The Nigerian power market experiment: a critical appraisal of the PHCN privatisation

15 MAR 2019
By: Dimitri Papaefstratiou

Introduction

This article intends to offer a brief description and analysis of the Nigeria power sector, explore the issues and challenges faced by private investors and potential solutions for reform.

It has been written from first-hand experience of the evolution of the Nigerian power sector and, in particular, the privatisation of the Power Holding Company of Nigeria (PHCN). The privatisation of PHCN took place in November 2013 and involved the unbundling of PHCN and privatisation of the power generation companies (GENCOs) and distribution companies (DISCOs).

This was a very hopeful time, when the high oil price generated considerable revenues for the Nigerian public purse and benefitted the economy as a whole. The privatisation was expected to generate immense investment in the power sector and turbo-charge the economy; private investors believed that the investment opportunity in the sector would lead to returns akin to those enjoyed in the telecommunications sector during the mobile telecommunications expansion. The privatisation of PHCN was intended to be the first step, to be followed shortly by the privatisation of the Niger Delta Power Holding Company. Further, independent power projects (IPPs) such as Azura and a number of renewable energy projects would, it was hoped, complete the picture of a transformed power sector.

Suffice to say that this vision has only been, at best, partially delivered. The power sector is currently failing to attract substantial new investment; it is mired in disputes and finger-pointing and many of the new IPPs under development are in stasis.

This article is intended to briefly explore some of the underlying reasons why the privatisation process failed to achieve its stated aims and to consider some of the areas in which changes can be made to resolve the deadlock gripping the sector.

Here at DLA Piper we have had the pleasure and honour of acting for many different clients in the Nigerian energy market, including sponsors of various IPPs, lenders and investors. Please note that although many insights have been incorporated, the views expressed in this article are entirely personal.

Background: the privatisation of PHCN

The privatisation of PHCN was launched in early 2011 and was led by the Bureau of Public Enterprises (BPE). Previously, PHCN had been a vertically integrated utility, selling (unreliable) power directly to consumers at subsidised prices. Most businesses of size and private consumers own and operate their own private power generators, which run on fuel that was also subsidised. Most power consumed in Nigeria was (and still is) privately generated at prices significantly more expensive than the (unreliable) power available on the grid. This was and remains the paradox at the centre of the Nigerian power market.
The privatisation of PHCN was intended to address this issue by three principal means:

- introducing the discipline of the private sector and access to private sector capital;
- allowing prices to become cost-reflective and therefore sustainable in the long-term without subsidies; and
- reducing losses from power transmitted and distributed and attracting further private investment into the transmission and distribution systems.

**GENCOs and DISCOs**

As part of the privatisation PHCN, was broken into:

- GENCOs that would each own and operate a single power generation asset;
- DISCOs that would own and operate power distribution networks; and
- the Transmission Company of Nigeria (TCN) that would own and operate the transmission assets of PHCN.

Shares in the GENCOs and DISCOs were sold to private investors (mostly Nigerian) as "clean skin" companies without any prior liabilities and it is estimated that the country earned about USD 2 billion from the sale. It is believed that most of these funds were paid to PHCNs unionised labour force in the form of severance packages.

TCN was to remain in public ownership but management would be outsourced to a private enterprise. The GENCOs and DISCOs were to be privatised on the basis of different criteria: these included technical capability and financial offers for GENCOs and tenders based upon an ability and willingness to reduce power losses for DISCOs.

**Nigerian Bulk Trader (NBET) and the Gas Aggregator**

NBET and the Gas Aggregator were created to sit between the different private sector participants in the newly privatised power market.
NBET would purchase power from GENCOs under a “standard form” Power Purchase Agreement (PPA) and sell it to the DISCOs for onward distribution to consumers under the terms of a sale contract known as a “Vesting Agreement”. The initial intention was that NBET would sit between GENCOs and DISCOs in order to ensure that GENCOs did not have to rely directly on DISCOs for their revenues. NBET was, therefore, intended to act as a “shock absorber”.

The Gas Aggregator was created to manage and “smooth” expected shortfalls in gas supply. GENCOs were expected to contract directly with private suppliers of gas for supply of natural gas. The Gas Aggregator was originally conceived of as a way of ensuring that GENCOs were able to access natural gas at regulated prices from private suppliers. The Gas Aggregator joined as a party to the various gas supply agreements but its role was and remains less clear.

Challenges identified: structural and procedural weaknesses

1. The privatisation process

   The design and implementation of the privatisation process suffered from a number of weaknesses. Many of these weaknesses were procedural and stemmed from practical difficulties in implementing the envisaged privatisation programme. For instance:

   - Reliable audited accounts detailing liabilities of the businesses to be privatised were not made available to investors and this was particularly problematic in the case of the DISCOs. Whilst the historical liabilities were to be transferred to a “bad bank” (AMCON), the private investors were soon to discover that the running costs of the DISCOs were significant and in many cases exceeded revenues.
   - GENCOs and DISCOs were purchased with minimal due diligence, limited warranty protections and no government support. Whilst it is not unusual for privatised assets to be sold on an “as is” basis, investors in the PHCN privatisation programme had in practice very little visibility of and information relating to the assets and businesses they were purchasing. In many cases, the acquisition of such assets was a leap of faith on the part of investors.
   - The operational capabilities of some of the privatised assets deteriorated throughout the privatisation process as scarce resources were no longer directed towards the continued operation and maintenance of those assets.

2. Failure to properly capitalise NBET

   In addition to weaknesses and deficiencies in the implementation of the PHCN privatisation scheme, there was a key design flaw in the scheme that has impacted many of the subsequent developments. In simple terms, NBET has no balance sheet or revenues of its own and has no clear access to government funding. This has resulted in
continued concerns about the creditworthiness of NBET and its ability to offtake and pay for power; this is especially likely to be the case in scenarios where DISCOs are in distress and are unable to pay NBET (or delay in paying) for purchase of power under their Vesting Agreements. Essentially, NBET was envisaged to occupy the space between GENCOs and DISCOs, acting as a conduit between the private sector operatives in the power value chain and as a “shock absorber” in case of market turbulence. Clearly, this is a role that NBET would only be unable to perform if it were creditworthy.

BPE sought to address the concerns raised in relation to NBET’s creditworthiness by: (a) proposing that a partial risk guarantee issued by the World Bank would provide credit support for a payment default by NBET; and (b) by proposing to provide GENCOs with a standby letter of credit from a rated financial institution, originally for a period equal to between 6 - 12 months’ of PPA revenues. However these proposed solutions proved impossible to implement. Subsequently, various proposals were announced to segregate public funds from asset disposals and Nigerian government bond issuances into ring-fenced NBET accounts. None of these solutions materialised and GENCOs (as well as subsequent IPPs) were required to accept the naked covenant of NBET, an unfunded but government-owned SPV.

3. **Economic viability of DISCOs**

DISCOs were known to have previously encountered financial difficulties which partially resulted from cash collection inefficiencies. At the time, it was assumed this problem was mainly with residential users and would be addressed through pre-paid meters. In addition, DISCOs were privatised with a fixed customer basis and an expectation that the new private owners would invest additional funds in order to reduce power losses. In the absence of “easy fixes”, the greater loss reductions bid required greater capital expenditure, to be funded by a mix of equity and debt - yet no additional ring-fenced income stream was envisaged in the privatisation structure to repay that capital invested; instead, it was envisaged that improving cash collection and becoming more efficient in other areas would ultimately lead to repayment of this additional investment.

What was also not well understood, especially given the absence of accounts, was the magnitude of the on-going operating costs of the DISCO businesses; and the persistent non-payment for power by certain powerful large-scale consumers, reputedly including both private and public sector entities.

4. **GENCO power tariffs**

There is a degree of confusion at the heart of the model for NBET’s purchase of power from the GENCOs. The PPAs entered into by NBET are typically drafted to reflect a “cost plus” model, whereby the cost of power for each individual GENCO is determined by a formula which is intended to compensate the GENCO for costs incurred, including fuel costs, operation and maintenance costs and returns on debt and equity capital employed. Given that GENCOs were subject to different levels of costs (due to the size, technology and different maintenance profiles of these assets) and were acquired at different prices determined on an individual basis by tender, one would expect each GENCO to have an individual power tariff. Yet in practice, it appears that there is no such “individualised” treatment but rather that power is purchased from GENCOs at a flat price per unit of power sold. As noted further in this article, this problem is compounded by the questionable legal status currently of the GENCO PPAs.

5. **The Trust Deficit**

An issue that is often overlooked is the deficit in mutual trust that was the by-product of the manner in which the PHCN privatisation was initially managed.

**Industry documents**

Bidders were requested to provide their bids for GENCOs and DISCOs on the basis of certain commitments contained in the tender documents.

Bidders had been informed in the initial tender documentation that they would have a period of time after signing the acquisition documents to negotiate and finalise the terms of the “industry documents” which included the PPA, Gas Supply Agreement and Vesting Agreements for DISCOs. It had been assumed that during this negotiation period various bankability issues (including the provision of credit support) would be resolved. As bidders walked in to sign the acquisition documents, they were informed that the existing management of the yet-to-be-privatised GENCOs and DISCOs were signing the “industry documents” based on the pro forma drafts circulated with the
tender documents. None of these documents were to be meaningfully negotiated and various bankability issues (including credit support issues) were not addressed.

It subsequently became clear that the BPE was prepared to use bid bonds provided previously as leverage to ensure that bidders did not drop out of the bidding process. Conversely, most bidders assumed, mistakenly as it turned out, that they would be able to negotiate and fine-tune their respective positions with the relevant Nigerian authorities once the privatisation was completed and the political pressure to conclude the process was relieved. Instead, following payment by the bidders for the shares in the privatised entities they were acquiring, an extraordinary turn of events ensued.

**Interim rules**

The bidders were not given the shares that they had paid for and instead were kept waiting for a period of nearly three months. The Nigerian authorities largely disregarded the process for completion of the privatisation as envisaged in the tender documents. It was subsequently announced that the rules by which the newly privatised market would operate had changed and “interim” rules would be enacted until all conditions precedent under the industry documents were satisfied (which is to be announced by the Nigerian authorities in due course).

The so-called “interim” rules were introduced to the power market structure by public authorities including the Nigerian Electricity Regulatory Commission (NERC). These had a number of significant consequences, including preventing the main “industry documents” entered into by the GENCOs and DISCOs from coming into effect (including PPAs that had formed the basis of the tender for the GENCOs) and altering the revenue and risk allocation profile between market participants.

Power generated by GENCOs was to be paid for on the basis of moneys actually collected from the DISCOs and remitted, following payment of their operational expenses, to NBET; there was a cap introduced for moneys to be recovered by each GENCO at under 50% of what such GENCO would have recovered under the previous system envisaged in the tender. Only after the announcement of the coming into force of the “interim rules” was made were the shares in the newly privatised entities released to the successful bidders. This intervention heralded a period of turmoil in the sector, ultimately leading to the stagnation of the sector and the cancellation of most new investment.

It is sometimes said that the “interim” rules were the by-product of crisis management once it became apparent that the privatised DISCOs were not economically viable. Subsequently, a number of initiatives have been introduced, including the provision of liquidity directly into the power generation and distribution value chain by the Central Bank of Nigeria (CBN), to try and improve market conditions. In 2015, NERC went further and announced that Nigeria’s liberalised electricity market subsequently achieved the next stage of the Transitional Electricity Market (TEM). Various plans and new regimes have from time to time been promulgated, announced and consulted upon. But the stark fact that the Nigerian authorities wrong-footed investors from the outset remains and continues to poison the sector.

**The impact on IPPs**

The existence of this crisis in the privatised power market has, as one can readily understand, a profound effect on IPPs and their existing and planned projects.

The manner in which the Nigerian authorities treated private investors in the privatisation of PHCN suggests that IPPs are not able to count on a benevolent investment climate or a private-sector friendly regulatory environment. Rather, private sector investors look to robust assurances from multilaterals, export credit agencies (ECAs), development finance institutions (DFIs) and insurers to mitigate these risks, either through guarantee instruments, political risk insurance or the “halo” effect that multilateral entities like MIGA provide. Project lenders will further price these risks in their interest rate margins and carefully scrutinise the project for weaknesses that may allow the Nigerian authorities to backtrack on their commitments.

This situation is compounded by the crisis gripping the solar IPPs, which have remained in stasis for years over on-going disagreements over the desire of the Nigerian authorities to further reduce previously agreed tariffs. It would seem churlish to point out that tariffs remain stubbornly high in circumstances where increased risk is priced in.

As a result, new investment in the power sector in Nigeria has largely stalled. Those investments that do proceed take time, incur substantial development costs and tend to generate power that is described as expensive in
comparison with other relevant markets on the continent. Whilst these are not unusual criticisms of African power projects as a whole, the impact on Africa’s largest economy is notable.

**The current stalemate**

It was recently reported in the Nigerian press, that a group of thirteen GENCOs have filed law suits against the Federal Government of Nigeria (FGN) for driving them to the brink of "economic ruin", by allegedly giving preferential treatment to two competitors. This matter remains before the Nigerian courts.

More recently, the Association of Power Generating Companies on 1 January 2019 concluded its damning assessment of the Nigerian power market as follows:

"...The declaration of the Transitional Electricity Market (TEM) would signal the commencement of all contracts but contrary to the TEM promise, the conditions for declaring it are still far away. Without effective contracts – Power Purchase Agreements (PPA), Ancillary Agreements, Gas Supply Agreements (GSA), Vesting Contracts between Discos and NBET and other industry contracts, TEM cannot be said to have taken off... The power sector is yet to attain a contractual market status. According to the GENCOs, the current market situation, “gives room for conjectures, no contract is binding, and all are on best endeavour.”"

The announcement by the GENCOs also indicates the continued importance of credit support for NBET’s obligations: “With the existence of an enhanced payment security, GENCOs will be able to fund working capital and raise capital expenditure to upgrade their operations in order to meet the electricity demands of Nigeria. GENCOs require adequate payment security from NBET as per the PPA to back stop payments due under the PPA.”

**An eye to the future: potential solutions?**

The current state of the power market in Nigeria is not compatible with achieving a high level of economic growth. It is also relatively clear that, whilst private capital can and should play a very important role in the future development and growth of this market, no further substantial investments will be made in this sector as it currently stands unless substantial changes are made. It is, therefore, for the FGN to take brave steps to unlock this problem and provide solutions. This is not to belittle the economic challenges facing the public purse or to discount suboptimal behaviours from the private sector; but ultimately, it is only the FGN, in association with NBET and NERC, that can effect real changes in the market at this stage.

It is noted that the FGN has tried to take a number of steps to improve the conditions in the market over the last few years. In coordination with CBN, a programme to inject liquidity in the market was implemented; whilst this did provide some relief, such an ad hoc measure was only sufficient as a temporary improvement to market conditions. More recently, in May 2017, the minister for Power, Works and Housing invoked the Eligible Customer Declaration in accordance with Section 27 of the Electric Power Sector Reform Act 2005, allowing certain “Eligible Customers” (in practice, those whose electricity consumption exceeds 2MW per month) to purchase power directly from licenced power generation companies, such as GENCOs. The net effect of this measure is to allow certain large customers to elect to cut DISCOs out of their power supply chain and further incentivise the supply of large-scale customers from captive projects (noting that there is some uncertainty as to what types of capacity would be considered eligible). Other approaches include “embedded generation” projects supplying power directly to certain DISCOs or proposals to supply power to certain regional or state governments. In our view, such measures allow for limited respite from the key problems gripping the sector. In our view, such measures allow for limited respite from the key problems gripping the sector. For the Nigerian electricity market to thrive, a more wholesale government intervention is likely to be required that addresses head-on the legacy of the sector privatisation.

With much trepidation, given the sensitivities of all parties, below are some key issues that may be necessary to address as part of any large-scale government intervention in the Nigerian power market:

- Restoring trust must be a key part of any reform. A consultation period must involve substantial discussion with market participants. As a minimum, contracts agreed must be adhered to and all market participants (especially public sector entities) must be seen to comply with their obligations to the best of their ability.
- NBET is essentially an empty shell, a shock absorber with no balance sheet which needs to be properly capitalised and supported financially by the FGN in ensuring payments are made to the GENCOs on time and in full. This must include liquidity and credit support of some kind for the benefit of the GENCOs. Credibility of offtake and lowering payment risk are key to ultimately reducing the price of power.
- The FGN and NERC should abandon the rush to introduce a “bilateral” market (where GENCOs depend directly on
revenue raising of individual DISCOs for payment, rather than selling their power to NBET without "retail" exposure). The PHCN privatisation depended on NBET acting as shock absorber and this model should be retained for the foreseeable future (or at least until DISCOs are profitable and represent an acceptable credit risk for GENCOs).

- In the absence of cost-reflective tariffs and given the current difficulties with DISCO’s cash collections, the public sector must remain involved - acknowledging that this will involve financial outlay incurred in supporting NBET which needs to be budgeted for in the medium term. The increased cost to the public purse may be justified to taxpayers on a number of grounds, including (a) that paying for power even at relatively high tariffs is a better use of resources than enduring power shortages; and (b) that purchasing power from the grid, even at cost-reflective tariffs, should be cheaper than running diesel generators, provided that the security of such supply is safeguarded.
- Tariffs must be allowed to rise progressively and on the basis of an agreed schedule over a number of years towards the cost-reflective mark. At the same time, FGN needs to clarify and agree with the GENCOs the basis on which it will procure power from them - whether at a “cost plus” or flat tariff. The PPAs must then be amended accordingly and must “go live”, regulating the future relationship between NBET and the GENCOs. The sector cannot attract investment if it is not regulated by contractual principles. This must include an acknowledgement that private capital must be permitted to make sustainable returns.
- All IPPs must be treated fairly in accordance with their agreed contractual arrangements - the IPPs procured on the basis of bilateral arrangements (including Azura) and the GENCO’s must be regulated in accordance with the same rules, with power dispatched and paid for accordingly. Regulatory powers should not be used to amend contractual obligations.
- It may be appropriate for the FGN to negotiate the re-transfer of certain DISCOs into public ownership. Those DISCOs that remain privately owned must be supported by FGN in seeking a DFI-backed programme of investment to reduce losses, potentially with government financial support. An interesting model is currently being showcased in Ghana, with ECG having invited and accepted private investment and management in its distribution business, with pre-agreed commitments to inject capital from the private sector, in exchange for donor funding commitments and overall programme supervision. In any event, it must be acknowledged that in Nigeria and in the current circumstances, the DISCOs will struggle to raise additional capital whilst their businesses are loss-making, without the intervention of the public sector. DISCOs must continue to seek to minimise and better manage their costs, increasing the transparency of this process.
- FGN must oversee, procure and pay for investment into the transmission and gas supply network infrastructure. It is worth noting that unless the FGN can both provide and secure an adequate return on capital invested, private capital is unlikely to invest in loss reduction, grid upgrade, gas transportation or other efficiencies. Gas supply will also need to be improved and the cost of gas must also be allowed to gradually escalate towards a cost-reflective price.
- FGN must recognise that tariffs cannot be fully denominated in Naira. Investors may accept to bear some limited shorter term foreign exchange risk, however, ultimately foreign exchange risk will have to lie at the doorstep of the public sector for now. It is possible for a portion of the tariff to be denominated in Naira, but that cannot exceed the portion of each GENCO’s expenses that are denominated in Naira. Assuming that DISCOs continue to earn their revenues in Naira, and in the absence of a functioning USD-Naira hedging market, the only player that can sensibly bear that burden must be NBET (or rather, FGN through NBET).

There is little doubt that a reform along these lines would result in economic pain for the public purse for at least the medium term. The gain would be a much better supported electricity market that could serve the needs of the nation. The aspiration must be that the economic growth that would follow would be worth the up-front investment. It must follow that an investment of that nature is the sole prerogative of FGN, with support from the DFI and multilateral communities. Whilst the private sector should continue to have a substantial role, ultimately the public sector in markets such as Nigeria must take the lead in fostering economic development in country.

1 See https://www.thecable.ng/verge-collapse-13-gencos-drag-fg-court - “Nigeria’s power crisis is in for more shocking waves as 13 power generation companies (GenCos) have sued the federal government for giving “preferential treatment” to two competitors with intent to harm the business interests of the others.”
2 As reported in ThisDayLive
3 For an excellent presentation of the effects of this measure, see "Eligible Customer Declaration - Matters Arising"

AUTHORS

Dimitri Papaefstratiou
DLA Piper is a global law firm operating through various separate and distinct legal entities. Further details of these entities can be found at www.dlapiper.com. This may qualify as