funds; and
 - project financing lenders rely on the predictability of the procurement process and the PPA helps to mitigate risks associated with the project by establishing clear guidelines.

Overall, the PPA helps to ensure that public funds used in project financing are spent efficiently and effectively, while promoting fair competition in the construction sector.

Bureau of Public Enterprises (BPE) Act

Established in 1999, the BPE Act typically focuses on the privatisation and commercialisation of state-owned enterprises (SOEs). The BPE Act is primarily concerned with ensuring a smooth and transparent process for private sector involvement in SOEs.

In some cases, the BPE Act might play a role if privatisation involves the construction of new assets or infrastructure as part of the deal. The BPE Act would ensure proper procedures are followed for selecting a private partner and structuring the transaction.

While the BPE Act might not directly govern construction project finance, it can play a supporting role in specific cases

involving privatisation and create a more open environment for private investment, which can benefit project finance in general.

Overview of the various financing options for construction projects in Nigeria

Large-scale infrastructure projects play a crucial role in driving economic development, improving living standards and enhancing competitiveness in countries like Nigeria. However, the complexities of these projects often demand substantial financial resources, necessitating innovative finance sourcing and strategic partnerships to ensure their successful implementation. The financing of these large-scale infrastructure projects poses significant challenges due to their long gestation periods, high costs and inherent risks. In this context, understanding the diverse financing options available for large-scale infrastructure projects becomes paramount. Some of these project financing options will be discussed below.

- Traditional bank loans: Debt is a common project financing option for large-scale construction projects, providing access to capital from commercial banks and financial institutions through loans. These loans provide project developers with the required capital to fund these projects from its initial stage to completion. These loans typically involve fixed or variable interest rates and may often require collateral or security, as well as a provision for its repayment terms.
- Equity financing: Equity financing involves raising capital by selling ownership stakes or shares in the construction project to potential investors. Equity investors, such as individuals, private equity firms and institutional investors, provide capital in exchange for ownership equity. In return, they receive dividends or a share of the project's profits on completion and within a specific duration.
- Government funding: Government agencies at the federal, state or local levels may provide funding or grants for construction projects, particularly those deemed to be of public interest or strategic importance. Government funding can include budget allocations, subsidies or concessional loans to support infrastructure development initiatives.

- Government guarantees: The government acts as a guarantor, assuring lenders of loan repayment in the case of project failure. This attracts private lenders and increases access to capital.
- Initial public offerings (IPOs): SOEs involved in the project can raise funds by issuing shares to the public through an IPO, attracting investment from the stock market.
- PPPs: PPPs involve collaboration between public and private sector entities to finance, develop and operate infrastructure projects. In PPPs, the private sector partner typically provides funding, expertise and resources for the project development, while the public sector contributes land, regulatory support and revenue guarantees.
- Sovereign wealth funds (SWFs): Governments with SWFs can utilise these funds to directly invest in state-owned projects.
- Development banks: National or multilateral development banks can provide project-specific loans or grants that align with their development goals.
- Alternative financing mechanisms: Construction projects may explore alternative financing mechanisms, such as lease financing, mezzanine financing, crowdfunding or peer-to-peer lending platforms, to raise capital from individual or institutional investors. These alternative financing mechanisms are innovative financing options that offer flexibility and access to capital, as opposed to the conventional banking systems.

Raising finance for large-scale construction projects can be complex as it involves navigating various financial, legal and regulatory challenges. The complexity of raising finance stems from several factors. First, the scale of construction projects is large and often requires substantial capital investment, which may exceed the investors' capacity to handle projects independently. Second, projects may encounter uncertainties and risks, ranging from regulatory changes and price fluctuations to environmental challenges, making investors sceptical about committing funds to these projects.

In this challenging landscape, legal agreements play an important role in facilitating project financing by providing a structured framework for defining rights and obligations, and ensuring the enforceability of every financial arrangement. These legal agreements serve as binding contracts that prescribe the terms and

conditions of financing, establish security interests, allocate risks among project stakeholders and provide mechanisms for dispute resolution. They help to enhance the clarity and certainty of project financing arrangements, thereby bolstering confidence among lenders, investors and other stakeholders.

Risk allocation strategies in Nigerian construction projects

Construction projects in Nigeria face a variety of risks that can impact their success. Effective project financing hinges on a clear understanding and allocation of these risks among project stakeholders. This process helps to:

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- attract investors: by demonstrating a well-defined risk management plan, a project becomes more attractive to lenders and investors, and a clear allocation of risks shows that they understand potential challenges and have strategies in place to address them;
- secure favourable loan terms: the allocation of risks can influence the terms of a loan and shifting certain risks to parties better equipped to handle them can lead to lower interest rates or more favourable repayment structures; and
- enhance project success: when each stakeholder understands the risks they are responsible for, they are more likely to proactively manage and mitigate them, which can lead to smoother project execution and less chance of unforeseen issues derailing the project.

Risk evaluation: the heart of project finance

Project financing relies heavily on a thorough evaluation of these risks. Lenders need to understand the potential financial impact of various risks before they commit funds. This evaluation considers factors like:

- Likelihood of the risk occurring: how probable is it that a specific risk will materialise?

- Impact on project costs: if the risk occurs, how much will it potentially cost the project?
- Risk mitigation strategies: what measures are in place to reduce the likelihood or impact of the risk?

Allocating risks in project finance

Based on the evaluation, risks are then allocated in project financing agreements. Here's a possible breakdown for common Nigerian construction project risks:

- Financial risks (funding shortages and price fluctuations): these might be shared between the borrower (construction company) and the lender (bank); the lender may require certain financial instruments to mitigate these risks, such as performance bonds or guarantees.
- Project delays (regulatory approvals): the allocation depends on the reason for the delay; if it's due to unforeseen bureaucratic hurdles, the risk may fall on the government entity responsible for approvals; however, if delays stem from poor planning by the contractor, this party may bear the financial burden.
- Environmental risks: the contractor typically holds most of the responsibility for managing and mitigating environmental risks associated with construction activities.
- Legal and regulatory risks: both the borrower and lender may share these risks, depending on the specific nature of the legal issue; strong, well-drafted contracts can help minimise these risks.
- Political and socio-economic risks: these can be difficult to allocate as they are often external factors; however, some risk transfer mechanisms, like political risk insurance, can be explored to protect against unforeseen government actions.

Proactive risk identification: don't wait for problems to arise. Conduct comprehensive risk assessments at the project planning stage, considering PESTEL factors specific to Nigeria

By carefully evaluating and allocating risks, project financing in Nigeria can be placed on a more solid footing. This leads to a more predictable project environment, increased investor confidence and ultimately, a higher chance of project success.

Recommendations for enhancing project financing and risk management practices in Nigeria

Our recommendations for enhancing project financing and risk management practices to achieve better project outcomes and stakeholder satisfaction in Nigeria are:

Project financing

- Diversification of funding sources: relying solely on traditional bank loans can be limiting; thus, explore options like PPPs, infrastructure bonds and development finance institutions to spread risk and access wider funding pools.
- Project viability assessments: before securing financing, conduct thorough feasibility studies that consider not just financial viability but also social and environmental impact. This builds confidence with lenders and stakeholders.
- Local content requirements: integrate local participation in project financing. This can entail involving local banks, fostering domestic investment and creating employment opportunities, leading to increased stakeholder buy-in.

Risk management

- Proactive risk identification: don't wait for problems to arise. Conduct comprehensive risk assessments at the project planning stage, considering political, economic, social, technical, environmental and legal (PESTEL) factors specific to Nigeria.
- Contingency planning: develop clear and actionable contingency plans for identified risks. These plans should outline mitigation strategies, resource allocation and communication protocols in the case of disruptions.
- Stakeholder engagement: actively engage stakeholders throughout the project lifecycle. Keep them informed of potential risks, mitigation efforts and project progress. This fosters trust and reduces surprises that can lead to dissatisfaction.
- Focus on sustainability: integrate environmental and social considerations into project planning and execution. This reduces long-term risks and improves stakeholder perception.

By implementing these recommendations, project financing in Nigeria can become more secure and risk management practices can be more proactive. This will lead to a higher chance of project success and increased satisfaction among all stakeholders involved.

Conclusion

In conclusion, the success of construction projects in Nigeria relies heavily on effective project financing as, most times, individual investors or the government cannot finance large-scale projects independently. However, these projects have inherent risks and identifying these risks, as well as allocating them to project participants, makes all the difference. This implies that effective project financing and risk allocation are essential for the development of construction projects in Nigeria. To enhance project outcomes, stakeholders must prioritise risk management, leverage legal frameworks and adopt best practices in financing and risk allocation.

Note

- 1 The World Bank, Nigeria National Policy on Public-Private Partnerships <https://ppp.worldbank.org/public-private-partnership/library/nigeria-national-policy-public-private-partnerships> accessed 11 June 2024.

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