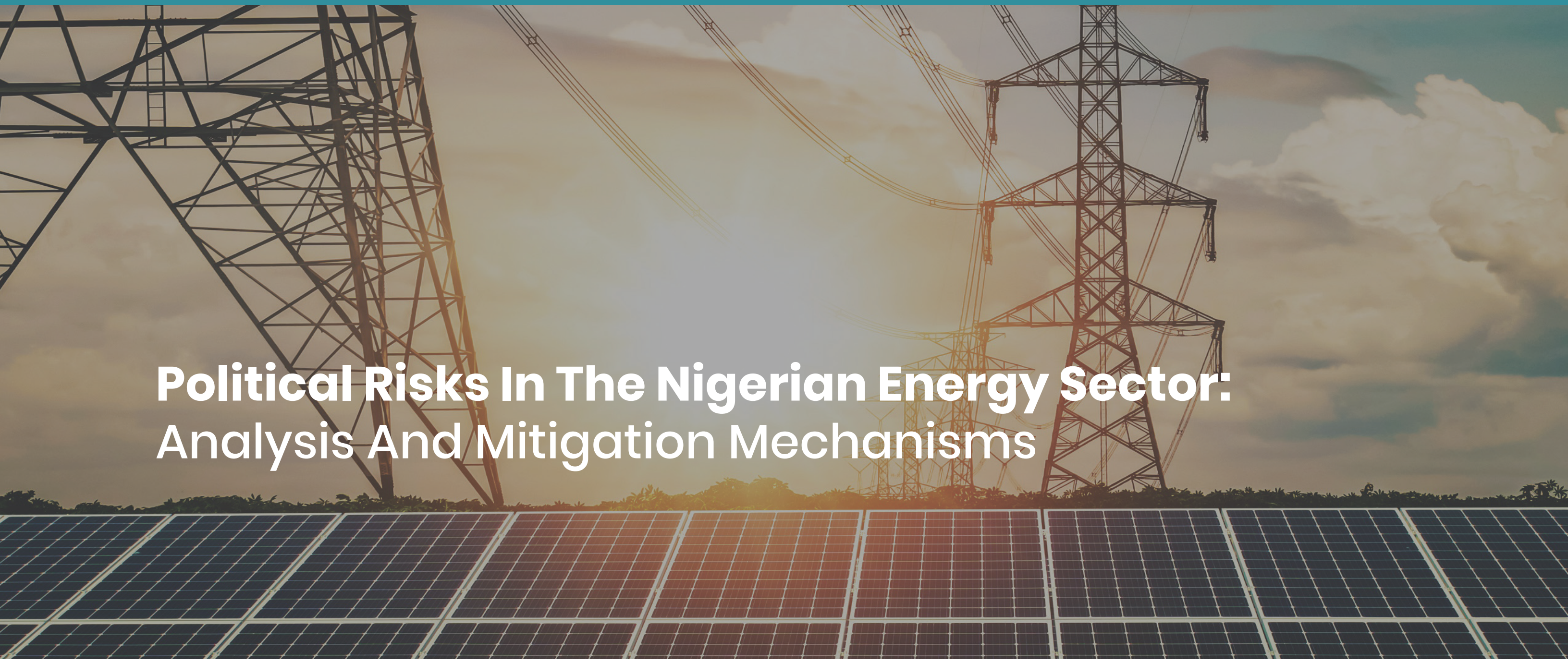

Political Risks In The Nigerian Energy Sector: Analysis And Mitigation Mechanisms

Proem

Nigeria is one of Africa's most prolific oil-producing countries[1], with an energy source mix of fossil fuels (such as oil, bitumen, natural gas, and coal) and renewable energy sources (such as solar, wind, hydropower, and biomass), with nuclear energy still being in its early developmental stages.

The Nigerian energy sector is focused largely on the extractive industry (particularly, the oil and gas industry) which encompasses activities such as exploration, production, refining, and distribution of crude oil and natural gas. Electricity is another aspect of Nigeria's energy and includes activities related to generating, transmitting, and distributing electricity to meet the country's enormous electric power needs. Electricity is generated from both grid-connected power plants and off-grid solutions like mini-grids and Stand-alone Power (SAP) systems, whether through gas-fired plants, or renewable energy sources. These renewable energy sources which include solar, wind, hydropower, biomass, and geothermal energy have become key components of Nigeria's energy mix plans, to ensure a robust diversity of its energy sources, improve the security of energy supply, reduce greenhouse gas emissions, and promote sustainability.

Risks in the Energy Sector

To have electricity supplied to the burner-tip (final consumers such as residential users, factories, and businesses), there is a host of activities, as have been described above, that would take place and much of these, will occur within the context of projects of various forms. These projects will typically require financing and such financing will usually be off-balance sheet-type lending and would usually rely on the cashflow from such projects to be financed. Off-balance sheet lending which relies on the future cashflow from such projects is generally referred to, as 'project finance'. There are risks inherent in doing projects in Africa (most especially sub-Saharan Africa) and more so, in a capital-intensive sector, like the energy sector.

Whilst there are many definitions attributable to the concept of risk, it has been defined as the chance of injury, damage, or loss; danger or hazard.[2]

Indeed, risks exist in several forms, especially in relation to the financing and or development of gas or power projects infrastructure, in Nigeria. They generally include investment and economic risks such as credit worthiness of investors, liquidity and refinancing, inadequate business models, volatile exchange rates and inflation; environmental risks, such as natural disasters (fire, storms, flood), governmental and societal actions, such as civil unrests, strikes, wars and sometimes infrastructure failure; legal and regulatory risks, such as regulatory reforms, executive orders, changes in tax laws or safety and environmental policies; and Social Risks such as poverty, limited community resources, low community participation, social and cultural norms that encourage violence.

However, this article particularly discusses the type of risks, known as political risks; including the nature and extent of this risk and how it should be mitigated by players in the Nigerian energy industry.

Political Risks in the Nigerian Energy Sector

Political risk refers to the potential for the disruption of business operations due to political or government action, forces, or events[3], in a way that significantly influences the perception of both domestic and foreign investors and lenders regarding the profitability and viability of investments, business operations, and project financing in a particular country. In relation to the Nigerian energy sector, political risk events include the following:

a. **Government Reforms**: The Nigerian government may undertake reforms which may directly or indirectly impact the energy sector. This includes changes in regulations, policies, and fiscal frameworks pertaining to either oil and gas operations or the power industry. Such reforms introduce uncertainties and potentially affect the profitability and investment climate for companies that already have investments in these sectors. Also, one of the inherent risks is the vagueness that some of such reforms may have in respect of their implementation and enforcement, therefore leading to inconsistent interpretations and potential conflicts among stakeholders.

1. Premium Times Nigeria, 'Nigeria Regains Position as Africa's Largest Oil Producer'. Available at https://www.premiumtimesng.com/business/604891-nigeria-regains-position-as-africas-largest-oil-producer.html accessed 27 July 2023.

2. Garner, B. A. (1999). Black's Law Dictionary (7th Edition). St. Paul, MN West Group, pp 1928

3. Ayodele Oni, (2020). Understanding Petroleum (Oil & Gas) Transactions and the Nigerian Market. Ciplus.

b. **Risk of Expropriation and Nationalization**: Due to the unfettered discretion of many host sovereign governments, to exert control over their natural resources, host states may seek to retain control and ultimately gain financial benefit from their energy resource. This creates a risk of expropriation or nationalization of energy assets by the government.

c. **Political instability**: Concerns about political instability exist when there is the probability that government policymakers may be removed from office or where there is the likelihood of uncertainty due to frequent changes in governments, policies, and regulations especially in way that causes a hindrance to economic development. For oil developing countries like Nigeria, this can be a genuine source of vulnerability to petroleum supplies.[4]

d. **Civil Unrest, Terrorism, and Public Resistance**: Nigeria faces challenges related to civil unrest, terrorism, and internal violence in certain regions. Attacks on energy infrastructure, such as pipelines and facilities, can and have disrupted energy operations and pose a real security threat to personnel and assets, with reports also pointing particularly to conflicts between oil companies and host communities in Nigeria's oil-producing regions, due to a growing dissatisfaction at benefits accruing to such communities.[5]

e. **Risk of Corruption and Market Distortion**: Corruption is a significant concern in Nigeria and can affect the energy sector. Bribery, embezzlement, and other corrupt practices can distort the market, create unfair advantages for certain players, and hinder fair competition. While past administrations expressed their commitments to tackling corruption and governance issues, curbing corruption remains a significant challenge in Nigeria's federal system of governance.

Political Risk Mitigation Mechanisms in the Energy Sector

Political risk mitigation mechanisms are the tools or global best practices that are usually deployed to reduce the impact of potential risks by employing measures to prevent, eliminate, or limit potential setbacks that may arise therefrom. The following mitigation mechanisms are worth noting, especially for energy projects in Nigeria.

a. **Adequate Contracts with Risk Mitigation Provisions**: Negotiating and implementing contracts with clear risk mitigation provisions, such as stability clauses, force majeure provisions, and dispute resolution mechanisms, can help protect investors from political risks and uncertainties. One key risk mitigation provision in contracts is the inclusion of stabilization clauses. Stabilization clauses are inserted in most petroleum contracts entered into between host states and foreign investors, to avert any party from taking independent decisions that may have a negative impact on the contract. This stability helps instill confidence in investors, particularly in the energy industry which has long-term projects that require significant capital investments.

b. **Risk Guarantees and Political Risk Insurances:** Risk guarantees are financial commitments made by a third party, typically a government or financial institution, to compensate investors for losses incurred due to political risks. They take various forms, such as payment guarantees, performance guarantees, or investment guarantees.

Political risk insurance is a specialized type of insurance coverage that protects investors against risks caused by government actions, such as expropriation, political violence, and contract repudiation[6]. Creation and implementation of such risk-mitigating instruments can attract more investors to engage in long-term projects, leading to job creation, infrastructure development, and the overall prosperity in Nigeria's economy.

c. **Proper Use of Financial Instruments**: Employing financial instruments, such as hedging strategies and risk-sharing mechanisms, can help manage and mitigate the financial impacts of political risks against the risk of arbitrary government actions such as nationalization and expropriation. In most instances, compensation is given on the occurrence of such events.[7] Hedging, as an example, involves using financial instruments, such as currency derivatives, to protect against fluctuations in exchange rates and potential losses due to currency devaluation or inconvertibility. This can be particularly relevant in Nigeria, where exchange rate volatility has been a concern in the past.

d. **Bilateral Investment Treaties:** Bilateral Investment Treaties ("BITs") are agreements between two countries that govern the treatment of investment made in each's territory by investors from the other state. BITs aim to address four (4) substantial issues which are - standards of treatment of foreign investors; conditions for the admission of foreign investors to the host state; methods of resolving investment disputes and protection against expropriation. The Most Favored Nation clause and Umbrella Clause are very important clauses that are usually inserted in a BIT. The Most Favored Nation clause provides equal competitive conditions to foreign investors in relation to the operation of investments. The Umbrella Clause constitutes an advantage for investors by placing obligations or commitments entered into by the host state under the protective "umbrella" of an international treaty.

e. I**nclusive Community Engagement:** Engaging with local communities and stakeholders in a transparent and inclusive manner can help mitigate social and political risks, as they help build positive relationships and address concerns that can foster support and minimize potential conflicts. One of the objectives of the Host Communities Development provisions of the PIA is the promotion of sustainable prosperity and provision of social and economic benefits to host communities affected by petroleum activities.[8] This is a welcome development in the Nigerian energy industry.

f. **Adequate Dispute Resolution Options**: Both national and foreign investors should ensure that energy-related contracts have adequate dispute resolution options. It may be proactive for the Nigerian government to set up a tribunal solely for the purpose of settlement of disputes that may arise from the sector. For foreign investments, investors should carefully structure their investment and any related agreements to maximize protection. Foreign investors should ensure that access to a mechanism for investor-state dispute settlement (ISDS) is present, in a neutral forum and before an independent and impartial panel of adjudicators. Without ISDS, foreign investors may have no effective investment protection in the face of adverse treatment by the host state.

4. Fawzeya Abdelhameed & Abeer Rashdan, 'A Deeper Look into Political Instability and Economic Growth: Case Study and Empirical Analysis on a Selection of Countries'(2021) 12(3) RIWE< https://www.sciedu.ca/journal/index.php/rwe/article/view/20108 > accessed 26 July 2023.

5. Donald I. Hamilton, 'Oil and Gas Companies and Community Crises in the Niger Delta' (2011) 9(1) ARPE < https://arpejournal.com/article/123/galley/118/view/ > accessed 19 July 2023.

6. Adegoke Adedoyin and Ayodeji Jolaoso, 'Project Finance: Identification, Allocation and Mitigation of Risk Factors'. < https://www.mondaq.com/nigeria/project-financeppp-amp-pfi/1177538/project-finance-identification-allocation-and-mitigation-of-risk-factors > accessed 25 July 2023.

7. World Economic Forum, Strategic Infrastructure Mitigation of Political & Regulatory Risk in Infrastructure Projects'. <https://www3.weforum.org/docs/WEF_Risk_Mitigation_Report_2015.pdf> accessed 25 July 2023.

8. Section 235 of the Petroleum Industry Act, 2023.

g. **Presence of International Commitments:** Nigeria's adherence to international commitments, such as treaties and agreements, can provide reassurance to investors about the stability and predictability of the regulatory environment. Nigeria has taken practical steps to mitigate political risks by becoming a member of the World Bank's Multilateral Investment Guarantee Agency (MIGA)[9]. As a member, Nigeria provides political risk insurance to foreign investors, offering guarantees against expropriation, currency transfer restrictions, and political violence. This move signals Nigeria's commitment to creating a stable and predictable environment for foreign investors across sectors such as power, oil and gas, and infrastructure.

h. **Competent Government Willing to Preserve Established Laws**: A competent and committed government that demonstrates willingness to preserve established laws, regulations, and contractual provisions can enhance investor confidence and mitigate political risks. However, a level of due diligence on the host government may be required, to ascertain the frequency of adherence to court orders, government regulations and public policy.

Conclusion

The Nigerian energy sector is subject to various political risks that can impact investments and operations. Proper implementation of political risk mitigation mechanisms would enhance investor confidence, attract investment, and create a stable and conducive business environment for sustainable growth. It is important to address such risks early in the project lifecycle and understand the magnitude of risk as it relates to the project size and complexity. The opportunity to manage risks efficiently decreases as a project lifecycle advances; thus, a project's development/concept phase is important to facilitate timely and effective risk management.

9. Multilateral Investment Guarantee Agency – World Bank Group. <https://inquiries.worldbank.org/knowledgebase/articles/931722miga#:~:text=The%20Multilateral%20Investment%20Guarantee%20Agency,all%20regions%20of%20the%20world> accessed 25 July 2023

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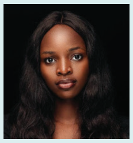

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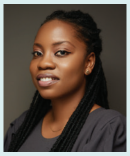

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