# PUBLIC PRIVATE PARTNERSHIPS IN NIGERIA

## MANAGING RISKS & IDENTIFYING OPPORTUNITIES

GEORGE NWANGWU

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palgrave
macmillan

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Abuja, Nigeria

ISBN 978-1-137-54241-0 ISBN 978-1-137-54242-7 (eBook)
DOI 10.1057/978-1-137-54242-7

Library of Congress Control Number: 2016939628



Cover illustration: Cover design by Samantha Johnson

Printed on acid-free paper

This Palgrave Macmillan imprint is published by Springer Nature
The registered company is Macmillan Publishers Ltd. London

*To the memory of my father, who died while I was working on this book*

# Preface

The paucity of funds and the failure of public authorities to provide even the most basic of public services led to Nigeria (similar to most countries in the world) turning to public private partnerships (PPPs) to finance, develop and improve its infrastructure. A number of projects in different sectors of the Nigerian economy have been completed using the PPP model. A few of these projects have since become operational, and this provides an opportunity for this book to take stock of the legal, institutional and policy frameworks for PPPs in Nigeria.

This book focuses on the legal, economic and general policy principles underpinning the concept of PPPs and is intended both as a detailed resource book for practitioners who work in PPPs across the globe and as a useful introduction to the basic principles for those new to the subject area. It will also be useful for those investors who might wish to know about the immense opportunities available in infrastructure projects in Nigeria and enable them to navigate through some of the pitfalls in long-term infrastructure projects. It is also addressed to meet the needs of public sector officers who might benefit from understanding the reasons for the shortcomings in PPP

projects and how they might tailor policies and regulations towards overcoming these.

Finally, it is worth mentioning that this book is a product of my experience from nearly twenty years of practice as a lawyer both in Nigeria and in the UK. I have worked actively in PPPs for the majority of these years advising people in both the private and public sectors in deals across different sectors of the economy.

George Nwangwu

# List of Abbreviations

| | |
|---|---|
| ADB | Asian Development Bank |
| ADR | alternative dispute resolution (Nigeria) |
| BCL | Bi-Courtney Limited |
| BOT | Build-Operate-Transfer |
| BLT | build lease transfer |
| BLTM | build lease transfer maintain |
| BOO | build own operate |
| BOOR | build own operate remove |
| BOOT | build own operate and transfer |
| BOT | build operate and transfer |
| BPE | Bureau of Public Enterprises |
| BPP | Bureau of Public Procurement |
| BTO | build transfer operate |
| CERPAC | Combined Expatriate Residence and Alien's Card |
| CITA | Companies Income Tax Act |
| CSF | critical success factor |
| CSR | corporate social responsibility |
| DBFO | design build finance operate |
| DBFOM | design, build, finance, operate, Manage |
| DCF | discounted cash flow |
| DCMF | design, construct, manage, and finance |
| DMO | Debt Management Office (Nigeria) |
| ECA | export credit agency |

| | |
|---|---|
| EPC | engineering, procurement and construction |
| FAAN | Federal Airports Authority of Nigeria |
| FBC | full business case |
| FEC | Federal Executive Council |
| GAT | General Aviation Terminal |
| IBRD | International Bank for Reconstruction and Development |
| ICRC | (the) Infrastructure Concession Regulatory Commission |
| ICRCA | Infrastructure Concession Regulatory Commission Act |
| ICSD | International Centre for the Settlement of Investment Disputes |
| IDA | International Development Association |
| IFC | International Finance Corporation |
| IISD | International Institute for Sustainable Development |
| IMF | International Monetary Fund |
| IRR | internal rate of return |
| LCC | Lekki Concession Company |
| LDO | lease develop operate |
| LPVR | Least Present Value of the Revenues |
| LROT | lease renovate operate and transfer |
| MDA | ministry, department or other agency of government |
| MIGA | Multilateral Investment Guarantee Agency |
| MMA 2 | Murtala Mohammed Airport Terminal 2 |
| NCP | National Council on Privatisation (Nigeria) |
| NESREA | National Environmental Standards and Regulations Enforcement Agency (Nigeria) |
| NPA | Nigeria Ports Authority |
| NPC | National Planning Commission |
| NPV | net present value |
| OBC | outline business case |
| OECD | Organisation for Economic Cooperation and Development |
| PDP | Peoples Democratic Party |
| PFI | Private Finance Initiative (UK) |
| PIT | public interest test |
| PPIAF | Public Private Infrastructure Advisory Facility |
| PPP | public private partnership |
| PRG | political risk guarantee |
| PRI | political risk insurance |
| PSC | public sector comparator |
| PSP | private sector participation |

| | |
|---|---|
| SPV | special purpose vehicle |
| STR | subject to regularisation |
| TWP | temporary work permit |
| UNIDO | United Nations Industrial Development Organization |
| VAT | Value-added tax |
| VFM | value for money |

# Contents

# 1

# The Concept of Public Private Partnerships

## 1.1 What Is A Public Private Partnerships?

Despite a general level of consensus regarding what constitutes a PPP, there are variations in the way in which the concept has been defined. The variations in definitions of the concept can be traced to the political and economic consequences of PPPs, which makes their meaning—and, consequently, their desirability—susceptible to different interpretations by diverse parties. For instance, the UK Labour government under Tony Blair reshaped the concept to fit into its political mandate.[1] The Private Finance Initiative (PFI), which was originally a creation of the Conservative government, was readily embraced and re-energised by the Labour government because the government believed that it was the best way to secure improvements to public utilities promised by the party without adversely increasing the country's debt profile. This same scenario has been played out in varied ways in different countries and, as we shall see later, even in multilateral institutions around the globe. The political and economic

[1] "What are Public Private Partnerships", available at http://news.bbc.co.uk/2/hi/uk/1518523.stm (last accessed 14 May 2015).



G. Nwangwu, *Public Private Partnerships in Nigeria*,
DOI 10.1057/978-1-137-54242-7_1

stakes are very high and it is therefore unsurprising that different professions, countries and institutions manipulate the definition, ambit and use of PPPs to achieve their own specific ends.

It is interesting to explore the definitions of PPPs from the viewpoint of different institutions that are involved in PPP transactions around the world. These institutions tend to define the concept from the prism of the nature, extent and desired objective of their involvement in the PPP process. The differences between the objectives of these multilateral institutions perhaps best explain the reasons for the varying definitions employed by diverse institutions. More importantly for the purposes of this work, these various institutional definitions also help us distil the essential elements of PPPs.

According to the International Monetary Fund (IMF), "Public Private Partnerships involve private sector supply of infrastructure assets and services that have traditionally been provided by the government".[2] This definition looks at PPP from a historical perspective, stressing the novelty of the concept by contrasting it with traditional procurement. One crucial handicap of this definition is that it does not emphasize the partnership between the public and private sectors that is inherent in PPPs. This limitation in the definition is understandable when viewed against the backdrop that the IMF deals mostly with governments; therefore the lesser degree of elaboration on the relationship with the private sector is understandable.

In contrast with this definition is that offered by the Parliament of Australia which sees PPPs as "partnerships between the public sector and the private sector for the purposes of designing, planning, financing, constructing and/or operating projects which would be regarded traditionally as falling within the remit of the public sector. Infrastructural projects such as roads and bridges are prime examples".[3] This definition goes a step further than the preceding definition as it not only underscores that PPP is based on partnership, but also breaks down the different components of a typical PPP project, from designing, financing, construction

[2] International Monetary Fund, available at http://www.imf.org/external/np/fad/2004/pifp/eng/031204.pdf (last accessed 12 October 2015).

[3] Parliament of Australia, available at http://www.aph.gov.au/library/pubs/rp/2002-03/03rp01.htm#whatareppp (last accessed 23 June 2010).

to actual operation. This is important because it is believed that it is the bundling of these components into a single process and placing it in the hands of a single private sector provider makes PPPs very attractive and ensures the attainment of value for money in projects.

The Canadian Council for Public Private Partnerships defines PPPs as "a cooperative venture between the public and private sectors built on the expertise of each partner, that best meets clearly defined public needs through the appropriate allocation of resources, risks and rewards".[4] This definition highlights two important components: The first is that it stresses on the cooperative nature of the partnership between the public and private sectors. Second, based on the cooperative nature of the partnership, it emphasizes that risks and benefits are shared between the parties. It is noteworthy that the word "appropriate" is used in discussing the allocation of resources, risks and benefits between the parties. This is important because the success of PPP depends on how all these variables are allocated within the partnership so that the parties are only burdened with a level of risk which they can handle and receive the rewards that they deserve.

The National Council for Public Private Partnerships (US) defines a PPP as "a contractual agreement between a public agency (federal, state or local) and a private sector entity. Through this agreement, the skills and assets of each sector (public and private) are shared in delivering a service or facility for the use of the general public. In addition to the sharing of resources, each party shares in the risks and rewards potential in the delivery of the service and/or facility".[5] This definition highlights the legal and contractual nature of PPPs. Indeed, the relationship between the public and private sectors is more or less contractual in nature and evidenced in very detailed contractual documents.

The Organisation For Economic Cooperation and Development defines a public-private partnership as:

> An agreement between the government and one or more private partners (which may include the operators and the financers) according to which the private partners deliver the service in such a manner that the service

[4] Canadian Council for Public-Private Partnership, available at http://www.pppcouncil.ca/resources/about-ppp/definitions.html (last accessed 12 October 2015).

[5] Organization for Economic Co-operation and Development, available at http://ncppp.org/howpart/index.shtml#define (last accessed 17 September 2010).

> delivery objectives of the government are aligned with the profit objectives of the private partners and where the effectiveness of the alignment depends on a sufficient transfer of risk to the private partners.[6]

This definition, while accepting that the objectives and interests of the private and public sectors differ, underlines the need for the alignment of the objectives of the parties to the relationship and this meeting of interests is dependent on finding the right balance in the apportionment of risks between the parties.

According to the Public Private Infrastructure Advisory Facility (PPIAF) of the World Bank, "PPP is an agreement between a government and a private firm under which the private firm delivers an asset, a service, or both, in return for payments. These payments are contingent to some extent on the long-term quality or other characteristics of outputs delivered".[7] This definition seems to assume that the government always controls how payments are made to the private sector and is therefore able to benchmark payments to the quality or other characteristics of services provided. This may be true in some jurisdictions that mainly operate the availability payment model but not when private sector providers charge user fees directly from the public. As we shall see later in Chap. 8, the user fee model of payments presents its own challenges because it becomes difficult to find a balance, or even a correlation, between the quality of service and the payment the private sector party receives unless there are substitutes or alternatives available for the same service.

According to the UK Her Majesty's Treasury, "Public private partnerships (PPPs) are arrangements typified by joint working between the public and private sector. In the broadest sense, PPPs can cover all types of collaboration across the interface between the public and private sectors to deliver policies, services and infrastructure, where delivery of public services involves private sector investment in infrastructure".[8] This wide definition seems to accommodate

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[6] Jose Luis Navero Espigares and Jose Aureliano Martin Segura, 'Public Private Partnerships and Regional Productivity in the United Kingdom', (online), available at http://www.reser.net/file/75439/ (last accessed 12 October 2015).

[7] PPIAF, available at http://www.ppiaf.org/ppiaf/sites/ppiaf.org/files/publication/WB%20-%20PPP%20Units%202007.pdf (last accessed 12 October 2015).

[8] H.M. Treasury, available at http://webarchive.nationalarchives.gov.uk/20130129110402/http://www.hm-treasury.gov.uk/ppp_index.htm (last accessed 12 October 2015).

almost all transactions where there is collaboration between the private and public sector. This means that arrangements like privatization, for instance, will fall within the purview of this definition.[9] The preference in this work, however, is to exclude privatization from transactions regarded as PPPs since it involves a complete transfer and ownership of the asset or infrastructure to the private sector party. This, as we shall see later, has legal consequences in relation to proprietorship and control of the asset.

Also, the concept of PPP is based on a high degree of partnership or collaboration between the public and private sectors. Privatisation does not however offer a sufficient degree of partnership between the parties to fit within the umbrella of PPPs. It must be stated, however, that broadness of this definition provides governments with the flexibility to capture a number of transactions that would otherwise have been excluded from the umbrella of PPPs; this is consistent with the view that characteristics or boundaries of transactions which constitute PPPs are not closed. For instance, the European Commission observed that PPPs are still evolving, and comprise divergent arrangements that may be adapted to suit the requirement of projects and project partners on a pragmatic basis.[10]

The Asian Development Bank (ADB) appears to have the most comprehensive definition and seems to sum up all the characteristics that have been pointed out in the previous definitions. According to the ADB:

> "Public–private partnership describes a range of possible relationships among public and private entities in the context of infrastructure and other services. PPPs present a framework that—while engaging the private sector—acknowledge and structure the role for government in ensuring that social obligations are met and successful sector reforms and public investments achieved. A strong PPP allocates the tasks, obligations, and risks among the public and private partners in an optimal way. The public partners in a PPP are government entities, including ministries, departments, municipalities, or state-owned enterprises. The private partners can be local or international

[9] This definition is similar to the position of a number of writers from the USA that seem to give privatisation a wider meaning to encompass PPPs. See, for example, E. Dannin, 'Crumbling Infrastructure, Crumbling Democracy: Infrastructure Privatization Contracts and Their Effects on State and Local Governance ', (2011) *Northwestern Journal of Law and Social Policy*, 6(2): 46 –104.

[10] European Commission Guidelines for Successful Public Private Partnerships 2003, available at http://ec.europa.eu/regional_policy/sources/docgener/guides/ppp_en.pdf (last accessed 12 October 2015).

> and may include businesses or investors with technical or financial expertise relevant to the project. Increasingly, PPPs may also include nongovernment organizations (NGOs) and/or community-based organizations (CBOs) who represent stakeholders directly affected by the project. Effective PPPs recognize that the public and the private sectors each have certain advantages, relative to the other, in performing specific tasks. The government's contribution to a PPP may take the form of capital for investment (available through tax revenue), a transfer of assets, or other commitments or in-kind contributions that support the partnership. The government also provides social responsibility, environmental awareness, local knowledge, and an ability to mobilize political support. The private sector's role in the partnership is to make use of its expertise in commerce, management, operations, and innovation to run the business efficiently. The private partner may also contribute investment capital depending on the form of contract".[11]

This definition brings out clearly the use of PPPs for shaping government policies and sectoral reforms. This is consistent with the role of the ADB as a development institution.

Clearly, as seen in the discussion above, there are various definitions of what constitutes a PPP arrangement. Since it is constantly evolving in different ways, in different countries, there are bound to be so many more in the future. However, there are certain baseline characteristics that tie these different definitions together. Some of these characteristics are summarised below from the definitions presented above:

(i) PPPs are based on long-term partnerships between public sector entities and the private sector.
(ii) Under a PPP, the different components of an infrastructure project are bundled together. The public sector specifies certain verifiable and determinable outputs it desires from the private sector, while the private sector is more or less given a broad discretion to determine the optimal method for delivering the outputs. In effect, therefore, there could be an integration of design, construction, finance, and operation and maintenance into a single contract. It is widely believed that this enables the attainment of value for money in projects.

[11] Asian Development Bank (2008), available at http://www.apec.org.au/docs/ADB%20Public%20Private%20Partnership%20Handbook.pdf (last accessed 17 September 2010).

(iii) Under PPPs, risks and rewards are allocated in an efficient and optimal manner that ensures that risks are allocated to the party most able to manage them.
(iv) PPPs are regulated by long-term contracts that control the relationship between the parties, the quality and standards of services to be provided by the private sector and how the private sector will be remunerated for the services. In most cases, it also determines what will happen to the asset at the end of the contractual period. Typically, there is an option for the transfer of the infrastructure asset back to the public sector at the end of the contract period.[12]

The majority of projects that are classified as PPPs will have a number of these characteristics. Importantly, however, the partnership structure must allocate risks and rewards optimally between the public and private parties in accordance with the strengths and abilities of each party. It is only this optimal allocation of risks and benefits that ensures that each party contributes in an effective manner to the project.

From the discussions above, we may now offer a definition of PPPs as a long-term relationship between public sector agencies and private sector entities under which the responsibility for any or all of the combination of designing, financing, construction, management and operation of public infrastructure and utilities that were traditionally undertaken by the public sector are contractually shared and jointly undertaken by both the public and private sectors, usually in proportion to the type and quantity of risks each party can best carry.

## 1.2 Why Do Governments Use Public Private Partnerships?

The dominant factor for the widespread use of the PPP model for the provision of infrastructure—at least, across the developing world—appears to be the inadequacy of public funds to meet the increased demand for infrastructure. In developed economies, however, the argument for the use of PPPs

[12] See also Malaysian Public Private Guidelines (2009), PPP Unit, Prime Minister's Department Putrajaya, (online), available at http://www.ukas.gov.my/html/themes/miu/content/ppp_bi_131109.pdf (last accessed 29 February 2012).

seems to be a little more sophisticated and, as we shall see later, this influences the value-for-money argument in the divide between the two different developments. For instance, The Netherlands adopted PPP-type structures primarily to promote an efficient procurement regime and reform its public sector.[13] Other reasons for adopting PPPs include claims that PPPs provide superior value for money and better efficiency in providing and running infrastructure services in more politically attractive forms than nationalization or privatization. However, the most controversial of these reasons is that PPPs reduce government debt levels. This assertion is very simplistic and not always correct, as most often PPPs merely defer government spending to a future period. This argument is easy to understand when the payment mechanism to the private sector is through availability payments as, in these cases, the capital cost for the project is funded by the government through periodic payments from the budget to the private sector. Even in cases where the private sector is to recover its capital cost by charging user fees, the argument is that government might as well build the asset and recover its expenditure through the collection of user fees, as a user fee is another form of tax on the user public. Therefore, it has been alleged that PPPs are merely used as a form of accounting trick to keep government expenditure off balance sheet.[14] It must be noted, regardless, that there are sufficient economic gains that accrue to the public sector because of the efficiency gains from PPPs. For instance, there are few public-funded projects in Nigeria that have been completed on time or that have not suffered severe cost overruns. This is remarkably different under PPPs because construction risk, and therefore the risk of costs overrunning, is transferred to the private sector.

## 1.3 The Arguments For and Against Public Private Partnerships

Like most concepts, PPPs have not been immune from criticisms. These criticisms are usually centred on issues like the high transaction costs, such as legal fees and the length of time it takes to negotiate and conclude

[13] Stephen Harris (2004) "Public Private Partnerships: Delivering Better Infrastructure Services", Working Paper, Inter-American Development Bank, Washington, DC, p. 3.

[14] Eduardo Engel, Ronald Fischer and Alexander Galetovic (2014) *The Economics of Public-Private Partnerships: A Basic Guide*. New York: Cambridge University Press, p. 13.

a PPP transaction.[15] It is argued that these issues may not encourage the attainment of value for money in PPPs.[16] It has also been contended that PPPs increase public sector risk, rather than reduce it; increase service cost for the public; and shut out the entry of small companies in the procurement process, thereby reducing competition.[17]

There is, however, considerable literature on the merits of PPPs. Most of the proponents for PPPs have variously argued that PPPs actually deliver value for money. This position is based on the view that PPPs appeal to people in charge of allocating public sector resources because they offer one of the most efficient means of resolving the large cost overruns and delays in traditional public procurement methods for infrastructure. This is because of the greater incentive to the private sector to act in more commercially oriented ways than the public sector.[18]

The major factor that ensures cost savings, and therefore better value for money, in PPPs is private sector's innovation and efficiency. Due to the fact that the private sector is responsible for the whole transaction process, including design and the actual provision of services, it creates a synergy that helps in achieving the lowest possible total life cycle costs while maximizing profits. Also, a transparent and efficient procurement process is essential in lowering transaction costs, as it shortens the time of negotiations.

The argument for and against the desirability of PPPs will continue for a long time, mainly because of the political and economic consequences of PPPs and the fact that not everyone will agree with the notion that PPPs have significant advantages over traditional procurement.[19] However, what is clear is that PPPs have continued to play an increased

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[15] Darrin Grimsey and Mervyn Lewis (2004) *Public Private Partnerships*: *The Worldwide Revolution in Infrastructure Provision and Project Finance*. Cheltenham: Edward Elgar.

[16] Darrin Grimsey and Mervyn Lewis (2004); Marcus Ahadzi and Graeme Bowles (2004) 'Public-Private Partnerships and Contract Negotiations: An Empirical Study', *Construction Management and Economics*, 22, November : 967–978; A. Ng and Martin Loosemore (2007) 'Risk Allocation in Private Provision of Public Infrastructure', *International Journal of Project Management*, 25(1): 66–76.

[17] W. Moore and T. Muller (1991) 'Impacts of Development and Infrastructure Financing', *Journal of Urban Planning Development,* September, 117(3): 95–107 (95), 10.1061/(ASCE)0733-9488.

[18] See, Darrin Grimsey and Mervyn Lewis (2004).

[19] These claims have been vigorously challenged. See, for instance, David Hall (2008) *Public-Private Partnerships* (*PPPs*) *Summary Paper*, Report commissioned by the European Federation of Public Service Unions (EPSU), p. 6, available at http://www.epsu.org/IMG/pdf/PPPs-summary-011008.pdf (last accessed 12 October 2015).

role in the provision of infrastructure across different sectors around the world, and there must be a good reason for this. It is also clear that there are significant advantages to be gained from the use of PPPs, especially in a developing country like Nigeria. For instance, PPP is a valuable tool in combating corruption, as it ensures that public sector officials' exposure to the commercial aspects of project operation is greatly diminished. Also, the rigorous procurement process in PPPs ensures greater transparency, competition and financial rigour in projects. Most importantly, because of the greater incentive of the private sector, PPPs are more likely to be completed within budget and on time. Besides, as mentioned, the risk for cost overruns and project delays are usually transferred to the private sector in PPP projects.

## 1.4 The History of Public Private Partnerships

The modern concept of PPPs is commonly said to have originated in the UK.[20] However, the concept that emerged in the UK is similar to the model used to facilitate independent power projects in the USA in the 1980s. Thus, while it can be said that the emergence of modern forms of PPP may be traced to the UK Private Finance Initiative (PFI) scheme that was launched in 1992, the template for modern PPP contracts may be traced to Power Purchase Agreements (PPAs) signed by the US authorities and independent power producers in the 1980s.[21]

Even though the modern concept of PPP is relatively new, the idea of toll roads and bridges is not. For example, in the UK and the USA as far back as the eighteenth and nineteenth centuries over 2500 companies were chartered and incorporated to develop private turnpikes.[22] These turnpikes basically involved local business entrepreneurs forming trusts, which borrowed money from private investors to repair roads and repaid them by charging tolls. For instance, in the nineteenth century, the Brooklyn Bridge in New York was built with private sector capital.[23]

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[20] Edward B. Yescombe, (2007) *Public–Private Partnerships: Principles of Policy and Finance*, London: Butterworth-Heinemann, p. 9.

[21] Ibid.

[22] Darrin Grimsey and Mervyn Lewis (2004), p. 136.

[23] Ibid.

Also, as far back as the seventeenth century, French concession models were employed to develop infrastructure, especially in sectors such as water.[24] A further development in the use of the concession model in France was the use of franchises or *affermage*, which basically is the right given to the private sector to exploit an already existing asset by making lump sum payments to the public sector.[25] The use of these methods faded away after the nineteenth century as the role of the state in the provision of infrastructure expanded.[26]

The PFI scheme itself emerged in the UK as an evolution from the previous government initiatives of privatization, which became competitive tendering before finally evolving into PFI.[27] The Conservative government in 1992 first laid the foundation for the PFI by abolishing the rules that had previously restricted the use of private capital for the funding of public assets. When the Labour government came into power in 1997, it further strengthened the PFI scheme by creating the Treasury Taskforce to develop and promote a common approach to ensure that best practices were available across all departments of government.[28]

More recently, PPPs have become a global phenomenon. Sectors in which PPPs have been completed worldwide include: electric power generation and distribution, water and sanitation, refuse disposal, healthcare, education, airport facilities, prisons, transportation (railways, roads) technology systems, and housing.

## 1.5 Types of Public Private Partnerships

PPPs come in various forms, with most depicted with different acronyms. A number of these PPP arrangements are merely slight variants of one another. Some of the popular examples are:

- build-operate-transfer (BOT)
- build own operate (BOO)

[24] Ibid.
[25] Ibid.
[26] Edward B. Yescombe (2007), p. 5.
[27] Stephen Harris (2004), p. 3.
[28] Ibid.

- build own operate and transfer (BOOT)
- build lease transfer (BLT)
- build lease operate transfer (BLOT)
- build lease transfer maintain (BLTM)
- build transfer operate (BTO)
- build own operate remove (BOOR)
- design, build, finance operate (DBFO)
- design, build, finance, operate, manage (DBFOM)
- lease
- lease develop operate (LDO)
- lease renovate operate and transfer (LROT)
- joint ventures
- operations and management contracts
- concessions

### 1.5.1 Build-Operate-Transfer (BOT)

This is the most popular PPP arrangement. In these types of projects, the private sector entity finances the building of the infrastructure asset and is allowed to own and operate it for a number of years, usually a long-term arrangement ranging between 25 and 30 years, before transferring control and ownership back to the public sector. Usually, the infrastructure is transferred back to the public sector at zero cost, or at least at a cost less than the asset's residual value. These types of arrangements are common with greenfield projects that involve a significant operating content. The idea of a BOT is to benefit from the private sector's detailed knowledge of project design and the materials used in the construction phase, which can result in the development of a tailored maintenance plan over the project lifespan.[29]

### 1.5.2 Build Own Operate (BOO)

This PPP arrangement is similar to a BOT in the sense that the private sector finances the construction of the infrastructure and is also allowed to

[29] Christina D. Tvarno (2010) "Presentation of the PPP Concept" in C.D. Tvarno (ed.), *Public Private Partnerships*: *An International Analysis – From a Legal and Economic Perspective* Asia Link, p. 35.

operate the infrastructure. However, the distinguishing feature between a BOO and a BOT arrangement is that a BOO permits the private sector to own the infrastructure in perpetuity. It is important to note that the fact that there is no government involvement in the beginning or at the end does not mean that it is not a PPP. The government may still be involved in fixing tariffs and guaranteeing revenues. These types of arrangement are common in the power generation sector.

### 1.5.3 Build Own Operate and Transfer (BOOT)

Under a typical BOOT, the private sector is responsible for financing the construction of the infrastructure asset; it is also allowed to own and render services deriving from that infrastructure asset for a number of years before transferring the asset to the government/public sector. Quiggin has argued that BOOT arrangements are usually poor schemes because they sacrifice long-term public interests and are only popular because they appeal to the elementary human weakness of wanting something for nothing.[30]

### 1.5.4 Build Lease Transfer (BLT)

In a BLT arrangement, after building the infrastructure asset with its own funds, the private sector leases the asset from the public sector entity, paying a periodic fee before ultimately transferring the asset to the public sector at the end of the lease period.

### 1.5.5 Build Lease Operate Transfer (BLOT)

This is similar to the BLT, the only difference being that there is an obligation on the part of the private sector to operate the asset for the duration of the lease before transferring the asset to the public sector entity.

[30] John Quiggin, "BOOT: In the Public Interest?", Presentation made at the University of Technology, Sydney, March 1998, organized by the Australian Centre for Independent Journalism, Australian Mekong Resource Centre, Sydney University and Community Aid Abroad available at http://www.uq.edu.au/economics/johnquiggin/conference/BOOT.html (last accessed 12 October 2015).

### 1.5.6 Build Lease Transfer Maintain (BLTM)

Under this arrangement, like a classic BLT, the private sector entity uses its finances to build an asset and then leases the asset from the public sector entity, before eventually transferring the asset back to the public sector. However, unlike a BLT, there is an obligation on the private sector entity to continue to maintain the asset even after the transfer of the asset to the public sector.

### 1.5.7 Build Transfer Operate (BTO)

Unlike the more popular BOT transactions, in this case the asset is transferred back to the government, which then allows the private sector to operate the asset for a number of years on behalf of the government.

### 1.5.8 Build Own Operate Remove (BOOR)

As the name implies, under this arrangement the private sector entity finances the construction of the infrastructure asset, owning and operating it for a number of years, following which the private sector entity must remove it.

### 1.5.9 Design, Build, Finance Operate (DBFO)

Under this scheme, the public partner specifies the services it wants the private sector to deliver; then the private partner designs and builds an asset specifically for that purpose, finances its construction and subsequently operates the asset by providing services that derive from it.[31] DBFOs are considered to be the classic PPP project and are, indeed, the most common. The Lekki Road Concession and the Murtala Mohammed Airport Terminal 2, both in Lagos, Nigeria, are, strictly speaking, examples of DBFO schemes.

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[31] International Monetary Fund (2006) *Public-Private Partnerships, Government Guarantees and Fiscal Risk*, prepared by IMF staff team, Washington, DC.

### 1.5.10 Design, Build, Finance, Operate, Manage (DBFOM)

In addition to all the responsibilities and obligations of the private sector partner under a DBFO scheme, the private sector partner also shoulders the responsibility of managing the asset. Another variant of this is Design, Construct, Manage and Finance (DCMF).

### 1.5.11 Lease

Leases (*affermage*) as a form of PPP are usually used where the assets are already in existence and it is no longer necessary to make investments in infrastructure, or where the risk premium of transferring the responsibility for the building of the asset to the private sector is very high. Thus, under this arrangement, investment and financing of the infrastructure is the responsibility of the public sector, as opposed to the private sector; however, the commercial risk continues to be allocated to the private sector. The length of contract in leases is usually shorter than in typical concessions. Note that, even though the arrangements in a lease and *affermage* are similar, there is a slight distinction in the sense that the private sector operator usually retains revenue collected from the users of the facility and makes specified lease fees to the public authority under a lease; under an *affermage*, the private sector contractor and the public authority share revenues from the customers/users.[32]

### 1.5.12 Lease Develop Operate (LDO)

This involves, first, the leasing of the infrastructure asset—usually empty land—by the private sector, and then the financing of the development of the asset before also operating the asset.

[32] United Nations (Economic and Social Commission for Asia and the Pacific) (2011) *Guidebook on Public-Private Partnership in Infrastructure*, Bangkok, p. 4.

### 1.5.13 Lease Renovate Operate and Transfer (LROT)

Under this arrangement there is, first, the lease of an existing asset; this is subsequently renovated and then operated by the private sector before finally being transferred to the public sector after a number of years.

### 1.5.14 Joint Ventures

Joint ventures are often alternatives to full privatizations in which the infrastructure is co-owned and operated by both the public and private sector. In practice, however, the private sector partner usually assumes the operational role. Under a joint venture, both parties may decide to incorporate a special purpose vehicle (SPV) which is the joint venture company and which is responsible for the project.

### 1.5.15 Operations and Management Contracts

Under this arrangement, the public sector outsources the provision of services which were hitherto provided by it to the private sector. The payment for services is made directly to the private partner by the public partner, rather than revenue being collected directly from the end users, like in other PPP arrangements.

### 1.5.16 Concessions

Under a typical concession, the public sector grants (concessions) the private sector (concessionaire) a right to deliver certain services in certain areas for a fee paid by the concessionaire for those rights. The private sector operator is responsible for operation, maintenance and even rehabilitation of the asset, including any capital required for upgrade and expansion, even though ownership of the asset remains with the government throughout the duration of the concession period. The public sector sets performance standards and ensures that they are met, thereby being, in effect, regulators of the price and the quality of services delivered.

## 1.6 Distinguishing PPPs from Similar Procurement Models

### 1.6.1 Public Private Partnerships and Conventional Public Procurement

Conventional public procurement refers to the purchase, lease, rental or hire of goods or services by the public sector. This method is desirable if the goods or services needed are not complex and there is a possibility of choosing from numerous providers.[33] Under a classic PPP arrangement (DBFO), the public sector specifies the services it wants the private sector to provide; then, the private sector designs and builds a dedicated asset for that purpose, finances its construction and subsequently operates the asset and provides the services deriving from the asset. This is different from traditional procurement, where the public sector is responsible for the design and financing of the provision of the asset and then operates it once it is built. The role of the private sector is only limited to building the asset on contract for the public sector. Thus, the main differentiating characteristic between a PPP and conventional procurement is the fact that finance, ownership (at least initially) and service delivery lie in the hands of the private sector.[34]

As noted earlier, PPP is a term that is usually employed to capture a range of possible relationships between the private and public sectors. Therefore, there is the erroneous tendency to consider different sorts of scenarios or relationships between the private and public sectors as PPPs—for example, private sector participation (PSP), contracting out and privatization as PPPs. There are, however, differences between most of these terms and PPPs, at least in the context of this work.

### 1.6.2 Contracting Out

This scheme arises where a private sector party commercially provides a service which was previously provided by the public sector itself.

[33] United Nations Economic Commission for Europe (2008) *Guidebook on Promoting Good Governance in Public-Private Partnerships*, *United Nations Publications*, Sales No. 08.II.E.1.

[34] Note that this classification differs from jurisdiction to jurisdiction and from institution to institution. There is a tendency by some countries to describe broad private sector involvement with the public sector as PPP.

The private contractor is paid a predetermined rate for its services and other anticipated costs. The difference between contracting out and PPPs is that, with contracting out, there is little transfer of control or risk to the private sector and no substantive private sector involvement in the decision making process leading up to the transaction. Under a PPP arrangement, there is some form of devolution of control and authority to the private sector, as well as private sector participation in the decision making process. The key advantage is that many operational gains that result from private sector management can be made without transferring the asset to the private sector.[35] It may take various forms, like franchise, service agreement or licensing.[36]

### 1.6.3 Privatisation

Privatisation is the complete transfer of previously owned public assets to the private sector. Indeed, critics of PPP have likened it to privatisation, claiming that it is merely privatisation "through the back door".[37] In Nigeria, PPPs have sometimes been viewed as a variant of privatisation. It was argued that PPPs should include privatisation and vice versa, since both involved some form of partnership between the public sector and the private sector.[38] This is not correct because, even though both are alternative service delivery arrangements to traditional public sector led procurement, and focus on the relationship between the public sector and private sector, they are different. The difference is that, in a PPP, despite the private sector involvement, the public sector retains a substantial role by retaining ultimate responsibility for the services despite their being provided by the private sector. However, when a government entity is privatized, the private sector not only takes over the business, but also

[35] Asian Development Bank (2008).

[36] Rob Hrab (2004) *Private Delivery of Public Services*: *Public Private Partnerships and Contracting-Out*, Panel on the Role of Government in Ontario, Research Paper No. 21, available at http://ssrn.com/abstract=694582 or http://dx.doi.org/10.2139/ssrn.694582 (last accessed 12 October 2015).

[37] See Stephen Harris (2004).

[38] This position is consistent with the thinking of academics and general practice in the USA. See Emanuel S. Savas, *Privatization and Public Private Partnerships*, available at http://www.cesmadrid.es/documentos/Sem200601_MD02_IN.pdf (last accessed 28 February 2012).

assumes responsibility for service delivery. Risks are entirely borne by the private sector under privatization but are allocated between the parties under a PPP.[39] For the purposes of this book, therefore, full-scale privatization or mere outsourcing is not considered as part of PPPs.

## 1.7 Critical Success Factors for Public Private Partnerships

Critical success factors (CSFs) in relation to PPPs are the key activities in which favourable results are absolutely necessary for successfully attaining the project goals.[40] A number of factors have been identified by different authors as being absolutely necessary for successful infrastructural projects. Grant identified CSFs in infrastructure delivery as appropriate risk allocation and risk sharing, and as multi-benefit objectives.[41] Jones et al. included a favourable legal framework and well-organized public agency as two of the important factors.[42] Stonehouse et al., on their part, identified the CSFs as government involvement by providing support, shared authority between public and private sectors, and commitment of public/private sectors.[43] Qiao et al. were of the opinion that the essential elements necessary for the success of infrastructure projects were a stable macro-economic environment, technical innovation and technology transfer, an available financial market, political stability and social support, good governance, and the technical feasibility of the projects.[44]

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[39] United Nations (Economic and Social Commission for Asia and the Pacific) *Guidebook on Public-Private Partnership in Infrastructure*.

[40] For the definition of CSF, see, for example, J. Rockart (1982) "The Changing Role of the Information Systems Executive: A Critical Success Factors Perspective", *Sloan Management Review*, 23(1): 4.

[41] T. Grant (1996) "Keys to Successful Public-private Partnerships", *Canadian Business Review*, 23(3): 27–28.

[42] Doug, Jones (2002) "Policy Development in Australia for Public-Private Partnership Projects – What More is there to Do?", Paper presented at a Seminar on Providing Value for Money Through Public Private Partnerships: The Lessons Learnt So Far from Economic and Social Infrastructure Projects, 26 June available at http://www.claytonutz.com/downloads/PPP%20paper%2026%20June%202002.pdf (last accessed 12 October 2015).

[43] J.H. Stonehouse, A.R. Hudson and M. J. Okeefe (1996) "Public-Private Partnerships: The Toronto Hospital Experience", *Canadian Business Review*, 23(2): 17–20.

[44] Lin Qiao, Shou Qing Wang, Robert L.K. Tiong and Tsang-Sing Chan (2001) "Framework for Critical Success Factors of BOT Projects in China", *Journal of Project Finance*, 7(1): 53–61.

Perhaps the most extensive enumeration of CSFs for PPPs is that offered by Hardcastle et al. The authors categorized CSF in PPP projects in five major groups with sub-factors under each group. These are:

1. *Effective procurement*: This includes transparency in the procurement process, a competitive procurement process, good governance, well-organized and committed public agency, social support, shared authority between public and private sectors, and thorough and realistic assessment and cost benefits.
2. *Project implementation*: This include a favourable legal framework, project technical feasibility, appropriate risk allocation and risk sharing, commitment and responsibility of the public and private sectors, and a strong and effective private consortium.
3. *Government guarantee*: This comprises government involvement by providing a guarantee, multi-benefits objectives and political support.
4. *Favourable economic conditions*: This includes stable macroeconomic conditions and sound economic policy.
5. *Available financial market*: This includes availability of suitable and adequate financial market.[45]

## 1.8 Infrastructure Development in Nigeria

The word "infrastructure" was coined out of the words "infra"(beneath) and "structure" (building) and thus usually encompass services or facilities that are underground, such as piped water and sewerage, or those that lie on the surface, such as roads and railways.[46] Investment in infrastructure is said to have crucial input in the economic development of a country.[47] The stock of public infrastructure in most countries plays an

[45] Cliff Hardcastle P. Edwards, A. Akintoye and Li Bing (2006) "Critical Success Factors for PPP/PFI Projects in the UK Construction Industry: ACritical Factor Analysis Approach" in T.S. Ng (ed.), *Public Private Partnerships: Opportunities and Challenges*, Center for Infrastructure and Construction Industry Development, University of Hong Kong, Pokfulam, pp. 75–83.

[46] Jose A. Gomez-Ibanez (2003) *Regulating Infrastructure*: *Monopoly*, *Contracts and Discretion*, Harvard University Press, USA, p. 4.

[47] Darrin Grimsey and Mervyn K. Lewis (2002) "Evaluating the Risk of Public Private Partnerships for Infrastructure Projects", *International Journal of Project Management*, 20: pp. 107–118;

important role in accelerating development and attracting private sector finance from overseas into the country. This is the case in most developing countries and Nigeria is no exception, hence the move by the country to develop its infrastructure base.

Infrastructure is broadly classified as being either economic or social.[48] Economic infrastructure provides key intermediate services to businesses and industry, and its principal function is to enhance productivity,[49] development and prosperity.[50] Some examples of economic infrastructure include roads, highways, bridges, railways, airports, telecommunication installations and power stations. Social infrastructure provides basic services to households. Its main role is to improve the quality of life and welfare of citizens.[51] Some of the recognized social infrastructure includes hospitals, schools, water supply and prisons.

As noted previously, the state of Nigeria's infrastructure is appalling and requires urgent attention. The power sector is marked by low generating capacity relative to installed capacity. For instance, electricity generation in 2015 ranged from between 2500 MW to about 4000 MW while estimated national consumption is in excess of 40,000 MW.[52] It is estimated that the country currently spends US$13 billion in fuelling power generators to cover the deficit in power needs;[53] it is also estimated that demand will double by 2020.[54] The state of the country's road network is poor, with only about 15.3 % of its 195,200 km paved, about 28 % of these paved roads being in a very poor condition and unsuitable for traffic.[55]

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A. Threadgold (1996) "Private Financing of Infrastructure and Other Long Term Capital Projects", *Journal of Applied Finance and Investment*, 1(1): 7–12.

[48] Infrastructure can be further subdivided into "hard"' and "soft" infrastructure and also as "material infrastructure", "personal infrastructure" and "institutional infrastructure".

[49] Darrin Grimsey and Mervyn K. Lewis (2004).

[50] A. Ng and Martin Loosemore (2007): 66.

[51] Darrin Grimsey and Mervyn K. Lewis (2004).

[52] As at October 2015, power generation has further dropped to 3373.18 mw. See *The Herald*, Nigeria, 9 October 2015, available at http://www.theheraldng.com/nigerias-power-supply-drops-to-3373-18mw/

[53] Nyananso G. Ekanem (2010) "Nigeria: The Most Dynamic PPP Market in Africa?", Paper presented at the Southern Africa Development Community PPP Forum and Network Launch in Midrand, South Africa, February 2010.

[54] Ibid.

[55] Uche Ohia (2011) "Infrastructure Concessions in Nigeria: Challenges and Opportunities", Paper presented at the 5th Annual Diaspora Conference held in Abuja on 25–27 July 2011.

The situation with the railway infrastructure is worse; the entire network is virtually moribund and outdated, as there has been no upgrading or maintenance since the early 1990s.

In many urban areas, hospitals, the water supply, sewerage and waste disposal infrastructure is virtually non-existent, and this is not an exhaustive list. Maintenance of the partially existing services has been poor. These shortfalls are being compounded by the twin problems of rapid population growth and urbanization. The investment required to meet the government's Vision 2020 target is estimated to be US$35 billion for the power sector, US$13 billion for the railways, US$5 billion for the ports and US$3.5 billion for the roads.[56]

Nigeria's Vision 2020 programme is aimed at Nigeria ranking among the 20 largest economies in the world by 2020. To achieve this, it is estimated that the country needs to invest between US$6 billion and US$9 billion per annum until 2020.[57] This is an enormous amount of money required within a very short time frame. The government alone obviously cannot afford to fund the provision of critical infrastructure and has turned to PPPs as its only viable alternative.

The primary motivating factor for the aggressive PPP drive in Nigeria is the lack of government funds to improve the country's derelict infrastructure. Therefore, the government is trying to attract much needed private sector funds for infrastructure development. The other factor is the failure and/or inefficiency of public authorities in providing much needed public services. It is hoped that the private sector would be more efficient in providing these services.

The decision to resort to PPP was made easier by the fact that the country had gone through a privatization programme that lasted since 1988. This also included a reform programme encompassing the

[56] Engr. Mansur Ahmed (2011) *Infrastructure Development for Nigeria*: *The PPP Imperative*, available at http://www.icrc.gov.ng/wp-content/uploads/2011/07/PPP-Forum-ICRC-DG-presentation-v4.pdf (last accessed 12 October 2015).

[57] Adekunle M. Animashaun (2011) *Public Private Partnership as a Strategy of Infrastructure Finance in Nigeria*, (online), http://njpg.pactu.edu.np/njpgfiles/4-animashaun-mojeed-adekunle-public-private-partnership-as-a-policy-strategy-of-infrastructure-financing-in-nigeria.htm (last accessed 12 October 2015).

liberalization and deregulation of the economy.[58] In essence, there was a partially liberalized economic environment in place; PPP was thus seen as the natural progression from privatization. Also, PPP did not carry "the baggage" which burdened the privatization programme simply because it did not lead to the complete transfer of ownership of assets from the government to the private sector (usually from overseas) and so people naturally found it a more comfortable concept.

Nigeria—being a developing country, with a moderate capital budget, an undeveloped capital market and not very buoyant private sector financial institutions—had to rely on foreign private sector funding to realize its goals of providing infrastructure for its citizens. It is therefore not surprising that most of the early investment in infrastructure via PPP came through collaboration between foreign investors and Nigerian businesses. The multilateral financial agencies also came in with considerable support and finance.[59]

Some of the transactions that have been achieved so far are mainly in the transport sector and include a new airport terminal in Lagos, a new toll road in the Lekki area of Lagos, the seaports located around Lagos and the Niger Delta region of the country. There are a number of other projects currently in the pipeline, such as the light rail project for the Federal Capital Territory and Lagos, and the concession of major road networks around the country. It is also mooted that the existing railway network will be concessioned. In other sectors, such as housing, the Federal Capital Administration has concluded plans to concession the provision of infrastructure in certain areas of the capital city to some investors and there are also ongoing deals being negotiated in the power sector.[60] Joint ventures and BOT arrangements appear to be the most common PPP delivery mechanism used in infrastructure projects in Nigeria.[61] However, apart from BOTs and joint

[58] This programme was pursued through the Bureau of Public Enterprises (BPE). Under this programme, over 200 transactions were concluded.

[59] On 17 March 2011, the World Bank approved a loan of US$115 million for the PPP initiative project aimed at helping increase private sector investment in PPP infrastructure in Nigeria.

[60] Most of the hitherto government-owned power assets are being completely divested through privatization. The only assets to be concessioned are the hydropower plants.

[61] Ahmed D. Ibrahim, Andrew F. Price and Andrew J. Dainty (2006) "The Analysis and Allocation of Risk in Public Private Partnerships in Infrastructure Projects in Nigeria", *Journal of Financial Management of Property and Construction*, 11(3): 149–164.

ventures, other popular PPP arrangements are BOOTs and DBFOs. It is also true that there have been a number of concessions.[62]

It is therefore clear from the forgoing that Nigeria has fully embraced the use of PPPs to finance infrastructure. However, due to the desperation and haste of government to provide infrastructure, crucial enablers to ensure successful PPP transactions were never put in place. This has been a significant hindrance because investors (foreign and local) are wary of tying down their capital for 25–30 years without sufficient guarantees that they will be able to recoup their investments and make some profit. It also does not help that the risks of doing business in Nigeria are higher than established economies. Therefore, prospective investors would like to see evidence or assurances that their investments will be safe and yield profitable returns. Currently, Nigeria is unable to provide such guarantees and, as such, faces the difficulty of attracting the calibre of investor that will partner with the government to develop the country's infrastructure.[63] Where it has been able to attract foreign investment to develop PPP projects, such transactions have suffered enormous setbacks. There are numerous cases in courts between the government and the investors on one hand and between the government and its citizens on the other, and a number of the contracts have already been renegotiated less than three years into their operation. There have also been instances where users or the public have refused to use the asset provided or refused to pay tolls.

Also, as a developing country, Nigeria has suffered more than most countries in Europe and the USA from governance issues that arise from the negotiation of long-term investment contracts like PPP contracts. These issues occur from the use of one-sided contractual clauses, such as stabilization[64] and non-compete clauses,[65] which are usually skewed

[62] The 26 Ports in the country were concessioned through the use of the "landlord tenant" model.

[63] With the population of over 160 million, large market and the strategic location of Nigeria in the African continent, the level of foreign direct investment into the country has been appalling.

[64] Stabilization clauses are risk management devices in investment contracts between host states and investors. They address changes in law or other circumstances during the life of the contract. See, for example, Lorenzo Cotula (2008) "Regulatory Takings, Stabilization Clauses and Sustainable Development", (online), available at http://www.oecd.org/dataoecd/45/8/40311122.pdf (last accessed 12 October 2013).

[65] Non-compete clauses usually prevent the government from providing alternative infrastructure that will compete with that of the private sector investor for revenue. These provisions effectively make the public the guarantor or insurer of the private sectors' expected revenues. See Ellen Dannin (2011).

heavily in favour of the local or overseas investors due, primarily, to a lack of technical capacity. There is also a lack of a genuine process for stakeholder engagement during the PPP contract negotiation process and throughout the execution of the project.

## 1.9 Conclusion

This chapter has looked at the various definitions of PPP. Also, the various types of PPP were discussed, with a complete examination of the different meanings of the various acronyms that represent the diverse but similar financing options that characterize the concept. It is noted that there are various definitions of PPP depending on who is defining the concept and the context from which the definition is being made. This chapter has tried to look at the various institutional definitions of the concept and has concluded that the definition by the Asian Development Bank (ADB) is the most detailed and utopian, and recommends that Nigeria should adopt and aspire towards the values enumerated in that definition.

One recurrent theme from most of the definitions is the importance of proper risk allocation and its necessity for successful PPPs. This is in line with various commentaries, which also emphasize the significance and necessity of good project governance and successful PPPs. It is therefore suggested that PPPs in Nigeria can be enhanced through better project risk management.

# 2

# The Legal and Institutional Framework for PPPs in Nigeria

## 2.1 Introduction

As was discussed in Chap. 1, the most common reason adduced for the widespread use of the PPP model in the provision of infrastructure by different countries across the world is the inadequacy of public funds to meet the increased demand for infrastructure. It is for this same reason that Nigeria turned to PPPs to help finance her infrastructure and also to provide much needed public services to its people. In order to facilitate the PPP process, the parliament of Nigeria enacted the Infrastructure Concession Regulatory Commission Act (ICRC Act) (ICRCA)[1] in 2005. This Act established the ICRC to manage PPP transactions at the federal level.[2] Even before the ICRC Act came into force, a number of transactions had been completed using the PPP model in different sectors of the Nigerian economy. Most of the large transactions undertaken so far are in the transport sector and include projects at the ports, and in aviation and road sectors.

[1] Infrastructure Concession Regulatory Commission (ICRC) Act (2005).

[2] Some of the 36 states of the Federation have also enacted enabling legislations—for example, the states of Lagos, Rivers, Cross Rivers, Ekiti and Niger.



G. Nwangwu, *Public Private Partnerships in Nigeria*,
DOI 10.1057/978-1-137-54242-7_2

Prior to the enactment of the ICRC Act, it was apparent that government was gradually shifting away from the erstwhile policy of exclusive public finance of infrastructure projects. This was obvious from the unveiling of various long-term developmental plans such as the Vision 2010 and Vision 2020 policies,[3] which both actively advocated for an increase in private sector participation in the provision of infrastructure. Also, Nigeria had gone through an aggressive privatisation programme enabled by the Privatisation Act, which led to the acquisition and control of key government infrastructure by a host of private sector investors. A number of concessions were also put in place under the Privatisation Act even after the ICRC Act had become operational. For a long time, therefore, it seemed as though government could choose randomly between either of the two laws in setting up PPP transactions, as public authorities vacillated between either of the laws for different transactions. Interestingly, also, the ICRC Act itself was largely modelled after the Privatisation Act by creating a board membership that is chaired by a political leader of stature.

## 2.2 Legislative Framework for PPPs in Nigeria

Nigeria operates a federal system of government where legislative powers are shared between the constituent units of government comprising the federal, the state and the local governments. The Constitution divides legislative power into three lists. Items on the exclusive list are preserved solely for the federal government.[4] Both the federal and state governments may legislate on items listed in the concurrent list.[5] A third list, the residual list, may also be inferred and is reserved exclusively for state governments.[6] The first puzzle a potential investor must solve is to determine which of the levels of government it should deal with on a particular project, as certain types of infrastructure assets on the concurrent list, such as roads and electric power, are owned either by the federal

[3] Nigeria's Vision 2020 Policy is predicated on the fact that Nigeria intends to be the ranked among the 20largest economies in the world by the 2020.

[4] S. 4(2) of the 1999 Constitution of the Federal Republic of Nigeria.

[5] Note that, if there is any conflict, the federal government will override the state government.

[6] These are matters that are not in the Exclusive and Concurrent legislative lists. See S. 4(7)(a) of the Constitution of the Federal Republic of Nigeria 1999.

or state governments. The net effect of this distribution of power is that there are both federal and state legislations regulating PPPs in Nigeria and. depending on the particular infrastructure in which a private sector is involved, it may deal with a particular state or both a state and the federal government, and this may invariably determine which set of laws will regulate the transaction.

Based on this distribution of legislative powers by the Constitution, the federal government and a number of states[7] within the Federation have enacted specific laws regulating PPPs. These laws operate along with other legislations that indirectly affect a potential PPP project within the country. Some of these laws are the different planning laws of the states of the Federation, the multiple tax legislations and the general law of contract that is largely centred on received English law.[8] Since most of the large infrastructure projects undertaken within the country have been federal projects, the analysis of the legal framework for PPPs in this book will be based primarily on federal legislation and policies.

The legal framework for PPPs at the federal level itself, as pointed out, comprises a confusing and conflicting web of regulations and policies. Therefore, a potential investor would need to decipher which of the several legislations, or even institutions, would regulate a particular transaction before initiating a PPP project in Nigeria. It is also worth noting that these laws and policies are also generally inadequate, contain conflicting provisions and, thus, contribute to manifest uncertainty, thereby inordinately increasing transaction costs.[9] A review of some of these laws is presented below.

### 2.2.1 The Infrastructure Concession Regulatory Commission Act (2005)

The ICRC Act, which was enacted into law in 2005, provides the primary legal framework for private sector participation in infrastructure

[7] Some of the states with existing PPP legislation are Cross Rivers, Ekiti, Lagos and Rivers.

[8] This consists of common law and doctrines of equity, together with statutes and subsidiary legislations that were in force in England on 1 January 1900. See, for instance, the provisions of S. 2 of the Law (Miscellaneous Provisions) Law, Laws of Lagos State Cap 65 1973.

[9] George Nwangwu (2012) "The Legal Framework for Public Private Partnerships in Nigeria", *European Procurement & Public Private Partnership Law Review*, 7(4): 268–277.

development in Nigeria and is the principal legislation for Nigerian PPPs. The ICRC Act is divided into two parts. The first part vests government ministries, departments and other agencies of government with power to enter into a contract with or grant concessions to the private sector for the financing, construction, operation and maintenance of any viable infrastructure.[10]

The second part of the Act establishes the Infrastructure Concession Regulatory Commission (the ICRC), which is managed by a 12-member board that includes a part-time chairman, the Attorney General of the Federation, the Governor of the Central Bank and a person from each of the six geopolitical zones of the country. The main function of the Commission is to take custody of every concession agreement or contract entered into by the government ministry or agency, and monitor compliance with the Act and the efficient execution of any such Concession Agreements.[11] The Act does not, however, provide for detailed rules on how the procurement of PPP contracts should be carried out. This is a significant gap that is subsequently filled through policy documents.

Note that even though the Act only mentions "concession", it also applies to other forms of PPPs. However, despite the use of the word "regulation" in the title of the ICRC Act, the law does not seem to confer regulatory powers on the ICRC in the true sense of it. Under the ICRC Act, the institution is not empowered to perform any form of economic or technical regulation. However, it is given powers to monitor compliance with the terms of a PPP contract. There is no indication of what the monitoring of compliance entails except that the institution has no coercive powers to enforce such compliance. It can neither sue a defaulting investor for specific performance of the terms of the contract, nor can it sanction an investor or revoke a PPP contract for breach. Nevertheless, despite these glaring deficiencies in its enabling legislation, ICRC presently assumes the responsibility of a regulator for PPPs in Nigeria.

[10] S.1 of the ICRC Act.

[11] Ss. 14, 15, 16 and 17 of the ICRC Act.

### 2.2.2 The Public Enterprises (Privatisation and Commercialisation) Act (1999) (Privatisation Act)

The Privatisation Act provides the legal framework for the privatisation and commercialisation of various public assets in Nigeria. It also creates the National Council of Privatisation (NCP) as the apex body charged with the responsibility of setting and administering the federal government's policies and objectives on privatisation and approving transactions. The Act also established the Bureau of Public Enterprises (Bureau of Public Enterprises) to function as the secretariat of the NCP and carry out the actual day-to-day privatisation activities.

A number of concessions have been completed under this law by the BPE, including concessions of the 26 seaports, the trade fair complex, Tafawa Balewa Square, the hydroelectric power plants and the National Theatre. However, this seems to be clearly in conflict with the express and exclusive powers conferred on the ICRC by the ICRC Act regarding concessions in Nigeria. This has led to a good deal of confusion and bickering between the two organisations created under the respective legislation. There have been suggestions that the BPE should restrict itself to only brownfield concessions, while the ICRC should be in charge of greenfield transactions. However, this is not supported by legislation or any policy document. There are a number of transactions still listed under the schedule to the Privatisation Act including the concession of the airports and the railways, and this will definitely lead to further conflicts between the two organisations whenever the BPE attempts to complete transactions for those projects.

Ordinarily, there would be no conflict between the BPE and ICRC were the BPE to restrict itself to project development and ICRC to regulation. However, both agencies criss-cross between these two roles. The ICRC had, for a number of years, attempted to develop PPP projects and the BPE had relied on its post-privatisation monitoring role to assume powers of regulation.

### 2.2.3 The Public Procurement Act (2007)

The Procurement Act applies to procurement of goods and services carried out by the federal government of Nigeria and any public body

engaged in procurement and all entities which derive at least 35 % of the funds appropriated or proposed to be appropriated for any type of procurement from the Federation's share of the Consolidated Revenue Fund.[12] The Act does not therefore apply to procurement carried out by the constituent states of the Federation.

The Procurement Act also does not expressly mention procurements undertaken under PPPs, such as concessions, and so it is believed that it only applies to traditional procurement and not to procurements made as PPPs. It is based on this and the silence of the ICRC Act on detailed procurement rules that has caused the ICRC to stipulate certain guidelines under the National PPP Policy for PPP procurements.[13] This position is, however, questionable; it leads to further confusion and conflict because the Procurement Act also regulates the procurement of goods and services for infrastructure projects[14] and therefore may, indeed, apply to PPPs. It is obvious that the Procurement Act did not take into consideration the ICRC Act or the Privatisation Act, as it should have as these were already in existence.

In summary, while essential for the sake of clarity, the decision to provide specifically for PPP-type procurements under PPP Policy may have also led to more confusion, as the overlap between the Procurement Act and the ICRC Act, and conflict between institutions created under them, is further exacerbated. Despite this multiplicity of regulatory and institutional oversight over PPP procurements, the existing gaps in the process are yet to be adequately filled.

### 2.2.4 The Debt Management Office (Establishment) Act (2003)

The Debt Management Office (Establishment) Act[15] established the Debt Management Office (DMO) to prepare and implement a plan for the efficient management of Nigeria's external and domestic debt obligations, and to set guidelines for managing the country's risk and currency

[12] S. 15 of the Procurement Act, No. 14 (2007).

[13] Part 1 of the Supplementary Notes to the National Policy on Public Private Partnership (PPP).

[14] It is, however, silent on the non-tender aspects of PPP transactions or the handling of unsolicited bids.

[15] Debt Management Office (Establishment) Act (2003).

exposure with respect to all loans. PPP transactions will obviously require the government of Nigeria to borrow both externally and internally, as well as to issue guarantees. Therefore, the DMO is necessarily involved in concluding financial arrangements for PPPs in Nigeria. However, there is nothing in any of the existing laws regulating PPPs that takes this fact into consideration; therefore, potential investors are likely to be stranded where they require government intervention—for instance, to enhance the credit worthiness of their projects. Potential investors should be made aware of the need to begin consultations with the DMO early in the project preparation stage to avoid the DMO vetoing the transaction mid-stream for non-compliance with its policies.

It is, however, noteworthy that PPP projects are now required to go through the PPP office in the Ministry of Finance before being signed off to allow for the evaluation of the financial obligations of government to the projects. This makes it easier for certain government obligations that require the oversight of the DMO to be brought to the attention of DMO early in proceedings, since the organisation works closely with the Ministry of Finance.

### 2.2.5 The Fiscal Responsibility Act (2007)

The Fiscal Responsibility Act promotes the prudent management of the country's resources by ensuring greater accountability and transparency in fiscal operations, and also by imposing limits on the country's spending and borrowing. The Act established the Fiscal Responsibility Commission to ensure that the objectives of the Act are met.

From the foregoing, it is apparent that there ought to be coordination between the different institutions created under the different pieces of PPP legislation and the Fiscal Responsibility Commission. This is essential, since PPPs will usually involve some form of borrowing or spending on infrastructure by the government. However, neither the Fiscal Responsibility Act nor the ICRC Act mentions any sort of interface between the organisations.

Potential investors also run the risk of running into problems in the middle of their projects, suffering cost overruns and even possible project abandonment, should the Fiscal Responsibility Commission ever decide to flex its muscle. The proper thing to do is to ensure that the PPP laws,

especially those dealing with project preparation, clearly provide for the extent, period and method of involvement of the Fiscal Responsibility Commission in the PPP process.

### 2.2.6 The National Planning Commission Act (1993)

The National Planning Commission was established by Act No.12 (1992) and later amended by Act No. 71 (1993). The major function of the Act as it relates to infrastructure development is in relation to designing, coordinating and monitoring the implementation of the nation's infrastructure master plan. It is therefore necessary that the project proponents will need, first, to ensure that any project earmarked for PPP is included in the nation's master plan as approved by the National Planning Commission. For a considerable while, there was no infrastructure master plan and project arrangements were completed without reference to any agreed plan. Indeed, it was doubtful whether there was any coherence in the manner in which projects were earmarked for PPPs, since the majority of the projects originated from unsolicited proposals. It is hoped that the recent approval of a National Infrastructure Master Plan in 2014 will lead to a more structured approach to project prioritisation and delivery. It is also now more urgent than ever for primary PPP legislation to recognise the synergy between them and the National Planning Commission Act.

### 2.2.7 National Policy on Public Private Partnerships

Usually, policies are drafted before the enactment of legislation in a particular sector. The reason for this is that policy guidelines are broad in nature and legislation is more specific in embodying government policies in a particular area. However, this was not the case with the National PPP Policy as it was, rather, designed to explain and fill in the gaps in the ICRC Act. In fairness to the ICRC, it inherited badly drafted legislation that hardly dealt with some of the pertinent issues necessary for successful PPP projects. Therefore, relying on its mandate to provide general policy guidelines and the rules and regulations for its operation,[16] it produced

[16] See S. 19, ICRC Act.

the National PPP Policy, which was approved by the Federal Executive Council (FEC) in April 2009.

The PPP policy is however a mere policy document of government and is therefore incapable of creating any strong legal authority for the ICRC to act. For instance, neither the ICRC nor private sector parties can sue or approach the courts for specific performance or compliance of its provisions. The government is not even obligated to comply with the provisions of this policy document and, besides, Nigerian governments over the years have never been known to be strict adherents to their policies. It is because of this that this book questions the legal and transactional value of the provisions of this policy document.

### 2.2.8 The Federal Ministry of Finance

The PPP Unit of the Federal Ministry of Finance is responsible for assessing the financial viability of PPP projects within the country. The core function of the PPP Unit is to manage government's contingent liabilities in PPP projects by identifying, tracking, mitigating and monitoring the liabilities; to evaluate projects for viability gap funding; and to support other ministries, departments or agencies by providing advice on the financial aspects of PPP contracts. The PPP Unit is housed as a Division within the Technical Services Department of the Ministry of Finance.

### 2.2.9 The Federal Executive Council

The Federal Executive Council (FEC) is the Cabinet of Nigeria and therefore the highest executive decision making arm of government. The members are appointed by the president and oversee the ministries and major parastatals of government. The ICRC Act specifically provides that the FEC must grant approval before PPP contracts may be entered into. The ICRC Act also provides that no guarantees or similar undertakings may be given by any government agency to an investor without the approval of the FEC. The ICRC has interpreted the provision dealing with approvals before the entering into of contracts to mean that approvals must be obtained from the FEC before the undertaking almost all

steps of the PPP process. This interpretation has protracted timelines for completing projects. Therefore, while conceding that the buy-in of the FEC is essential to project delivery, it is emphasised that it is necessary to limit the Council's involvement in the approval process so that the country can deliver projects more quickly.

### 2.2.10 Various Infrastructure Sector Acts and Bills (Currently Before the National Assembly)

A number of existing infrastructure sector legislations—for example, the Electric Sector Reform Act—are in conflict with the ICRC Act. This is primarily because these laws create sector regulators with whom the ICRC seems to be competing for regulatory space. This is the same with a number of Bills that are currently before the National Assembly. These Bills seem to have been drafted without reference to the ICRC Act.

From the foregoing, it is obvious that any investor coming into Nigeria will be wary of the considerable number of regulatory risks which it is likely to face in Nigeria due to the multiplicity of laws and institutions. This situation has contributed to confusion and, unless these various pieces of legislation are properly synchronised with one another and also with the wider legislations, this will continue to impact negatively on PPP transactions in the country.

## 2.3 Other Aspects of the Law that Affects PPPs

A discussion of the legal framework for PPPs in Nigeria would be incomplete without a discussion of other key areas of law that are likely to affect a PPP project in Nigeria. An investor in Nigeria will not only need to comply with extant PPP and procurement regulations, but also with other bodies of legislation, such as contract and tax laws, for example. This section therefore examines the other non-PPP specific bodies of law and other legal issues that are most likely to arise at various stages of a PPP project in Nigeria. It evaluates how these laws affect PPP projects and advises on how to navigate through them. For the sake of completeness,

the checklist promoted by the World Bank guidelines on legal framework assessment will be adopted.[17]

### 2.3.1 Settlement of Disputes/Alternative Dispute Resolution

A potential investor in a PPP project, like any other investor, is bound to take into consideration the forms of legal redress available in the intended country of investment. Traditionally, the domestic courts serve as the first point of call whenever a dispute arises from any commercial venture in Nigeria. However, investors are likely to encounter the challenge thrown up by the slow judicial system there. Investors would usually opt for the alternative dispute resolution (ADR) process that presents a more efficient method of dispute resolution. The fact that Nigeria is a signatory to a number of international arbitration treaties is also very helpful. For instance, Nigeria ratified the International Centre for Settlement of Investment Disputes (ICSID) Convention on 23 August 1965. The convention was re-enacted as a local legislation via the International Centre for Settlement of Investment Dispute (Enforcement of Awards) Act. The New York Convention on the Recognition and Enforcement of Foreign Arbitral Award 1958 is also applicable in Nigeria by virtue of section 54 of the Arbitration and Conciliation Act.[18]

Foreign investors are however typically reluctant to rely on a legal system that they have little knowledge of and therefore would seek to designate the governing law of the contract and forum of arbitration to be in a neutral country. Where arbitration proceedings have taken place outside the country, a number of laws and practices exist that allow for the local enforcement of foreign arbitral awards within the country. There are five methods through which a foreign investor can enforce foreign arbitral awards:

- by an action upon award;
- by registration under the Foreign Judgment (Reciprocal Enforcement) Act (1990);

[17] See http://ppp.worldbank.org/public-private-partnership/legislation-regulation/framework-assessment (last accessed 12 October 2015).

[18] Cap 19 Laws of the Federation of Nigeria 1990.

- under S. 51 of the Arbitration and Conciliation Act;
- by the enforcement of foreign arbitral awards; and
- by an arbitral award enforceable under the ICSID Convention.

*By an action upon award*. The Nigerian Supreme Court held in *Toepher Inc. of New York v. Edokpolor & Sons* that a foreign arbitral award could be enforced in Nigeria by suing upon an award, even where there is no reciprocal treatment in the country where the award was obtained. In Nigeria, it is estimated that this procedure could take about one year or more to conclude.[19]

*By registration under the Foreign Judgment (Reciprocal Enforcement) Act (1990)*. Under this Act, a judgement or award obtained in a foreign country may be enforced in Nigeria within six years of the judgement or award being made. It is noteworthy that only countries that accord reciprocal treatment to Nigeria, as designated by the Minister of Justice, would be recognised. Ordinarily, this is a swift process but it is of limited application due to the requirement that the award must be for the payment of a sum of money and the judgement must have become enforceable as a judgement of a court according to the law of the place where it is made.[20]

*Section 51 of the Arbitration and Conciliation Act* stipulates that an arbitral award shall, irrespective of the country in which it is made, be recognised as binding and subject to S. 32 of the Act shall, upon application in writing to the Court, be enforced by the Court. Section 51(2) stipulates the grounds which the applying party must meet for an application to be successful for enforcement.

*Enforcement of foreign arbitral awards* is also possible under the New York Convention (1958). Nigeria has made a reciprocity reservation and so only awards made in contracting states that undertake to recognise and enforce awards made in other contracting states, including Nigeria, will be recognised and enforced in Nigeria.

*Under the ICSID Convention, an arbitral award is enforceable* in Nigeria and given the same priority as if it were an award contained in a final

[19] "Enforcement of Foreign Arbitral Awards in Nigeria", February 2009, available at www.blackfriars-law.com/index.php/en/docs/doc_download/52-litigation-and-arbitration-newsletter-feb09 (last accessed 12 October 2015).

[20] Ibid.

judgement of the Supreme Court of Nigeria (the highest court of justice). The requirement is that a copy of such an award is duly certified by the Secretary General of the Centre and is filed in the Supreme Court by the party seeking its recognition and enforcement.

### 2.3.2 Law of Contract

PPP contracts comprise a suite of agreements between the parties and it is only natural that the interpretation and enforcement of these contracts will be of upmost importance to investors. Nigeria is a common law country and most of the principles of contract law that apply widely across common law jurisdictions apply in Nigeria. When a contract is breached, the two most common remedies available to the innocent party are either an order of specific performance by the court or an award for damages. As a matter of course, the courts will only order specific performance where damages will not be adequate. For this reason, this section will concentrate on the attitude of the Nigerian courts to the award of damages.

The traditional common law position on damages is that a party that sustains a loss by reason of breach of contract should be placed in the same position as if the contract were performed.[21] However, due to the fact that an unqualified application of such a wide principle would prove too unfair on a contract breaker by making him liable for a chain of unforeseen and fortuitous circumstances, the principle of damages has been adapted and balanced to afford reasonable cover for the extent of non-performance by the party in breach, as well as adequately to compensate the innocent party. The current position under common law and, by extension, Nigerian law is that damages recoverable for breach of contract or other obligations should be limited to the level of damage or loss actually suffered. Consequently, any provision in a contract that seeks to set damage levels above justifiable levels will be voidable and considered a "penalty" if it exceeds what would be a genuine pre-estimate of damage. In practice, in most circumstances this leaves the

[21] *Robinson v. Harman (1848) 1 Ex Rep 850.*

responsibility to determine the appropriate level of damages entirely to the Court.

Therefore, where two parties have made a contract which one of them has broken, the damages which the other party ought to receive in respect of such a breach of contract should be such as may fairly and reasonably be considered as either arising naturally—that is, according to the natural course of things from such breach of contract itself, or such as may be reasonably be supposed to have been in contemplation of both parties at the time they made the contract as the possible result of the breach of it.[22]

### 2.3.3 Taxation

A host country's tax law is of paramount importance to a private investor in a PPP project as it directly impacts on the profitability, or otherwise, of such project. On its part, the host government ought to consider the impact its tax regime may have on the viability of businesses, including PPP projects. This is an important consideration because jurisdictions with more friendly tax regimes attract a greater number of investors, as they are confident of recouping their investments as well as earning some profit. Under Nigerian law, taxation is enforced by the three tiers of government—federal, state and local government—with each having its sphere clearly spelt out. The first thing to note is that most transactions with any public agency in Nigeria require the production of evidence of tax payment—that is, a Tax Clearance Certificate certifying that all taxes due, usually for the three immediately preceding years of assessment, have been settled in full.

The government of Nigeria, mindful of the multiplicity of taxes, recently published an approved list of taxes for the three tiers of government.

Taxes collectible by the federal government include:

- Companies Income Tax;
- Withholding Tax on companies;

[22] See *Hardley v. Baxendale (1854) EWHC J70*, where an English court categorised the understanding of damages as being direct or indirect damages.

- Petroleum Profit Tax;
- Value-added Tax (VAT)
- Education Tax;
- Capital Gains Tax –Residents and corporate bodies of Abuja Federal Capital Territory;
- Stamp duties involving a corporate entity;
- Personal Income Tax in respect of:
  - Armed forces personnel;
  - Police personnel;
  - Residents of Abuja Federal Capital Territory;
  - External Affairs of officers; and
  - Non-residents.

The Nigerian tax regime is relatively stable and the categories of tax listed apply to both residents and non-residents. The general position under Nigerian law is that every entity, whether an individual or a corporation, is subject to tax to be imposed by a relevant tax authority within one year of assessment. The Companies Income Tax Act (CITA)[23] regulates the taxation of companies. Article 9(1) of CITA provides that a company is chargeable for a tax payable at a specified rate on its profits accruing in, derived from, brought into, or received in Nigeria in respect of certain provisions. For the purpose of imposing company tax, a company is defined as "any company or corporation (other than a corporation) solely established by or under any law in force in Nigeria or elsewhere".[24]

The above provision affirms the widely understood position that every company is taxable. However, a company could be resident or non-resident. A company is resident in Nigeria if it is incorporated in Nigeria, while a non-resident company is that which is not incorporated in Nigeria but which derives its income or profits from Nigeria. A non-resident company is taxable in Nigeria on the profits attributable to its business or trade carried on in Nigeria. Section 13(2) of CITA provides

[23] The Companies Income Tax Act No. 31 (1996) Cap N.107 LFN 2004..

[24] S. 105 of The Companies Income Tax Act, ibid.

that a non-resident company is only liable for corporate tax under the following circumstances:

- if the non-resident company has a fixed base in Nigeria to the extent that profits are attributable to the fixed base;
- if the non-resident company habitually operates in Nigeria through a dependent agent authorised to conduct business on its behalf or on behalf of other companies controlled by it;
- if the trade or business or activities involve a single contract for surveys, deliveries, or installations or construction, the profit from that contract; or
- if the transactions between associated members are contrived or fictitious.

In all the circumstances mentioned here, the non-resident company would be subject to corporate tax on any investment income earned by it such as dividends, interest, royalties and rent.

### 2.3.4 Health and Safety Laws

Health and Safety laws are one of the primary considerations of parties to a PPP project. For instance, most PPPs involve the construction of large infrastructure; it is therefore expected that the conditions of workers on construction sites are prioritised and best practice standards are applied. In Nigeria, the legal framework for Health and Safety is in its infancy and still evolving. Most sector regulations, however, prescribe requisite health and safety standards for their respective sectors. Also, where multilateral agencies provide finance for projects, they usually stipulate health and safety standards to which the projects must conform. Some of the extant national laws on safety are the Factories Act (1987), the Factories Act (1990) and the Factories Act (2004). However, these laws only refer to factories and not to general safety standards.

In Nigeria, multinational corporations, obviously influenced by global best practices, have been the pioneers of health and safety in industries and continue to lead to the way in this area. This could also be partly attributable to the fact that they are subject to stricter health and safety laws in their own countries. The petroleum industry remains the sector with the highest

awareness on health and safety due to the high-risk nature of their business and other impacts. It is clear that this is an area where considerably more needs to be done by the legislature in passing appropriate laws.

### 2.3.5 Insurance

The Marine Insurance Act (1961),[25] the National Insurance Corporation of Nigeria Act (1969),[26] and the Insurance Act (2003)[27] are the three major laws governing insurance in Nigeria. However, there are other key provisions that are likely to affect the execution of PPP projects. Under S. 9(3) of the Pension Reform Act (2004), every employer of labour with five or more employees is required to take out a life insurance policy for a minimum of three times the annual total emolument of the employee. This law is applicable both to private and public sector employees. Failure to comply with this provision is an offence punishable with imprisonment for up to one year, or a fine of NGN 250,000,[28] or both. Section 63 of the Insurance Act also requires every owner or contractor of any building under construction with more than two floors to take out an insurance policy to cover liability against construction risks caused by his negligence or that of his servants, agents or consultants which may result in death, bodily injury or property damage to workers on site or members of the public. This insurance policy also covers liability for the collapse of buildings under construction. Failure to comply with this provision will attract punishment to the tune of NGN 250, 000, or three years imprisonment, or both.

### 2.3.6 Labour and Employment Issues

There are a number of labour law provisions that are of importance within the context of a PPP project. Nigeria is a signatory to most of the international labour conventions, which have subsequently been domesticated. However, it is important to note that immigration laws dealing

[25] Cap. 216 LFN, 1990.
[26] Cap. 263 LFN, 1990.
[27] Cap. 117 LFN, 2004.
[28] US$1100.

with work permits would affect a PPP project that involves the participation of foreign employees.

Under the Immigration Act,[29] companies cannot employ a foreign national without the permission of the Director of Immigration unless the Minister of the Interior grants a waiver or exemption by notice.[30] Furthermore, companies wishing to employ foreign nationals in Nigeria must first seek and obtain the consent of the Minister of the Interior in writing.[31] The employer company is responsible for the application and would be held liable for failure to obtain the required consents. A foreign investor under a PPP may likely require expatriates for temporary construction assignments, such as erection or installation work, feasibility studies, repairs of machinery and equipment, research work and such other assignments. The correct procedure here would be for the company to apply on the expatriate's behalf for a temporary work permit (TWP). TWPs are usually issued exclusive of the expatriate quota[32] allocation of the company.

A potential foreign investor who intends to live, work or carry on business in Nigeria on a more permanent basis would qualify as a resident. In the instance of a foreign subsidiary that is already incorporated, the company would need to apply for a business permit, an expatriate quota, and a subject to regularisation (STR) visa.[33]

### 2.3.7 Environmental Standards

PPP projects often involve construction of large infrastructure, which entails the application of heavy industrial machinery. These activities all have the potential to cause substantial changes to the structure of the land.

[29] Cap 11 LFN, 2004.

[30] Ibid., S. 34.

[31] Ibid., S. 8(1).

[32] An expatriate quota is a permit issued by the Federal Ministry of the Interior which allows a company registered in Nigeria to employ foreign nationals. The expatriate quota is granted for a period ranging between two and three years at the discretion of the Minister of the Interior and subject to renewal on expiry.

[33] An STR visa allows an employee (including their spouse and children) into Nigeria and is valid only for 90 days, pending the time an application is made to the Comptroller General of Immigration for a residency permit. After the permit is granted, a Combined Expatriate Residence and Alien's Card (CERPAC) is issued.

Therefore, most countries have a legal framework in place to monitor and regulate the impact of industrial activities on the environment.

In Nigeria, there are a handful of laws and regulations to this effect. The most notable regulation is the National Environmental Regulations (2009). The Environmental Regulations cover a number of areas including Pollution Abatement in Mining and Processing of Coal, Ores and Industrial Minerals; Pollution Abatement in Wetlands, River Banks and Lake Shores Protection; Pollution Abatement in Watershed, Hilly, Mountainous and Catchment Areas; Ozone Layer Protection; Noise Standards and Control, to mention a few.[34]

The most relevant law that affects PPP projects is the Environmental Impact Assessment Act.[35] The Environmental Impact Assessment Act places restrictions on embarking on public or private projects without prior consideration of the environmental impact of those projects. The law stipulates that all agencies and all institutions (whether public or private), unless exempted under the Act, shall, before embarking on a project, apply in writing to the Environmental Agency so that their activities can be identified and an environmental assessment conducted as the activities are being planned.[36] The Act also exempts certain projects from Impact Assessment. Under S. 14, an environmental assessment of a project shall not be required where:

- in the opinion of the Agency the project is in the list of projects which the President or the Council is of the opinion that the environmental effects of the project are likely to be minimal;
- the project is to be carried out during national emergency for which temporary measures have been taken by the government;
- the project is to be carried out in response to circumstances that, in the opinion of the Agency, the project is in the interest of public health or safety

All PPP projects in Nigeria must undergo Impact Assessment, except where they fall within the scope of the exemption mentioned above.

[34] See, http://www.nesrea.org/lawsandregulations.php (last assessed 21 October 2015).

[35] Cap. E12 LFN, 2004.

[36] Ibid., S. 2.

Any other projects that fall outside the scope of exempted projects must undergo the Impact Assessment procedure.

To ensure the enforcement of environmental laws, guidelines, policies, standards and regulations, such as those mentioned above, the federal government established the National Environmental Standards and Regulations Enforcement Agency (NESREA)[37] under the Federal Ministry of Environment, Housing and Urban Development. In addition to enforcing national laws and regulations, NESREA is also charged with the responsibility of ensuring compliance with the provisions of international agreements, protocols, conventions and treaties on the environment.[38]

For projects seeking funding from multilateral institutions, the criteria required to be fulfilled before the projects can access funding relate to a higher standard of environmental and social impact.

### 2.3.8 Lender Issues

As mentioned consistently in this book, one of the major reasons for the adoption of PPPs by the Nigerian government is the paucity of funds with which to provide infrastructure for its people. Therefore, a sizeable amount of the funding for PPPs is expected to come from the private sector. Private sector partners—and, indeed, the government—are most frequently inclined to raise required funding from lenders. It follows, therefore, that lender considerations would be one of the most critical issues that needs to be given adequate consideration during the preparation of PPP projects. Due to the immaturity of the market in Nigeria and the unpredictability of demand for PPP services, most investors would require sovereign guarantees from the government to backstop their investments. Guarantees help to mitigate critical government performance risks that the private sector is reluctant to assume. They also insure against the failure of government to meet specific obligations to the investor or to the project.

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[37] National Environmental Standards and Regulations Enforcement Agency (NESREA) Act, Cap F10 LFN, 2004.

[38] http://www.nesrea.org/about.php

Guarantees come in several forms and there are some specialist instruments offered by multilateral organisations; for instance, the World Bank Group offers a range of guarantees for the financing of infrastructure projects in developing countries.

- The International Bank for Reconstruction and Development (IBRD) and the International Development Association (IDA) offer Partial Risk Guarantees (PRGs) that provide coverage for breach of contract, as well as traditional political risks.
- The IBRD offers Partial Credit Guarantees (PCGs) that support sovereign borrowing.
- The Multilateral Investment Guarantee Agency (MIGA) offers Political Risk Insurance (PRI) against the specific risks of transfer and convertibility, expropriation, war and civil disturbance, and breach of contract.
- The International Finance Corporation (IFC) offers credit guarantees of performance of private borrowers.[39]

The PPP policy acknowledges the use of guarantees as a source of support for PPP financing. Under the National Policy on PPPs,[40] the federal government encourages diversity in the sources of funding and ensures that different classes of investors, both domestic and foreign, are able to participate in project financing. Therefore, the government will use guarantees or other risk insurance provided by multilateral agencies such as the World Bank where these provide value for money.[41] Due to the fact that sovereign guarantees create contingent liabilities for the government, the National Policy on PPPs charges the DMO and the Ministry of Finance with the task of ensuring that any contingent liabilities are manageable within the government's economic and fiscal forecasts. Typically,

[39] See "Nigeria: World Bank Support for Power Sector Reforms: Mobilizing Financing", Presentation by Erik Fernstom, Senior Energy Specialist, available at http://www.nigeriaelectricityprivatisation.com/wp-content/uploads/downloads/2011/02/World_Bank_Partial_Risk_Guarantee_Program_Nigeria.pdf (last accessed 12 October 2015).

[40] "National Policy on Public Private Partnerships and Supplementary Notes 2", available at http://www.icrc.gov.ng/National-PPP-Policy.pdf (last accessed 12 October 2015).

[41] Ibid., p. 21.

the DMO, on its part, will need to be consulted in advance by project teams within any ministry, department or agency, which is considering the involvement of multilateral agencies in providing guarantees or other financial instruments.[42]

## 2.4 Conclusion

While the discussions in this chapter have shown that there are obvious attempts at protecting private sector investments in PPPs in Nigeria, the analysis shows that, initially, there was no conscious and well-thought-out plan or programme by the Nigerian authorities with which to embrace PPPs as a method of provision of public infrastructure and service delivery. The enabling legislations were all separately conceived and therefore confuse and conflict with one another. The subsequent attempts to cobble these laws together into a coherent legal regime through the use of a PPP policy document is fraught with structural, legitimacy and operational difficulties, which therefore explains why the country's PPP programme is not working effectively.

Consequently, it is the suggestion in this chapter that Nigeria should enact new PPP legislation to replace the existing ICRCA and Privatisation Act. This new legislation should try and resolve these conflicts with other laws, and also merge the two major institutions involved in PPPs in Nigeria. The existence of multiple laws and institutions is doing more harm than good. Apart from exacerbating confusion in the system, it is also unduly expensive to run both agencies, as this entails the duplication of staff and resources. The efficacy and the legality of the use of a policy document to bridge the gap in an enabling legislation is very doubtful and untidy, to say the least. Nigeria deserves appropriate PPP legislation that will match its ambitions. Proper legislation must therefore be put in place to ensure that private sector entities, both within and outside Nigeria, have the confidence to invest in the country.

[42] Ibid., p. 12.

# 3

# The PPP Transaction Cycle

## 3.1 Introduction

The stages leading to the completion of PPP projects can be broadly divided into three categories. The first is the preparation stage, which solely involves the public sector party. This stage involves the selection of eligible projects for PPP procurement and the development of appropriate strategies for executing the project. The second stage is the actual transaction stage, which is dominated by the actual project procurement of the private sector partner. This stage involves the active interaction of both the public and private sector partners. Finally, the third and final stage is the post transaction stage, which involves evaluation and monitoring of the project. While these stages are all important to the success of PPPs, this chapter focuses on the procurement stage in the following subsections. This is because it is the most intricate stage, involving the delicate and sometimes complex interplay of activities and relationships between two parties with differing motives but, ultimately, seeking the same outcome, which is the successful closure of the PPP project.



G. Nwangwu, *Public Private Partnerships in Nigeria*,
DOI 10.1057/978-1-137-54242-7_3

## 3.2 Project Identification/Selection

The ICRC Act gives sole responsibility to ministries, departments or other agencies (MDAs) of government to identify and prioritise projects eligible for PPP procurement. This provision resolves the historical conflict between MDAs and other government project development bodies over responsibility for project development. For instance, at the time the privatisation programme was at its peak, the BPE had experienced multiple conflicts with several MDAs over the control of project development. Thus, while the privatised projects or enterprises were based within MDAs, the Privatisation Act also gave the BPE powers to privatise the same projects or enterprises. A good example of this was during the concession of the ports, which is discussed in greater detail in Chap. 7. The disputes were usually reconciled in favour of the BPE through the donation of Powers of Attorney to the BPE by the MDAs, but this did not help the relationship between the different institutions and therefore affected the delivery of the projects. This express provision appears to be directed at finally resolving the controversy in favour of MDAs.

The power of MDAs to be project proponents ostensibly only relates to projects that have already been included in the country's infrastructure master plan and are subject to the approval of the FEC. However, for long periods there was no infrastructure master plan and therefore MDAs were not restricted in the choice of their projects. This was not good for the country, as there was no evidence that proper needs analyses were carried out on the selected projects and therefore the economic and social viability of the projects chosen for PPP were never ascertained beforehand. Now that the Federal Infrastructure Master Plan has been finally approved,[1] it is assumed that this provision will take full effect and that projects will have fully undergone the rigours of a national planning process before being identified and prioritised as PPP projects. Nevertheless, the practice still remains that majority of projects selected for PPPs are usually born of unsolicited proposals originating from the private sector. However, as the PPP space matures, this trend is bound to change towards a more orderly and structured project development process.

[1] The Infrastructure Master Plan was approved by the FEC in 2015.

After the selection of a project by the MDAs, it is usually submitted to the FEC for approval. The law does not state the method to be used in bringing the project forward to the FEC. However, it is safe to assume that the submission should be undertaken by the line minister in charge of the particular MDA that is proposing the project, since all ministers are members of the FEC. It is difficult to understand the reason for this requirement, which seems unnecessary and a waste of time, as the FEC still has to give final approval to the transaction after the completion of the procurement process. It would have been better to involve the National Planning Commission at this stage to ensure that the proposed project conforms with the National Development Plan. The approval of projects by the FEC should only be solicited once within the transaction cycle to receive political approval. The technical approval processes should be left to more technical bodies with the requisite skills to add value to the process.

On approval of the project by the FEC, the ICRC is mandated to include the project in the list of projects to be published in the *Federal Republic of Nigeria Official Gazette* and in at least three national newspapers having a wide circulation. The reason for this requirement for publication is not entirely clear and it seems to be quite unnecessary as there is a further requirement under S. 4 of the ICRC Act for another advertisement inviting potential bidders to participate in the procurement process. In practice, however, there have been very few publications of lists of projects eligible for PPPs and it seems not to be a prerequisite for the commencement of the procurement process.

## 3.3 Prefeasibility Stage

At this stage, the onus is on the MDA project proponent to convince relevant government teams that the project being proposed by the MDA for PPP is viable, both technically and commercially. The MDA must also prove that the proposed project is able to attract financing—that is, that it is bankable. The way the MDA is able to do this is through the submission of an outline business case (OBC). Most importantly, the OBC will evaluate the different procurement options and should prove that a PPP is the best procurement route.

To be able to submit an OBC, the MDA usually appoints an external technical team to carry out the prefeasibility study on the project. The OBC which is submitted for approval will contain a variety of information, such as the policy and business context and objectives of the project; a cost benefit analysis; evaluation of the options for meeting the project objectives; the preferred procurement route; analysis, mitigation and allocation of project risks; and a financial model proving that the project is affordable.

On submission of the OBC, the government's team will determine whether or not the project is viable as a PPP. In assessing the project, the ICRC will evaluate the project to determine whether it creates value for money, is in the public interest, reveals well-defined and verifiable output requirements, and whether it meets the strategic needs of the country. There are three possible decisions that the ICRC may come to: the first is to approve the OBC and grant a Certificate of Compliance; the second is to determine that the project is not viable, in which case the government will discontinue the PPP procurement process and deliver the project through traditional procurement; or, third, require the project proponent to provide additional information in order to enable the institution make a decision.

## 3.4 Procurement Stage

There are no detailed procurement rules for PPPs in Nigeria. This is despite the fact that Nigeria has a Public Procurement Act which regulates the procurement of public works and services. The Procurement Act does not refer to PPP transactions but most of its broad agenda is in line with the objectives of the National PPP Policy. For example, one of the objectives of the Bureau of Public Procurement (BPP) —the institution created under the Procurement Act to superintend the procurement of goods and services—is "ensuring the application of fair, competitive, transparent, value for money standards for the procurement and disposal of public assets and services".[2] However, the BPP's approach to achieving this objective is through the establishment of pricing standards and

[2] S. 4(c) of the Procurement Act, Act No. 14 (2007).

benchmarks. There are concerns that the integration of different elements of a project into a single contract, as is the case with PPPs, makes benchmarking difficult; this process is also likely to slow down the procurement timetable and increase the cost to the bidders as well as to the public authorities.[3] It was due to the unsuitability of the Public Procurement Act that the ICRC tried to use the National Policy on PPPs to expand on the very general and limited provisions dealing with PPP procurement in the ICRC Act.

The analysis of PPP procurement that follows will rely principally on the provisions of the ICRC Act and the National Policy on PPPs. This comes with the caveat that there are ongoing discussions between the ICRC and BPP to reconcile the relevant provisions for procurement of PPP projects, and the issues relating to this matter are far from settled. The reason, however, for basing the analysis on the provisions of the ICRC Act instead of the Procurement Act is that the ICRC Act is the primary legislation for PPPs in Nigeria and should therefore supersede the very general procurement provisions of the Procurement Act. The PPP policy is a policy document by government that was basically used to add flesh to the limited provisions of the ICRC Act and therefore fills any gaps left by this Act. However, it must be pointed out that the policy has its major limitations, not being legislation but mere a policy instrument. Despite these shortcomings and the unsettled nature of the laws in this area, the ICRC Act and the Procurement Act are mostly similar in terms of policy direction and both pieces of legislation provide us with an indication of the direction that the government intends to follow in its PPP procurement.

### 3.4.1 The Underlining Principles for PPP Procurement

The National Policy for PPPs stipulates some fundamental principles which guide the procurement of PPP projects. The principles were adopted by the PPP Policy from the Procurement Procedures Manual issued by the BPP under the Procurement Act. The discussions that follow are based on

[3] Part 1 of the National Policy on Public Private Partnerships and Supplementary Notes, available at http://www.icrc.gov.ng/National-PPP-Policy.pdf (last accessed 12 October 2015).

a combination of the provisions of the ICRCA and the National Policy. Some of the major principles are that:

- the private sector project proponent or contractor is expected to recover its investment. It is assumed that this includes also making a profit from that investment. The private sector party may recover its investment either through the collection of user charges, in which case it is expected to make periodic payments to the government for the concession, or receive availability payments from the public authority by way of amortisation payments.[4] Where the investment recovery option is by way of availability payments, it is expected that the public authority would duly authenticate the project cost to determine the amortisation payments to the private sector.[5] This is not likely to be relevant where the procurement process is competitive, as it is assumed that the competition among bidders would guarantee value for money. However, this provision may be useful in dealing with unsolicited bids. In order to ensure that such amortisation payments are made as and when due, the ICRC Act provides for the establishment of a special account into which both monies due to the government and those payable to the private sector would be paid.[6] This provision is ostensibly to prevent the public authority meddling with monies that are due to the private sector. There has, however, been no known project where this type of account has been operated. It is also not an efficient way of operating a concession. The government should simply fix the concession fees to be paid by the private sector and not attempt to share revenues in the manner contemplated by this provision. The reason for this is that it will invariably lead to disputes and could stifle the motivation of the private sector to be more efficient, since it will share any cost savings arising from its efficiency with the public sector.
- the law guarantees the sanctity of any contract entered into by the parties. Section 11 of the ICRC Act specifically provides that "No agreement reached in respect of this Act shall be arbitrarily

[4] S. 7(3) of the Infrastructure Concession Regulatory Commission (ICRC) Act (2005).

[5] S. 8 of the ICRC Act.

[6] S. 9 of the ICRC Act.

suspended, stopped, cancelled or changed except in accordance with the provisions of this Act".[7] This provision appears to have been adhered to, as there has not been any evidence of any major political interference with PPP transactions that have been completed since the operationalisation of the ICRC Act. However, a breach of contract of the nature of the MMA2 contract may amount to arbitrarily changing a contract.

- PPP procurements in Nigeria are predicated on the positive creation of value for money and this consideration must be taken into account when bids are being evaluated and contracts awarded.[8] However, the National Policy on PPPs does not provide any discernible basis for how to determine whether a particular transaction meets this requirement. The possible use of the public sector comparator (PSC) for the computation was mentioned. However, it was conceded that there is no simple rule that can be used to satisfy a value for money test because of the difficulty in measuring the quality and the cost of the service, as well as the unavailability of relevant data. The policy document, however, suggests that the assessment of value for money, whenever it is made, should consider the whole life cost of the service requirement and not just the initial cost and associated risks, which may have financial impact.[9] The question regarding value for money is considered in greater detail in Chap. 5.
- the National PPP Policy advocates transparency as one of the cardinal principles on which PPP procurements are based. The policy provides that the procuring public authority should set out the basis on which successful bidders will be selected from potential bidders from the very outset of the procurement process. The policy considers that this is important for a private sector that would like to evaluate whether the cost of participating in the bidding process is commensurate with their chances of eventually winning the bid.[10] Similarly, the policy advocates fairness to all potential bidders. It provides that all bidders should have

[7] S. 11 of the ICRC Act.

[8] Part 1 of the National PPP Policy.

[9] Ibid., National PPP Policy, p. 34.

[10] Ibid., National PPP Policy, ch. 2.2, p. 20.

access to the same level of information concerning the bid process and directly assures international investors that a domestic preference clause will not be applied to PPP projects.[11]

- all PPP procurements are encouraged to be efficient. This is aimed at combating unduly extended procurement timelines, reducing significant bid costs and high procurement costs to the procuring authority.[12] This aim has not been met in practice as the procurement process for PPPs in Nigeria still takes an inordinate amount of time. The ICRC produced an 11-step guideline in 2014 aimed at simplifying the PPP procurement process; however, it transpired that the document protracted the process even further. It is essential to shorten and simplify the approval processes for PPPs as the current protracted approval process is a major disincentive to MDAs, and even the private sector, in the pursuance of projects through PPPs.
- the PPP Policy advocates accountability and good governance. The different individuals and teams of the public authority handling the different aspects of the procurement process should be accountable for delivering the project to agreed timetables and also for ensuring that all stakeholders are involved in the decision making regarding the project.

### 3.4.2 The Procurement Procedure

Once a project is approved by the FEC, the public authority is required to publish an invitation to tender open competitive bids for the project in at least three national newspapers with a wide circulation in Nigeria.[13] This notice is required to invite bidders to express their interest in being shortlisted for the project. The Act, however, provides that competitive bidding may be dispensed with where there is only one contractor or project proponent applying or submitting a bid, or where only one contractor or project proponent meets the prerequisites of the project. In such situations, the public authority may go into direct negotiations with

[11] Ibid., National PPP Policy, ch. 2.3, p. 21.

[12] Ibid. National PPP Policy, ch. 2.4, p. 22.

[13] S. 4 (1) of the ICRC Act.

the contractor or project proponent.[14] Public authorities are conferred with the power to supervise the construction phase of the projects for which concession has been granted.[15] However, this power to supervise the project must be used with caution, as it may lead to unanticipated consequences. For instance, in situations where the public authority approves a building plan or makes adjustments to one, it may end up transferring design and even construction risk back to itself. This may not be a good idea, as it distorts the risk allocation process.

The ICRC Act does not expressly make provisions for unsolicited bids; however, PPP policy attempts to fill this lacuna by borrowing from the United Nations Commission on International Trade Law Legislative Guide on Privately Financed Infrastructure Projects. The requirement of PPP policy is that such unsolicited proposals are submitted to the ICRC for joint evaluation by the ICRC and the relevant public authority. Where the proposal relates to a sector with an existing economic regulator, the promoter of the unsolicited bid may proceed and apply for a licence from the regulator. However, where the proposal would confer rights which would create a monopoly, then the project would most likely undergo competitive bidding in which the promoter of the unsolicited bid may participate. Also, the public authority has an option to reimburse the private sector promoter for its intellectual property and, in some instances, the project development costs incurred by the private sector. There is no indication regarding the formula to be used in making such calculation.

## 3.5 Negotiation/Full Business Case

At this stage, the government and the private sector bidders enter into a form of dialogue to determine the most appropriate technical solutions for delivering the project and the optimal risk allocation for the parties. Most often, this will take place during the pre-bid conferences and various question and answer sessions between the government procuring authority and the bidders. It is this negotiation process that provides the

[14] S. 5 of the ICRC Act.

[15] S. 12 of the ICRC Act.

necessary information for preparing the full business case (FBC). The FBC stage itself is actually the stage where the complete feasibility study is submitted.

Typically, the FBC is never materially different from the OBC; however, it is usually an upgrade on the OBC. The FBC will contain a full analysis of the technical and financial aspects of the project. It will also include the draft contract detailing the risk matrix, output specifications including penalties for non-compliance. The FBC will, in the main, be evaluated against the same criteria that were employed in the assessment of the OBC but, in this instance, the benchmark is set higher. On the successful completion of the assessment process, the MDA would be granted a Compliance Certificate by the ICRC.

## 3.6 Commercial/Contract Close

The ICRC Act stipulates that the public authority should ensure that the project proponent possesses the financial capacity, relevant expertise and experience with which to undertake the particular project.[16] This requirement is met if the public authority identifies the most technically and economically comprehensive bid from those received.[17] Note that approval of the FEC is also required before concluding a contract. Public authorities are barred from giving guarantees, letters of comfort or any other undertaking in respect of the projects without the consent of the FEC.[18] This is ostensibly to check the previous tendency of indiscriminately creating contingency liabilities on the fiscal regime of the country from the haphazard use of these guarantees and other financial undertakings. Recently, the PPP Division of the Federal Ministry of Finance, in conjunction with the DMO and the Budget Office of the Federation, has started monitoring projects for possible contingent liabilities.

After the negotiation of the contract is complete, the accounting officer of the public authority is permitted to sign the PPP contract or concession

[16] S. 2(3) of the ICRC Act.

[17] S. 3.4, National PPP Policy.

[18] S. 3 of the ICRC Act.

on behalf of the public authority. Note that the signing of the contract is not automatic after the negotiation of the Agreement and the public authority is allowed to retain the option of reverting to the second-placed bidder should agreement not be reached with the preferred bidder.

The concession should be awarded to the bidder who has satisfied the pre-qualification criteria and submitted the most technically and economically comprehensive bid.[19] This, according to the National Policy on PPPs, means "the bid that offers the best value for money against the criteria set out in advance by the procurement authority".[20] The private sector partners are advised to bid as a consortium, since all the requisite skills for a project will probably not reside in one entity. However, members of the consortium are bound jointly and severally under the contract and the withdrawal of any member of the consortium before or during the implementation of the project may be a ground for review or possible cancellation of the contract.[21] When a private sector partner becomes the preferred bidder, that partner is also advised to finalise all of the subcontracts and financing agreements for review by the public authority before signing the Agreement with the public sector partner. It must also take out appropriate insurance policy on the concession.[22]

## 3.7 Financial Close

The financial close of the project marks the end of the procurement phase of the project, provided that the project may be periodically reviewed to assess whether the project objectives and assumptions are met. There may also be some precedent that has to be met before financial close, such as access to the site, and to permits and consents by relevant authorities. These are all the responsibilities of the public sector partner and are further discussed in the next section. At financial close, the private sector will have concluded and obtained firm commitments on the financing of

[19] S. 4(2) of the ICRC Act.

[20] Part 1, National Policy on PPP, p. 31.

[21] S. 4(3) of the ICRC Act.

[22] S. 7 of the ICRC Act.

the project from its investors and all that remains to be done is to draw down the funds for project execution.

PPPs are normally financed through project finance. Typically, the firms bidding for a project are required to submit detailed financing plans along with their bids. The plans are usually accompanied by evidence of commitments from investors and lenders towards the project. Note that the financing plan and commitments from investors need not be conclusive but should be sufficient to prove that the investors have, indeed, given the financing of the project serious thought and convinced their financiers to consider the project favourably. The majority of investment is obtained as part debt and part equity, with the debt syndicated by a host of lenders. Also, there are no hard and fast rules regarding the gearing of the investments, but most of the recent requests for proposals have demanded at least a 70:30 debt to equity ratio. It is now that the initial plans and commitments that were submitted at the bid stage are finalised and concluded at financial close.

Lenders play an important role in the PPP process and the public authorities must ensure that the lenders are reasonably comfortable with the project. Therefore, the interests of the lenders are usually taken into consideration in the structuring of the project. Lenders will typically appoint their own advisers, paid for by the private sector partners to provide both legal and technical advice to the lenders on the project. These advisers interface with the investor's advisers to conclude the closure of financing for the project. Also, it has been common practice for the government to enter into direct agreements with lenders to give them reassurance regarding their investments. These direct agreements grant the lenders step-in rights in certain cases where the private sector party is in breach and the lenders need to step in to operate the asset and secure their investments.

## 3.8 Permit Process

Prior to the commencement of the construction phase of the project, the investor is required to comply with a number of laws and regulations which demand that certain permits be obtained before commencing the

construction of the project. Note that, in some economic sectors, the requirement to obtain permits occurs much earlier in the process. A good example is in the power sector where, as a condition precedent to the grant of generation licences, investors are required to obtain all necessary permits before approaching the regulator. Some of the major permits are land approvals in situations where the public authority has not provided land for the project; environmental permits, the major one of which is the Environmental and Social Impact Assessment Certificate; and construction permits, which range from building approvals to water rights where dams, bridges or other construction interfacing with inland waterways are involved.

The key question in the majority of transactions in Nigeria is agreement on which party, the private sector or the public sector, should carry this risk. On the one hand, these permits are operational permits, which are required by any investor whether under a PPP or traditional procurement. Therefore, the investor should assume this risk and pass it down to the Engineering Procurement and Construction contractor to handle. However, on the other hand, these are activities within the direct control of government agencies and government should be in a better position to manage the risk. There is therefore no straightforward answer here, but the recommended practice is that the risk should be shared. The private sector should, in the first instance, assume the risk but secure a commitment from the government to assist in facilitating the expeditious processing of the permits.

## 3.9 Project Implementation

At the project implementation phase, the relationship between the parties changes and the public authority's role becomes one of monitoring and enforcing the contract, and authorising payments when due, if the contract is based on an availability payment model. The project implementation stage is also one of the most important aspects of the project cycle, as it is the phase that is most visible to the user public. However, it is assumed that, if the entire planning and procurement process that occurs before this stage has been executed properly, it will make this operational phase of the project cycle a success.

An important and relevant agreement at this stage is the operations and maintenance agreement. This agreement is central to validating the argument that PPPs provide better value for money. The fact that project costs under PPPs also include the operations and maintenance costs of assets gives credence to the whole argument of PPPs enabling whole life costing of projects. The key issue to take into consideration when drafting or reviewing the operations and maintenance agreement is to ensure that there are clear, verifiable and assessable performance standards in the agreement. This will allow for proper evaluation monitoring of the operations and maintenance contractor. To ensure better performance from the contractor, it is recommended that the agreement should provide penalties for non-performance to agreed performance standards and incentives to encourage the contractor to exceed standards. Where necessary, performance guarantees should also be requested from the contractor, especially where the contractor is inexperienced and its default is likely to trigger the crystallisation of contingent liabilities.

## 3.10 Project Monitoring and Evaluation

There are four possible institutions that are likely to be responsible for the monitoring and evaluation of PPP projects post-procurement in Nigeria. These are the ICRC, the BPE, the sector regulator and the responsible MDA. The ICRC and the responsible MDA both rely on S. 10 of the ICRC Act as the basis of their authority to conduct post-transaction monitoring and evaluation. However, the BPE also continues to carry out post-privatisation monitoring of all the transactions completed under its enabling legislation and this can lead to manifest confusion. An example of where this confusion is currently playing out is the hydropower sector. The BPE was responsible for the concession of the country's hydropower assets under the recently concluded privatisation exercise. By virtue of its enabling legislation and the agreement with investors, the BPE continues to pay periodic visits to the plants to monitor the private sector concessionaires.

The ICRC, on its part, relying on S.10 of the ICRC Act, continues to visit the power plants and demand regulatory compliance from the companies. The Ministry of Power, which is the responsible MDA for the project, also exerts authority over the companies. When all these are considered against the backdrop that the National Electricity Regulatory Commission also heavily regulates this sector, then the full effect of the chaos will be better put into context. Not only is a considerable amount of time, energy and funds being wasted on duplicated monitoring exercises, the present regulatory environment is not encouraging to private sector investments.

Furthermore, the Act does not stipulate what powers, if any, the ICRC has over any defaulting concessionaires. It is assumed that the ICRC will then have to refer breaches of the terms of the concession to the MDAs, or even to the BPE, for action, as the ICRC is not a party to the contract. This position is further complicated when it is realised that the ICRC does not have any post-contract monitoring powers over public authorities. Since the concessioned assets remain the property of the public authority granting the concession, the ICRC cannot assume post-contractual regulatory powers over the MDAs statutorily, contractually or even by way of a legal or equitable interest in the asset. Neither does the ICRC Act say which of the parties, between the ICRC and the MDAs, has overriding powers when there is conflict in the monitoring process undertaken by both parties. This provision is also in conflict with other functions of the ICRC. For instance, the PPP policy stipulates that the ICRC may act as arbitrators in disputes between the public authority and the private sector. First, it is doubtful whether the private sector would ever nominate a government establishment as arbitrator in a dispute between the private sector and another government entity. The problem is further compounded by the fact that the ICRC is supposed to work in conjunction with one of the parties to the dispute to investigate the private sector party, thereby becoming a potential accuser or prosecutor. This is unlikely to engender confidence in any arbitration proceedings conducted by the ICRC. This further proves that the monitoring and evaluation powers of the ICRC are completely unnecessary and should be left solely within the purview of the MDAs.

## 3.11 Contract Expiration, Termination and Transfer of Asset

A PPP concession may come to an end either through the effluxion of the term of the contract, the termination of the contract by either party due to a serious breach of contract, or through the persistence of a force majeure event. Where the contract comes to an end due to effluxion of time, there is usually no dispute between the parties and no need for compensation to either party.[23] The only requirement is that the assets should be handed back to the government in the agreed condition. One of the most effective means of ensuring the handover of the asset in good condition at the end of the concession term is to withhold a certain percentage of the fees due to the private sector party in an escrow account until the end of the contract. The private sector partner is only able to claim back the money after an assessment by a third party expert who confirms that the assets are being handed over in the agreed condition.

Where termination occurs as a result of breach of contract by either party, it is usually for a fundamental breach of the contract, even though persistent and continued breaches of minor aspects of the contract might also lead to termination. In this case, the private sector partner is usually entitled to some form of compensation payment. It is good practice for the contract to stipulate the formula for arriving at the compensation amount in advance. As a general rule, the private sector party receives considerably more if the public authority caused the breach than if the breach was caused by the private party. Another way through which the contract comes to an end is the exercise by the government of its right to step in and take over the operation of the project at the occurrence of certain pre-agreed events. This situation may occur as a result of either a breach by the private sector or even as a result of the unilateral breach of the government.

Finally, the contract may also end through the occurrence of a force majeure event from no fault of either of the parties. In this case, the parties are discharged from their obligations to each other and subject

[23] Note that, in some cases, the public authority is mandated to pay a token sum as consideration for the repurchase of the asset.

to the agreement of the parties, the private sector may also be entitled to compensation. At the occurrence of a stipulated force majeure event, contracts usually direct that parties should give requisite notice to each other and suspend operation of the contract for a period, before taking a final decision to terminate if the force majeure event persists beyond the agreed time frame.

Presently, none of the major PPPs in Nigeria has come to an end due to the contract term running out naturally. However, the Lekki toll road concession discussed in detail in Chap. 9 came to an end due to the government exercising its option to step in to take over the operation of the project.

## 3.12 Conclusion

This chapter considered the different transaction cycles of PPPs generally and, in particular, the practical steps for navigating through the different project stages in Nigeria. The chapter reveals some of the shortcomings in the legal and regulatory framework from the point of project selection, through the procurement stage to the post-contract evaluation and monitoring stages. Indeed, these articulated problems further emphasise the need for a new legal framework and improved regulatory environment for PPPs in Nigeria.

# 4

# Contractual Structure for PPP Projects

## 4.1 Introduction

The National Council for Public Private Partnerships (USA) defines PPP as "a contractual agreement between a public agency (federal, state or local) and a private sector entity". This definition, like most other definitions of PPPs, rightfully underscores the contractual nature of PPPs. However, the main contract between the public sector and the private sector, which is referred to as the grant or concession agreement, usually breeds an additional avalanche of contractual arrangements. Some of these further contracts include engineering, procurement and construction (EPC) contracts, shareholders agreements, operations and maintenance contracts, and financing agreements. These are all further elaborated on in the following sections.

## 4.2 Grant/Concession Agreements

The use of the word "grant" in this section is, first, to underline the fact that the nature of the agreement under discussion is one that conveys a right or entitlement to the private sector, and also to underscore the fact that this



G. Nwangwu, *Public Private Partnerships in Nigeria*,
DOI 10.1057/978-1-137-54242-7_4

principal PPP agreement can either be a concession agreement, or even wider than a traditional concession agreement. However, it is not unusual to refer to this "grant agreement" as a "concession agreement". This is also the style adopted by the ICRC Act. The reason for this approach might be due to the fact that concessions are the most popular of all the PPP grants or, put another way, that most grants by the public authority to a private sector operator involve some form of concession. Bearing these clarifications in mind, further discussions under this section will basically employ the term "concession agreement" to refer all forms of grants.

The concession agreement is therefore the principal contractual document delineating the rights and obligations of the parties in a PPP arrangement. Over the years, its use has become not just commercially pragmatic, but also politically expedient. The reason for this is that, unlike privatisation, concessions ensure that the ownership of public assets do not transfer from the government to the private sector.

A concession agreement grants a right (usually exclusive) hitherto belonging to the public sector to a private sector partner to operate and manage an asset for certain duration of time. Usually, and particularly with regard to greenfield projects, this right is coupled with a right to invest in the construction of the asset to provide the specified services. It is this right to invest that is depicted by the letter "B" standing for "build" in the different PPP acronyms such as BOT, BOOT, and so on. The concession agreement also often demands that the private sector grantee makes either upfront fixed payments or periodic term payments to the grantor. The making of this payment is significant not only because it generates revenue for government, but also because it evidences the fact that the ownership of the asset remains with the grantor.

The concession agreement will also allow the private sector to recover its investment and make profits from the exploitation of the grant. The revenue of the private sector may accrue from periodic availability payments from the granting authority or from the direct collection of user fees from the public for services rendered. The concession agreement contains some key terms which are unique to these types of agreements. The most important of these clauses is "the Grant". This is the operative clause in the agreement and conveys the right or interest in the asset from the public authority to the private sector. Another important clause is the "concession term",

which defines the extent of the interests of the private sector in the concession. The "payment terms" clause stipulates the amount and method of payment of the concession fee by the private sector.

The "operations and maintenance" clause grants the private sector concessionaire the authority to operate and maintain the asset conveyed. The concession agreement will also contain an obligation on the private sector concessionaire to transfer the property back to the government at the end of the concession term. Finally, the agreement will give the public authority power periodically to inspect and monitor the concession to ensure that the concessionaire is adhering to its obligations.

## 4.3 Construction Agreements

Once the private sector entity or project company has secured the grant or concession, it commences negotiation of the construction contract with a contractor. The major objective of this contract is to ensure that the contractor delivers a facility in accordance with the specification of the project company. To ensure that the entire construction process is delivered in an efficient manner, on time and within budget, the most common construction contract awarded by the project company is the type that bundles together the engineering, procurement and construction aspects of the project. This is commonly referred to as an EPC contract. The advantage of the EPC contract is that it saves time and money, as it allows the three aspects of the project to move concurrently on a turnkey basis.

The payment structure of the EPC contractor may be restructured in various ways. For instance, it is usually designed as a fixed price contract, which allows the project company to pay a fixed fee to the contractor for its services. This is particularly helpful where the project company is worried about inflation or currency exchange risks and wishes to transfer them to the contractor. For assuming these risks, the contractor would typically charge a risk premium to enable it to manage whatever contingency is likely to arise. However, there are certain instances where the contractor's risk premium will not suffice, especially where the fault for the occurrence of the risk is not that of the contractor. In these cases, the contractor protects itself by negotiating a contingency payment

to manage the uncertainties. These are usually in cases where a force majeure event occurs, or where the delay that leads to the manifestation of the change in price is the fault of the project company. The alternative arrangement is a cost plus fee contract, which ensures that the project company assumes the cost of construction and only pays the contractor a fee for its services. This arrangement effectively transfers all risks capable of increasing construction costs to the project company.

Whatever payment model is chosen, the major aim is to ensure that the contractor is efficient in delivering the project on time and within budget. Therefore, an incentive may be built into the contract rewarding the contractor where it meets targets and a penalty where it exceeds budget. Construction contracts will typically contain a number of key terms; these include the scope of work, the contractor and project company's responsibilities, the payment terms and conditions of subcontracts.

## 4.4 Operations and Maintenance Agreements

After the private sector company completes the construction of the PPP project, it will then have to operate and maintain the facility for the remainder of the concession period. The company is faced with two options: either to operate the facility itself, or to subcontract this aspect to other specialist companies. It will be recalled that the project company is usually a consortium of various companies including financiers. Therefore, self-operation is only possible where one of the consortium members has experience in operating the facility, in which case the responsibility for operation and maintenance is assigned to that entity. Nevertheless, regardless of whether the consortium is self-operating or subcontracting, it usually enters into an operation and maintenance agreement, either with a subcontractor or with the consortium member that is charged with the responsibility.

An operation and maintenance agreement, like other PPP agreements, must take cognisance of the different risks that are likely to arise during the course of the operation and maintenance process and mitigate them accordingly. Some of the risks are the possibility that the operator may not perform in accordance with the contract (due to inexperience or negligence), or that

operating and maintenance costs may exceed budgeted figures. The risk of inexperience is easily handled by making sure that there is a competitive bidding process that selects the best qualified and experienced organisations to undertake an operation and maintenance agreement. Negligence or other instances of non-performance may be mitigated by requiring the appointed operation and maintenance company to post-performance bonds or guarantees, which secures the right of the project company to liquidated damages on the occurrence of the guaranteed event. It is important to ensure that the operation and maintenance contractor has the financial capacity to meet its obligations to the project company.

## 4.5 Off-Take Agreements

Investors need to assure themselves that there is a ready market for the product or services provided by the PPP project. The reason for this is that the cash flow and profit of the business depends on this, and financiers under non-recourse financing relying on the assurances of the off-take in funding the project. There are different ways through which investors ascertain certainty of off-take. One of which is to request a purchase guarantee from the government, alternatively, the project company will enter into forward agreements with potential purchasers of the project offerings. These potential purchasers are referred to as off-takers, guaranteeing the purchase of the products or services. A good example of an off-take agreement is the power purchase agreement found in electricity sales, where the government or another entity buying electricity enters into an agreement with a power utility to purchase power from the utility at a particular price and under certain terms during the term of the agreement. This agreement guarantees cash flow to potential investors.

## 4.6 Financing Agreements

Like in a majority of projects, whether PPPs or traditionally procured projects, obtaining finance to execute the project is one of the important steps towards the development of the project. In broad terms, the financing raised can come as either debt or equity; other forms of finance are

merely different shades of either of them. Equity investors, for increased rewards, take greater risk in the business than credit providers and therefore, even though their investments and returns are hardly guaranteed, their rewards are expected to be higher. On the other hand, providers of credit to the project would typically require security for their investments and any credit assessment of the project is based on the value of the asset provided as security by project promoters. Creditors would therefore have recourse to the security provided by the borrower in cases where the borrower is unable to pay back the debt. This traditional distinction between equity and debt providers becomes a little more blurred under project finance. This is because provision of credit in such cases is typically undertaken through non-recourse or limited recourse financing.

Non-recourse financing, as the name implies, is a project financing structure where lenders look towards the proceeds of the project or/and the assets of the project as security for their loans to the project company. The implication of this is that borrowers under PPP projects will have to prove to financiers that the project will be able to repay the loan and interest when they become due. This, as one can imagine, is not a particularly easy task, as lenders rely principally on the technical and financial project documents for this assurance. Some of these documents are the feasibility studies, the environmental and social impact assessment reports, the financial models and a host of other supporting agreements. These agreements include shareholder agreements, concession agreements, guarantee agreements, operation and maintenance agreements, off-take agreements, and so on.

Typically, these agreements are presented to financiers to determine, from looking at these documents in their entirety and collectively, whether they would be willing to invest in the project. If the answer is in the affirmative, the financing documents will be negotiated with the project sponsors. Having discussed a number of these agreements, this section will focus on the principal financing documents. These are:

- *Loan Agreements*: This is the primary financing document. It details and regulates the relationship between the sponsor borrower and the lenders.
- *Intercreditor Agreements*: Since PPPs are usually financed via syndicated loan arrangements with multiple debt providers, the intercreditor

agreement is usually entered into between the different debt providers to document their various interests, rights and obligations with regard to each another. One of the important issues which an intercreditor agreement deals with is the priority of lenders in repayment and their various lien positions in relation to each other.

- *Direct Agreements*: This Agreement is entered into between the lenders and the government. It grants financiers step-in rights in the event that the private sector becomes unlikely to fulfil its obligation to repay the loans. These rights would allow the banks or other financial institutions to take over the asset and recover their investments in the event of default from their private sector borrowers. This was widely used during the power sector privatisation in Nigeria.
- *Credit Enhancement Agreements*: In theory, PPPs are completed through non-recourse project finance. However, in practice, lenders will require some form of additional support to make a project bankable. Credit enhancing agreements mitigate credit default risks and enhance the credit worthiness of the project. In Nigeria, most investors have requested some form of sovereign guarantee to enhance the credit worthiness of the project.
- *Export Credit Agreements*: Sometimes, project sponsors might seek financing from export credit agencies (ECAs) and therefore enter into export credit agreements. The nature of the financial support from these agencies to the project includes direct lending, which is usually conditional on the purchase of equipment from the country of origin of the ECA. The other is the financial intermediary loan, where the ECA grants loans to a domestic commercial bank for on-lending to the project sponsor. Also, interest rate equalisation allows a commercial bank to receive the difference between the market rate and its lending rate to the project sponsor from the ECA.

## 4.7 Risk Management Through Contracts

The PPP contract is the principal document that regulates the partnership and ensures risk allocation between the public and private sectors over the term of their relationship. It also provides the foundation on which

other project documents rest; for example, the financing agreement. The other contractual documents that are relevant to risk allocation are the shareholders agreement between project sponsors, the credit agreement with the project lenders, an EPC contract, an operations and maintenance contract, and supply contracts, which have all been discussed. The specific level of risk allocation between the private and public sector partners varies according to the method of PPP used for a project because the scope of activities delegated to the private sector varies from mode to mode.

Contractual clauses themselves are the basic instruments for the transfer of risk in PPPs, and risk allocation in PPP contracts significantly affects project outcomes. For instance, project-related risks—such as construction risks, cost overrun risks and demand risks—are all allocated through the contract design. For each type of contractual mode (whether BOT, DBFO, concession, and so on.), risk is allocated to the private sector through contractual incentives and penalties incorporated within the payment mechanism and through activities for which the private sector party is responsible.

The contract may basically allocate risks through the use of indemnities, conditions, warranties and force majeure clauses. However, contract design is generally not a straightforward task; it is even more complicated if it also assigns risk, like in PPP contracts. Problems arise when the contract transfers the wrong amount or the wrong types of risk to the private sector party. It is therefore widely acknowledged that the imperfect allocation of risk in contracts constitutes one of the primary reasons for the failure of PPP arrangements.[1] Failure to allocate risks properly in PPP contracts may lead to other undesirable consequences, such as contract renegotiation.

Contract renegotiation may invariably lead to bargaining between the private sector operator and the government in a non-competitive and non-transparent environment. Renegotiation may, in that instance, become a part of the strategy for the private sector to ask for other concessions from the government by raising other unrelated issues at the risk of damaging the public interest in the project. Marques and Berg contend

[1] Timothy Murphy (2008) "The Case for Public-Private Partnerships in Infrastructure", *Canadian Public Administration*, 51(1): 99–126.; M.R. Berg "Revisiting the Strengths and Limitations of Regulatory Contracts in Infrastructure Industries", PURC Working Paper No. 14, University of Florida, Glanville, cited in R. Marques and S. Berg (2011) "Risk, Contracts and Private Sector Participation in Infrastructure", *Journal of Construction Engineering and Management*, 137(11): 925–932.

that this promotes opportunistic behaviour, including opportunistic bidding at the tender stage, so that the winner's curse becomes a winner's blessing.[2] Where risk is inappropriately or excessively transferred to the private sector, it may reduce the number of bidders and foster opportunism in the remaining tenderers.[3]

The issue of risk allocation is therefore essential in PPP contracts for three main reasons: it improves risk allocation and reduces economic costs; it provides incentives for the sound management of the PPP; and it reduces the need to enter into a renegotiation process.[4]

The PPP contract should be drawn up in such a way that it takes into consideration all eventualities that may affect the risk profile of the parties. Contracts that fail to address risk in a comprehensive manner are likely to raise the cost of infrastructure services to the final consumers.[5] On a policy level, it can be useful to provide for risk allocation and mitigation guidelines in policy and legislative instruments. This will guide the parties through the contract negotiation process in the allocation, mitigation and pricing process before their reduction into contractual clauses such as, for instance, conditions, warranties or other contractual terms. There is also sometimes a need for standardisation of PPP contracts by creating templates, as this may contribute towards greater transparency and reduces the incidence of corruption. However, such standardisation may lead to a greater deal of rigidity in the PPP process.

When allocating risks in contractual documents, the following goals should be pursued:

- the provision of incentives to reduce long-term costs of a project;
- the provision of incentives to complete the project on time and within budget;
- the provision of incentives to improve the quality of service and revenue yield;

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[2] Ibid.

[3] Jeff Zitron (2006) "Public-Private Partnership Projects: Towards a Model of Contractor Bidding Decision-Making", *Journal of Purchasing and Supply Management*, 12(2): 53–62.

[4] Darinka Asenova (2010) *Risk Management in Private Finance Initiative Projects: The Role of Financial Services Providers*, Saarbrucken: Lambert Academic Publishing.p. 45.

[5] R. Marques and S. Berg (2011).

- the insurance of the public and private partners against risk.[6] Risk insurance for the public partner helps to improve its profile of expenditure on the project by converting variable operation and capital costs into predictable unitary payments. Risk insurance for the private partner helps reduce the cost of capital.

These goals can be achieved by contractual provision for the service output specifications of the private sector. This will fully ensure that risk for the quality of the service is transferred to the private sector by ensuring that the private sectors revenue has a correlation with the quality of its service. It also enables the public sector effectively to monitor the output of the private sector.

Various types of risk should be given consideration in the formulating of a PPP contract:

- Insurance risk
- Design, construction and technical specification risk
- Planning and approvals risk
- Legislative change risk
- Operational performance risk
- Financial/economic risk
- Exchange rate risks
- Default risk
- Demand risk
- Political or legal risks.

### 4.7.1 Insurance Risk

Insurance is a viable tool for mitigating risks. However, on occasion insurance for certain risks may become unavailable or not be available on unfavourable terms. To address this issue, PPP contracts may include insurance benchmarking with an adjustment to PPP payments, if market insurance premiums vary beyond a threshold. This will, of course, make

[6] World Bank (2007) "Contract Design in Public Private Partnerships", A report prepared for the World Bank by Elisabeth Iossa, Giancarlo Spagnolo and Mercedes Velez, (online), available at: http://www.gianca.org/PapersHomepage/Contract%20Design.pdf (last accessed 25 March 2012).

the project more expensive and government payments unpredictable. In some instances, uninsurability—which typically constitutes an event of default under the project loan—is a termination event, unless the public sector agrees to act as insurer of last resort.

### 4.7.2 Design, Construction and Technical Specification Risk

When the design, construction and technical specification risk eventuates, it may lead to the project not being concluded, or not being concluded on time. PPP contracts should be designed to be output based, such that the private sector assumes the design and construction risk. Payments also have to begin on the satisfactory completion of construction; that is, no service, no fee. This was one of the major problems with the Lekki toll road concession in Lagos, where the concessionaire started collecting tolls on the road after completing only less than 10 % of the road project.

The project SPV usually takes the construction and design risk and passes it down to construction subcontractors with appropriate warranties to the public sector. It is not advisable for the public sector to approve or sign off on design, as this will unwittingly transfer the risk back to it. This seems to be one of the shortcomings of the MMA2 airport concession, where the public authority approved all the private sector party's designs. The contract may also employ liquidated damages provisions to ensure that the private sector compensates the public sector for this risk. However, care should be taken to ensure that it does not become a penalty provision by ensuring that compensation is only payable on the public partner suffering economic loss from late delivery.[7]

### 4.7.3 Planning and Approvals Risk

Even though planning risks should be allocated to the private sector, the public sector may commit itself by way of warranty in the terms of the contract to provide assistance.

[7] If it becomes a penalty provision, the courts will not enforce it. See *Dunlop Pneumatic Tyre Co Ltd. v New Garage and Motor Co*. Ltd. [1975] A.C. 79.

### 4.7.4 Legislative Change Risk

This is best treated as a shared risk, whereby the general legislative change risk is shared and any change in legislation specific to the project is retained by the public sector. In a separate work, Yongijian et al. recommended that legislative change risks should be handled as follows:

- If a significant change in law prevents the private sector party from fulfilling its obligations, then the private sector party should be entitled to receive corresponding payments irrespective of its inability to supply contracted services.
- The private sector can be restored to the same economic position, if the change in law results in additional cost to the private sector company over and above an agreed threshold.
- The change in law provision should apply to any change in law after the bid submission date and should include any changes in tax regulations and the like.[8]

### 4.7.5 Operational Performance Risk

This risk is better allocated to the private sector through the use of contractual incentives and penalties incorporated within the payment mechanisms and performance/quality requirements to enforce standards during the operating phase. The contract should therefore clearly specify the consequence of not meeting these requirements.[9]

### 4.7.6 Financial/Economic Risk

The payment mechanism is also used to allocate economic risk between the public and private sectors. Proper allocation ensures that the users of the facilities only pay for services or outputs delivered. The public sector

[8] Yongjian Ke (2010) 'Preferred Risk Allocation in China's Public Private Partnership (PPP) Projects', *International Journal of Project Management*, 28:482–492.

[9] World Bank (2007).

should have the right to withhold payments, if the services are substandard and not remediated on time.

### 4.7.7 Exchange Rate Risks

To the extent that equity and debt funding for the project is denominated in local currencies, the public sector need not bear exchange rate risk. However, if funding for the project is denominated in foreign currencies, the government is likely to bear the exchange rate risk in order to maximise the cost efficiency of the project. One of the ways of handling this in the contract is by ensuring that the project payments are adjusted for exchange rate variations. The alternative would be to make provision in the contract for compensation to the private sector where an event within the control of the public sector eventuates. This is necessary in order to restore the economic equilibrium of the contract. Note also that delay in making payments usually exacerbates the exchange rate risk; parties should therefore ensure that the time difference between the submission of invoices and the making of payments is greatly reduced.

### 4.7.8 Default Risk

This occurs when the SPV is not able to deliver, either during construction or operation phase of the project. This can be dealt with and mitigated in the contract by providing step-in rights for the public sector to replace the private sector partner. Step-in rights may also be granted to the financiers, as default by the private sector may also affect the ability of the concessionaire to make its loan repayments.

### 4.7.9 Demand Risk

This occurs when the end user demand for project output is lower than the base case original forecast. In many sectors, it is difficult for the private sector to make a reliable prediction of end user demand. In such cases,

the PPP payment mechanism may be designed to eliminate demand risks. The contract design may also be used to mitigate demand risk. This may be dealt with directly by guaranteeing a minimum purchase of the project output, or indirectly through adjusting the tariff in accordance with demand, or a combination of both. For example, the price would increase in accordance with the reduction of demand beyond agreed thresholds. The government may also insist that price be reduced if the market volume increases.[10]

The contract may also provide for fixed term plus a given extension period, if the level of demand is below an agreed break-even point specified in the contract. Another option is to grant an upfront subsidy or a demand guarantee limited to a strictly enforceable period (e.g. three years, to vary according to the project's attractiveness). In toll road projects, the introduction of a dynamic tolling regime is another option. In this case, toll pricing varies according to travel peaks, or the time of day or days of the week.[11]

It is also good practice, where a non-compete clause is employed, to link the clause with congestion limits and expansion obligations. These will also help strike a good balance with the long-term sustainability of the infrastructure sector. These issues are considered in greater detail in Chap. 8 of this book, which deals exclusively with demand risk.

### 4.7.10 Political or Legal Risks

This includes risks of expropriation, non-convertibility or non-repatriation. This may be dealt with through political risk insurance to cover, for example, sovereign default and expropriation. The contract may deal with this risk by specifying, for instance, that expropriation is an event of default and that war and strife may be termed a force majeure event.

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[10] Sudong Ye and Robert Tiong (2003) "Effects of Tariff Design in Risk Management of Privately Financed Infrastructure Projects", *Journal of Construction Engineering Management*, 129(6): 610–618.

[11] Ibid.

## 4.8 Analysis of Some Case Studies

This section looks at some of the literature on case studies that have been carried out on the efficacy of contractual allocation of risks in some PPP projects.

### 4.8.1 Labin B. Power Project, China

Wang and Yongijian Ke carried out a case study of the Labin B. Power Project in China and came to the conclusion that one of the principal reasons for the success of the project was the way risks were handled in the contractual document.[12] This study provides a good indication of how some PPP risks may be allocated in contractual documents. According to them, the risks were handled as described in the following subsections.

#### 4.8.1.1 Legislative Change

The contract stipulated that, should there be any change in Chinese laws, regulations, decrees or any material conditions associated with any of the approvals applicable to the project which substantially adversely affect the rights and obligations of the consortium, the consortium could request the adjustment of the terms of the contract so as to place the consortium in substantially the same economic position it held prior to such changes. The government therefore assumed this risk.

#### 4.8.1.2 Exchange Rate

The government, under the contract, assumed the foreign exchange risk by allowing the project company to adjust the floating portion of the

[12] ShouQing Wang and Yongjian Ke (2009) "Case Study of Labin B. Power Project- The First State Approved Power Project in China in Public-Private Partnership in Infrastructure Development", *Case Studies from Asia and Europe*, Bauhaus Universitat Weimar, (online), available at http://e-pub.uni-weimar.de/volltexte/2009/ (last accessed 28 March 2012).

tariff (indexed in US dollars but payable in Chinese RMB) to reflect any changes in the RMB/US Dollar exchange rate.

#### 4.8.1.3 Political Risk

The contract provided for compensation for the private sector where the government defaulted with regard to the political risk that it assumed. For instance, where construction work was delayed or the cost of construction or financing was increased due to the fault of the government, the government could either extend the concession period accordingly, or adjust the tariff in order to compensate the private sector.

#### 4.8.1.4 Force Majeure

In the event of a force majeure event, either party was allowed to terminate the agreement; the project company's obligations under the agreement would cease, and the government would pay the private sector consortium compensation. On the payment of the compensation, the consortium was obliged to transfer the asset to the government. Lenders would be repaid and sponsors would receive compensation corresponding to their equity investment. However, if termination resulted from a company act of default, the private sector was not entitled to any compensation.

It was also important to stipulate clearly in the contract the events that would amount to force majeure. It is also good practice to specify clear thresholds for renegotiation (e.g. toll levels) in the event, for example, that the profitability of the project is affected.[13]

#### 4.8.1.5 Legal and Institutional Risk

This risk can occur due to changes in the general legal framework (taxes, environmental standards). A contract can specify clearly the trigger

[13] Ibid.

clauses for renegotiation (e.g. toll levels) in cases where the profitability of the project is affected. It is also good to strengthen the institutional framework in advance.

## 4.9 Conclusion

This chapter went through the different types of agreement that are used for PPP projects and emphasised the importance of the PPP contracts for risk allocation in PPPs. Case studies were reviewed to show the most practical and effective means of mitigating the different types of risk that practitioners may typically encounter in PPP projects.

# 5

# The Value for Money Question

## 5.1 Introduction: Value for Money Considerations

In deciding whether to finance a project through PPPs rather than through traditional public sector procurement, the major consideration for the public sector authority is usually whether the PPP alternative presents better value for money. The concepts of VFM and project best practices are related as, for example, proper risk allocation in a project contributes to the attainment of VFM. This correlation has been proven in so many studies. For instance, Cheung et al. carried out a comparative study of Hong Kong, Australia and the UK, and discovered that proper risk allocation was the greatest VFM enabler in all three jurisdictions.[1] They discovered that when risks are handled well, fewer pitfalls are experienced and this leads to the achievement of VFM. In similar vein, Bing Li et al., while conducting research on the factors that

[1] Esther Cheung, Albert Chan and Stephen Kajewski (2009) "Enhancing Value for Money in Public Private Partnership Projects: Findings from a Survey conducted in Hong Kong and Australia compared to Findings from Previous Research in the UK", *Journal of Financial Management of Property and Construction*, 14(1): 7–20.



G. Nwangwu, *Public Private Partnerships in Nigeria*,
DOI 10.1057/978-1-137-54242-7_5

enhanced VFM in PPP projects, found that the top three factors are efficient risk allocation, output-based specification and the long-term nature of contracts.[2] This conclusion was similar to the result reached by Arthur Andersen in another study.[3]

Like most concepts in PPPs, VFM is not an easy term to define because of its political underpinnings. Its definition depends on the motives and interests of a particular government. It may therefore change over time as the political, economic and social environment evolves.[4] The term "VFM" may either be used as an absolute or relative term. As an absolute term, it can be taken to mean that the benefits of purchase to the purchaser exceed the costs. While as a relative term, it means that one of the options for meeting the purchaser's needs provides greater benefits relative to cost than any other.[5] The mostly widely used definition of VFM is that of the UK HM Treasury Value for Money Guide. According to the guide, VFM is "the optimum combination of whole-of-life costs and quality (or fitness for purpose) of the goods or service to meet the users requirements. VFM is not the choice of goods and services based on the lowest cost of the bid".[6]

In essence, the UK HM Treasury's definition underlines the key considerations for VFM, which are both quantitative and qualitative in nature. The quantitative consideration is that, in determining the value of pursuing a project as a PPP, the public sector must consider the cost savings to be made from the project over the lifetime of the project and not just in

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[2] Bing Li, Akintola Akintoye and Cliff Hardcastle, "VFM and Risk Allocation Models in Construction PPP Projects", Preliminary result of ongoing PhD research, School of Built and Natural Environment, Glasgow: Caledonia University. Available at: http://www.reading.ac.uk/AcaDepts/kc/ARCOM/eorkshop/04-Edinburgh/06-Li.pdf

[3] Arthur Andersen (2000) "Value for Money Drivers in Private Finance Initiative", Arthur Andersen and Enterprise LSE.

[4] Kharizam Ismail, Roshana Takim and Abdul Hadi Nawawi (2011) "The Evaluation Criteria for Value for Money (VFM) of Public Private Partnership (PPP) Bids", *International Conference on Intelligent Building and Management Proc of CSIT*, 15(5): 349–355; Akintola Akintoye (2003) "Achieving Best Value in Private Finance Initiative Project Procurement", *Construction Management and Economics*, 21: 461–470.

[5] Nigerian National Policy on Public Private Partnership (PPP) (2009) Infrastructure Concession Regulatory Commission, Nigeria.

[6] HM Treasury (2006) "Value for Money Assessment Guide", London: HM Treasury; Roshana Takim, Kharizam Ismail and Abdul Hadi Nawawi (2011) "A Value for Money Assessment Method for Public Private Partnership. A Lesson from Malaysian Approach", *International Conference on Economics and Finance Research IPEDR*, vol. 4.

the immediate future. The qualitative component of the concept is that it points out that VFM assessment should ensure that public agencies focus also on the quality of the output including the competency of the private sector and not only on securing the lowest cost bids.

According to Grimsey and Lewis, a number of conditions should be met in order to achieve VFM in projects. First, projects should be awarded in a competitive environment. Second, economic appraisal techniques, including proper appreciation of risk, should be vigorously applied, and risk allocated between the public and private sectors so that the expected value of money is maximised. Finally, the comparisons between publicly and privately financed options should be fair, realistic and comprehensive.[7] In summary, these conditions all point to the fact that good project governance and practices should be diligently applied.

## 5.2 Comparing VFM in PPPs and Traditional Procurement

VFM is not a concept that is unique to PPPs; it is also widely applied in traditional public procurements. The difference is that under traditional public procurement, decisions on options to follow in procuring a particular project is based on a cost-benefit analysis that does not consider alternative ways of procuring the project but assumes a particular commercial approach, which is simply the procurement by the public sector. Once that procurement approach is decided, the public sector sets in motion competition between bidders where price and non-price factors are assessed to ensure that VFM is achieved. However, in PPPs, the test for VFM is two-pronged: first, there is competition between bidders to select the most competitive bid, as under traditional procurement. Second, the choice of that particular arrangement is also tested to ensure that it is capable of delivering VFM to the government.[8]

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[7] Darrin Grimsey and Mervyn Lewis (2005) "Are Public Private Partnerships Value For Money: Evaluating Alternative Approaches and Comparing Academic and Practitioner Views", *Accounting Forum*, 29: 345–378.

[8] Darrin Grimsey and Mervyn Lewis (2007) *Public Private Partnerships*: *The Worldwide Revolution in Infrastructure Provision and Project Finance*, Cheltenham, UK: Edward Elgar Publishing, p. 136.

VFM is usually associated with three "Es": economy, efficiency and effectiveness.[9] Therefore, in seeking VFM, three initial strategies should be deployed: an effective evaluation mechanism, the viability of the PPP contractor, and commitment to VFM.[10]

## 5.3 The Public Sector Comparator

VFM is a broad term that captures both financial (quantitative) and non-financial (qualitative) elements of evaluations. To ensure that the analysis of the two alternatives available to the government is comparable, there will be a need for proper accounting for quality of services, price, time frame, risk apportionment and certainty.[11] VFM is often computed in most jurisdictions by using a benchmark called the PSC. The PSC simply describes the options and assesses what it would cost the public sector to provide the outputs it is requiring from the private sector on its own. Thus, the private sector bids are assessed against the PSC to determine which option between the two will guarantee better VFM.[12]

In most countries, the method of calculating VFM using the PSC involves the comparison of the net present value (NPV) of the risk-adjusted PSC with the NPV of the proposed future service fees or benefits paid to the private sector bidder over the life of the PPP. It is based on estimates of full costs, revenues and risks, set out in cash flow terms, discounted at a public sector rate to the NPV, which is compared with the discounted value of payments under the PSC along with the adjustment for risks and costs retained.[13] Once the NPVs of both the PSC and the PPP project have been computed and adjusted to an equivalent basis, then a simple comparison of both will be undertaken. Note that there

[9] Linda English and James Guthrie (2003) "Driving Privately Financed Projects in Australia: What Makes Them Tick?", *Accounting, Auditing and Accountability Journal*, 16(3): 493–511; Darrin Grimsey and Mervyn Lewis (2005).

[10] Roshana Takim, Kharizam Ismail, Abdul Hadi Nawawi and Aini Jaafar (2009) "The Malaysian Private Finance Initiative and Value For Money", *Asian Social Science*, 5(3): 103.

[11] Partnership South Australia Guidelines, available at http://www.treasury.sa.gov.au/public/download.jsp?id=513 (online), (Last accessed 22 January 2012).

[12] Darrin Grimsey and Mervyn Lewis (2005).

[13] Darrin Grimsey and Mervyn Lewis (2005).

are different approaches to this in certain jurisdictions. However, most of them are mere variants of the methodology discussed. This is explored in greater detail in this chapter.

As pointed out, VFM methodology typically involves two primary assessments: quantitative and qualitative. While the quantitative component includes all project factors that can be valued in monetary or financial terms, the qualitative assessment of VFM takes into account aspects of the project that are not quantifiable in monetary terms. The quantitative assessment usually involves the comparison of the PPP bid with the PSC. The qualitative assessment, on the other hand, evaluates factors such as the characteristics of the market and the competitiveness of the bidding environment. It also assesses the resources and capabilities of the private and public sectors, and other benefits and costs not included in the quantitative assessment.[14]

### 5.3.1 Quantitative Assessment

According to Morallos et al., there are four components in a PSC:

- *The raw PSC*: This accounts for the base cost (capital and operation). Note that it does not incorporate the cost of risks involved in the project.
- *Competitive neutrality value*: This removes the inherent competitive advantages and disadvantages that are available to the public sector agency but which are not available to the private sector. This allows both projects to be compared on an equal footing. Examples of public sector advantages include exemptions from taxes. Disadvantages could be accountability costs and reporting requirements.
- *Transferable risks*: These are risks that are likely to be transferred from the public sector to the private sector. The value of transferable risk in the PSC measures the cost government could expect to pay for that risk over the term of the project if it were undertaken through public procurement.

[14] Dorothy Morallos, Adjo Amekudzi, Catherine Ross and Michael Meyer (2009) "Value for Money Analysis in U.S. Transportation Public-Private Partnerships", *Journal of Transportation Research Board*, 2115, Research Board of National Academics, Washington, DC: 27–36.

- *Retained risks*: These are those risks or responsibilities retained by the procuring public sector agency. The retained risks are the same for the PSC and under the PPP project.[15]

Once all risks have been categorised as either transferable or retained, the size and timing of the expected cash flows associated with each risk are aggregated to determine the NPV.[16] Once the total NPV the cost of each of the four components has been calculated, the values are then summed up to determine the final risk-adjusted PSC cost. For the PPP cost calculation of the VFM analysis, the procuring agency determines the projected cash flows of the project on the basis of the retained risks and service payments (if any) it would pay the private sector for the provision of the service. The projected PPP costs are then brought to NPV terms. The total PSC cost is then compared with the NPV of that of the PPP with the difference being the VFM.[17]

It will have been noted from this analysis above that the PSC uses discounted cash flow (DCF) analysis to provide a projection of the NPV of the expected cash flow. Critical to the integrity of the DCF analysis, therefore, is the discount rate mechanism employed. The discount rate that a public agency applies should reflect the government's time value of money plus a systematic risk premium for the interest rate involved in the project.[18] There are several approaches that are used across countries in determining the discount rate to be employed in the project:

- A single discount rate could be used for both the PSC and the PPP project without adjusting for the risks a public sector would acquire in the PSC. This is the method favoured in South Africa[19] and Ireland.[20]
- The values of project risks can be calculated and the costs of such risks then incorporated into the projected cash flows of each procurement

[15] Dorothy Morallos, Adjo Amekudzi, Catherine Ross and Michael Meyer (2009).

[16] Ibid.

[17] Ibid.

[18] Ibid.

[19] National Treasury PPP Unit (2004) "Public Private Partnership Manual", Pretoria, Republic of South Africa.

[20] Central PPP Unit, Ireland (2007) "Value for Money and the Public Private Partnership Procurement Process", Dublin, Ireland: National Development Finance Agency.

option. A risk-free discount rate could then be applied to these risk-free adjusted cash flows. This is the option that is used in the UK.[21]
- A risk mark-up or a risk-adjusted discount rate can be added to a risk-free discount rate to account for "risky" cash flow, while the risk-free rate can be used for "non-risky" cash flows. Partnership Victoria of Australia supports the use of the last option.[22]

The use of the PSC has inherent challenges, mainly as a result of the difficulties involved in obtaining historical data to make the comparison. This is because the baseline cost of the PSC is usually based on the historical cost for services and adjusted based on project future demand, demographical changes and political considerations. This is one of the reasons why the Nigerian PPP Policy accepts that the government cannot rely on the PSC in calculating VFM at this early stage of its PPP development. However, the Policy also concedes that it may do so over time when the country collates enough evidence of outturn costs to be able to rely on PSC effectively.

It is noted that it is not wise to jettison the PSC completely merely because of paucity of data. There are certain elements of the PSC that may, nevertheless, be useful to a country like Nigeria. According to Grimsey and Lewis, the PSC performs other indirect functions in a PPP apart from calculating VFM. According to them:

- It promotes full costing at an early stage in project development;
- It provides a key management tool during the procurement process by focusing attention on the output specification, risk allocation and comprehensive costing;
- It provides a means of testing value for money;
- It provides a consistent benchmark and evaluation tool;
- It encourages competition by generating confidence in the market that financial rigour and probity principles are applied.[23]

For projects that have been commenced through unsolicited proposals in Nigeria, the application of the principles enshrined in

[21] Darrin Grimsey and Mervyn Lewis (2007).

[22] Partnership Victoria (2003) "Use of Discount Rates in the Partnership Victoria Process", Technical note, Melbourne Department of Treasury and Finance, Australia.

[23] Darrin Grimsey and Mervyn Lewis (2007).

the PSC will lead to better "market testing" of projects. This is because the PSC ensures a level of competition in the process by subjecting the unsolicited bids to some form of empirical benchmarking.

### 5.3.2 Qualitative Assessment

This assessment typically covers the feasibility and desirability of a project based, inter alia, on the quality of a contract, the skills and resources of both the public and private sector, and the market interest for the project. It may also include additional costs and benefits that could not be quantified in the quantitative assessment, such as additional innovations and improvements a private sector SPV may provide to the public sector.[24] Therefore, all material factors that have not been included in the PSC should be used to evaluate the private sector bid.[25] Some of the examples given by Partnership Victoria include the reputation and competence of the private bidder, wider benefits or costs that a PPP should bring, and the accuracy and comprehensiveness of the information used.[26] According to Partnership Victoria, the consideration of the qualitative factors can make or break the attractiveness of the PPP procurement route, especially when the lowest private bid is very close to the PSC.[27]

In 2006, the UK HM Treasury published a VFM Guideline that replaced the requirement for a PSC with the OBC.[28] The OBC requirement is much wider than that of the PSC and requires, amongst other things, that potential PPP projects are assessed for whether they have potential of reaching successful procurement, and also whether there are any potential identifiable project management obstacles.[29] This guideline introduced three stages in the assessment of VFM for potential projects. The first stage is the Programme Level Assessment, which evaluates whether the use of PPP is appropriate for the potential project and whether VFM can be achieved. The second stage is

[24] Ibid.

[25] Partnership Victoria (2003).

[26] Ibid.

[27] Ibid.

[28] HM Treasury (2006) "Value for Money Assessment Guidance", London: HM Treasury.

[29] Tahir Nisaar (2011) "The Design and Implementation of Public Private Partnerships in the UK's Social Sector", Paper presented at *Improving the Quality of Public Services: A Multinational Conference on Public Management*, Moscow, Russia.

the Project Level Assessment, which requires an OBC; this is similar to the PSC. The final stage is the Procurement Level Assessment, which requires an ongoing assessment of the procurement process.[30]

The National Policy on PPP in Nigeria also considers the VFM proposition as the most appropriate way of maximising the overall benefit of a project.[31] The Policy concedes that there is no simple rule that can be used to satisfy a VFM test because of the difficulty in measuring the quality and cost of the service, as well as the unavailability of relevant data. It states, however, that the assessment of VFM should consider the whole life cost of the service requirement, not just the initial cost and associated risks, which may have financial impact.[32]

A pertinent question is whether developing countries like Nigeria with little or no money to pursue infrastructure projects have any real alternatives to PPPs, even when VFM analysis shows that it is more cost effective to undertake a project through public procurement. There seems to be only one option available to these countries, which is PPPs where they can find a private sector investor. The whole comparative testing scheme in these countries involves the governments merely going through the motions before deciding on the premeditated option to procure the projects through PPP.[33] However, it is not advocated that the PSC should be jettisoned. It is conceded that some of the other benefits that are accruable through the use of the PSC may warrant its continued use with appropriate adjustments to take into consideration the peculiar situations and needs of these countries.

There are, however, other arguments against the use of the PSC; these have been aptly summarised by Grimsey and Lewis after reviewing some

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[30] Esther Cheung, Albert Chan and Stephen Kajewski (2009) "Enhancing Value for Money in Public Private Partnership Projects: Findings from a Survey conducted in Hong Kong and Australia compared to Findings from Previous Research in the UK", *Journal of Financial Management of Property and Construction*, 14(1): 7–20.

[31] National Policy on Public-Private Partnership (PPP), a document of the Infrastructure Concession Regulatory Commission.

[32] Ibid.

[33] It is, however, claimed that VFM also helps the public sector understand how the project risks can be allocated between the public and private sectors, and also that the VFM tool helps give the government confidence about the use of PPPs and that scarce resources would be well spent. See, for example, Laurent J. Flores (2010) "The Value of the 'Value for Money' Approach When There's No Money", in *IFC Advisory Services in Public-Private Partnerships: Smart Lessons from Infrastructure, Health and Education*, International Finance Corporation, p. 7.

of the available literature where concerns have been raised about the VFM question. According to them, these are that:

- The value for money evaluation usually comes down to the choice between two very large NPVs, with the difference between them often very small and reliant on the risk transfer calculations included in the PSC. Because the PSC is entirely hypothetical, its value can be altered by assumptions made, especially about risk transfer to the private sector.
- The discount rate methodology is faulty and a free risk discount rate is advocated.
- Irrespective of how much risk is transferred to the to the private sector, the main risks (obsolescence, changing needs and service performance outcomes) are still held by the public sector and costs fall on the general public. Further, the real risk is uncertainty not risk, and the significance of this distinction renders risk calculation problematic.[34]
- With contracts lasting sometimes for more than 60 years, financial evaluations relating to cost estimates, discount rates and risks allocation are incomplete bases on to draw conclusions about the viability of proceeding with the PPP option and greater attention needs to be given to non-financial elements in the longer-term evaluation.[35]

## 5.4 Evaluating the Determination of VFM Across Selected Countries

It is worth mentioning that, apart from the PSC, VFM can also be measured against a number of proxies, including the business case, as mentioned, and by simply benchmarking costs.[36] The PSC, however, still

[34] Jean, Shaoul (2005) "The Private Finance Initiative or the Public Funding of Private Profit?" in *The Challenge of Public Private Partnerships*: *Learning from International Experience*, ed. G. Hodge and C. Greve (eds.), London: Edward Elgar.

[35] J. Broadbent, J. Gil and R. Laughlin (2003) "The Development of Contracting in the Context of Infrastructure Investment in the UK: The case of the Private Finance Initiative in the National Health Service", *International Public Management Journal*, 6(2): 173–197.

[36] National Audit Office (2003) *Managing Resources to Deliver Better Public Services*, HC 61-1, Session 2003–04, London.

remains the most popular of these methods. This is despite doubts about the accuracy of valuations arising from the PSC due to the fact that it relies on long-term forecasting assumptions. Grimsey and Lewis also identify four main alternative approaches through which VFM has been tested around the world:

- a full cost-benefit analysis of the most likely public and private sector alternatives;
- a PSC-PPP comparison before bids are invited;
- a PSC-PPP VFM test after bids; and
- reliance on a competitive bidding process to determine VFM once PPP "road testing" has been established.[37]

In practice, different countries use several variants of these approaches and some are now highlighted.

### 5.4.1 United Kingdom and Australia

In both countries, a PSC VFM after bids test is required prior to the final approval of the project. This procedure basically compares the financial differences between two procurement options (traditional procurement and PPP) for the same project. This is done by preparing a hypothetical set of costs for the public procurement of the project delivering the same output, including an evaluation of the project risk borne by the private sector. This hypothetical costing is compared with actual cash flows to be paid by the private sector provider, plus the value of any residual cost and risk transferred, and therefore retained by the public sector.[38] The PSC procedure is therefore based on "estimates of full costs, revenues and risks set out in cash flow terms, discounted at a public sector rate to an NPV. It is compared with the discounted value of payments under the PSC along with the adjustment of risks and costs retained".[39]

[37] Darrin Grimsey and Mervyn Lewis (2005).

[38] Ibid.

[39] Ibid.

This UK and Australian model has been adopted in many countries, including Hong Kong, Japan and Canada with slight variations. For example, the main difference between the UK model and the Australian model is that the latter has an additional assessment tool called the public interest test (PIT). This is to ensure that a broader assessment of the public interest is taken into account before a project can be offered as a private finance project. The PIT requires the completion of a checklist, which includes project effectiveness, impact of stakeholders, public access and equality, consumer rights, security, privacy and other associated non-economic costs and benefits.[40]

### 5.4.2 Malaysia

In Malaysia, the evaluation of a tender for VFM is made by evaluating the costs and benefits of the project. The bidding proposal is compared with the PSC of each project. The capital expenditure and the maintenance cost of the project must be less than the PSC benchmark before a project can be awarded to the private sector partner.[41]

### 5.4.3 United States

In the USA, most of the contracts for the provision of private prisons require that private firms offer services at 5–10 % below what it would have cost the state to provide a similar service.[42]

### 5.4.4 Japan and Netherlands

In both Japan and The Netherlands, an early indication that VFM will be achieved in a project is a prerequisite for a PPP project to proceed.[43] VFM is assessed before bids are requested, by using a hypothetical PSC

[40] Linda English and James Guthrie (2003.

[41] Roshana Takim, Kharizam Ismail, Abdul Hadi Nawawi and Aini Jaafar (2009) : 103; see also Kharizam Ismail, Roshana Takim and Abdul Hadi Nwawi (2011).

[42] Anne L. Schneider (1999) "Public Private Partnership in the U.S. Prison System", *Behavioural Scientist*, 43(1): 192–208.

[43] Darrin Grimsey and Mervyn Lewis (2005).

and a shadow PSC. This involves, first, a theoretical assessment and then, subsequently, the original assumption of VFM may be rechecked with a PSC. This second PSC test may be worthwhile because, in practice, an initial estimate of bidders' prices will often diverge widely from outturn.[44]

### 5.4.5 Nigeria

As pointed out earlier, it is debatable whether the PSC is suitable for developing economies like Nigeria where there is a paucity of government money to pursue credible public procurement alternatives. The Nigerian PPP Policy postponed the use of the PSC until the government accumulates historical data from actual PPP transactions. This seems to be a sensible approach, since the country has only completed a few PPP deals.[45] The other likely problem to be encountered with the use of the PSC and other comparative assessment methods in Nigeria is that, since the PSC is a mere hypothetical scenario that relies on estimations made by public agencies and the experience of staff, it may be easily manipulated.[46] This is more likely in developing countries like Nigeria.

However, before the government accumulates credible data to enable the use of the PSC, it must seek other credible alternatives to the PSC to evaluate the attainment of VFM in PPP projects. This is important, since a PPP project should not be undertaken for the sake of it but, rather, should be assessed to determine its economic and social value. For this reason, both the American model, due to its simplicity, combined with the PIT in the Australian model, which contains additional qualitative factors and which pays attention to the social importance of PPPs, seem to be the perfect option for Nigeria. However, PSC assessment should not be the sole basis of measuring VFM since its methodology has obvious limitations, as has been discussed. In addition, where the PSC is adopted, public agencies, especially those in developing economies, must evaluate their capacity to manage large, complex, long-term projects,

[44] Ibid.

[45] Nigerian National PPP Policy, ICRC, Abuja, Nigeria.

[46] Daniel Heald (2003) "Value for Money Tests and Accounting Treatment in PFI Schemes", *Accounting, Auditing and Accountability Journal*, 16(3): 342–371.

and the overall interest of the public must also be taken into consideration despite the outcome of the PSC test.[47]

## 5.5 Merits and Demerits of VFM

Several critics doubt whether VFM is achievable in PPP projects. This criticism is usually centred on the very high transaction costs for PPP procurements; for example, regarding legal fees and the length of time it takes to negotiate and conclude a PPP transaction.[48] It is argued that this may not encourage the attainment of VFM in PPPs.[49] It has also been contended that PPPs increases public sector risk, rather than reduce it, increase service cost for the public and shut out the entry of small companies into the procurement process, thereby reducing competition.[50]

According to Parker and Harley, the early history of the PFI in the UK was troubled by private sector complaints of over-protracted and wasteful project bidding, and aborted projects.[51] The UK National Audit Office estimated that the average cost of taking part in a PFI bidding process was between £0.5 million and £2.5 million.[52] Partnership UK tried to mitigate this through the introduction of model contracts and other similar measures. It is generally agreed that, if VFM is to be attained in PPPs, they have to result in genuine lower costs over the life cycle of a project for a given quantity and quality of service.[53]

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[47] Joaquim M. Sarmento (2010) "Do Public Private Partnerships Create Value for Money in the Public Sector? The Portuguese Experience", *OECD Journal on Budgeting*, 1: 93–119.

[48] Darrin Grimsey and Mervyn Lewis (2005).

[49] Darrin Grimsey and Mervyn Lewis (2005); Marcus Ahadzi and Graeme Bowles (2004) "Public-Private Partnerships and Contract Negotiations: An Empirical Study", *Construction Management and Economics*, November, 22: 967–978; Ng and Loosemore (2007).

[50] William B. Moore and Thomas Muller (1989) "Impacts of Development and Infrastructure Financing", *Journal of Urban Planning Development*, 115(2), ASCE 95-108.

[51] David Parker and Keith Harley (2003) "Transaction Costs, Relational Contracting and Public Private Partnerships: A Case Study of UK Defence", *Journal of Purchasing and Supply Management*, 9(3): 97–108.

[52] The National Audit Office (1997), The PFI Contracts For Bridgend and Fazakerley Prisons, HC 253, Sessions 1997–98, London,cited in David Parker and Keith Harley (2003).

[53] David Parker and Keith Harley (2003).

A further point that is readily made is that the concept of VFM is predicated on the assumption that both parties negotiating the PPP contract are acting in good faith and in the protection of their own interests. In the case of the public sector, it is to pursue optimal risk allocation and ensure that only the most economically and efficient project is pursued through PPP. Parker and Harley, basing their argument on "public choice" theory from economics, are of the opinion that the public sector will most likely act in its own self-interests. Consequently, it might not be ready to pursue efficiency in PPPs when it is unable to share in the cost savings of government. The public sector may therefore only pursue projects that do not adversely affect their position, status or income, in which case the public sector may employ several measures, including very low PSC figures, to deter the private sector from pursuing the project.

It is also difficult to obtain evidence of the capital cost of comparable, conventionally financed projects in order to aid proper PSC computation because it is well-known that construction costs vary widely depending on time, place, circumstance and specifications, and even from tender to tender.[54]

There is, however, considerable literature on the merits of VFM in PPPs. For example, Grimsey and Lewis,[55] who have variously defended the position that PPPs actually deliver value for money, argue that PPPs appeal to people in charge of allocating public sector resources because they offer one way of resolving the large cost overruns and delays in traditional public procurement methods for infrastructure (optimum bias). Because there is a greater incentive for the private sector to act in more commercially oriented ways than the public sector; they claim that the transfer of risk to the private sector provides an incentive to private entities. This is very true for Nigeria, where it is contended that PPPs will help reduce the high incidence of cost overruns in public sector procurement. There are very few public works projects that have not been subject to several cost variations, usually due to poor budgetary executions and, in some cases, even corruption.

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[54] Tahir Nisar (2007) "Risk Management in Public-Private Partnership Contracts", *Public Organization Review*, 7: 1–19.

[55] Darrin Grimsey and Mervyn Lewis (2005); Darrin Grimsey and Mervyn Lewis (2004).

It is clear that the major factor that ensures cost savings, and therefore better VFM in PPPs, is private sector's innovation and efficiency. Due to the fact that the private sector is responsible for the whole process from the conceptual design to the actual provision of services, this synergy helps to achieve the lowest possible total life cycle costs while maximising profits. Also, a transparent and efficient procurement process is essential in lowering transaction costs, as it shortens the time taken in negotiations. According to Arthur Andersen, the six main factors that ensure value for money in PPPs are risk transfer, the long-term nature of contracts, the use of output specifications, competition, performance measurement, and incentives and private sector management of skill.[56] The most important factors are said to be competition and risk. In fact, according to them, risk transfer was said to account for 60 % of the total cost saving for PFI projects in the UK.[57]

## 5.6 Assessment of the Achievement of VFM

In this sub-section, consideration is given to the important question of whether PPP projects that have been completed and operational around the world have been successful. The mechanism that is commonly used for this assessment is to consider whether VFM has been attained in these various projects. This is an important question, as the jury is still out on whether PPPs are actually better than public procurement. As this debate continues to rage, this book attempts a country-by-country analysis by comparing the various empirical studies that have been done on this issue.

### 5.6.1 United Kingdom

In the UK, Andersen and LSE Enterprises studied 29 business cases and estimated a 17 % cost savings from PFI projects when compared with projects done through traditional public procurement.[58] The UK National

[56] Arthur Andersen and LSE Enterprises (2000) "Value for Money Drivers in Private Finance Initiative", Report commissioned by the UK Treasury Task Force on Public-Private Partnerships; see also Darrin Grimsey and Mervyn Lewis (2005).

[57] Ibid.

[58] Arthur Andersen and LSE Enterprises (2000).

Audit Office in its 1998[59] and 2000[60] reports identified similar gains from the use of PFI in the UK, reporting an estimated 10–20 % cost savings in seven projects studied in the 2000 report. The reports also attributed these reductions to appropriate risk transfer from the public to the private sectors. In another study carried out in 2001, the National Audit Office found that 81 % of the public sectors interviewed were of the opinion that value for money was achieved from PPPs.[61]

Nisar carried out a case study of five PFI projects to examine the effects of risk transfer on value for money gains in PFI projects in the UK. He concluded that PFI contracts were more or less achieving risk transfer and delivering price certainty.[62] However, the Institute of Public Policy Research was of the opinion that, while PFIs were successful for prisons and roads, they were of limited value in hospitals and schools.[63]

Even though the majority of academics are of the opinion that PPPs have led to better VFM in infrastructure projects in the UK, there are contrary opinions. For example, Parker and Hartley carried out a case study of the use of PPP in the UK defence industry and concluded that the use of PPP will not necessarily lead to improved economic efficiency in defence procurement. It was discovered that PPPs involve significant transaction costs.[64] Edwards et al. also examined the structure and performance of PPPs in roads and hospitals, and concluded that PPPs appear to be an expensive proposition to the public sector.[65] They argued for a more transparent financial regime. According to them, this is essential in order to assess the performance of PPPs.[66]

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[59] National Audit Office (1998) The Private Finance Initiative: The First Four Design, Build, Finance and Operate Roads Contracts, HC 476, London.

[60] National Audit Report (2000) "Examining Value for Money Deals under the Private Finance Initiative", London.

[61] National Audit Report (2001) "Managing the Relations to Secure a Successful Partnership in PFI Projects", A Report from the Comptroller and Auditor General, HC 375, London.

[62] Tahir Nisar (2007) "Value for Money Drivers in Public Private Partnership Schemes", *International Journal of Public Sector Management*, 20(2): 147–156.

[63] The Institute of Public Policy Research (2001) "Building Better Partnerships: The Final Report of the Commission on Public Private Partnerships". London: Institute for Public Policy Research.

[64] David Parker and Keith Harley (2003).

[65] Pam Edwards, Jean Shaoul, Anne Stafford and Lorna Arblaster (2004) "Evaluating Operations of PFI in Roads and Hospitals", *ACCA Research Report* 84. London: Certified Accountants Educational Trust.

[66] Ibid.

### 5.6.2 Australia

Just like the UK, most of the reports that are in support of the attainment of VFM originate from the government and there have been calls for assessments of a more independent nature.[67] Another constraint pointed out by English is that it is difficult to assess whether VFM has been achieved in the PPP transactions undertaken in Australia because most of the audits carried out by the government in Australia have focused on the procurement stage and not paid much attention to the actual operation of the project.[68]

Fitzgerald carried out eight case studies of major projects in Australia and found that the discount rate and risk adjustment were integral to the issue of whether the commercial arrangements proposed in the tender offered VFM over the public procurement alternative.[69] Keating, while analysing PPPs in Australia, concluded that the Australian government is trying to transfer a considerable number of risks to the private sector, which the banks, in turn, shift to the contractor. Keating points out that this structure insulates debt investors from holding as much risk as possible.[70] Walker and Walker were of the opinion that accounting management of PPPs eroded accountability to representative public bodies.[71] English and Guthrie concluded that the Australian government is not as successful as the private sector at identifying and transferring risk.[72] It is therefore safe to conclude that, while there is evidence, albeit from the government, that VFM is achieved through PPPs in Australia, much work is still required to ensure that the process of VFM assessment is more transparent and objective. Independent assessments need to be undertaken by bodies that are not linked to the government to achieve a more credible appraisal of the state of affairs.

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[67] Linda English (2006) "Public Private Partnerships in Australia: An Overview of Their Nature, Purpose, Incidence and Oversight", *University of New South Wales Law Journal*, 19(3).

[68] Ibid.

[69] Peter Fitzgerald (2004) "Review of Partnerships Victoria Provided Infrastructure", Final report to the Treasurer, Melbourne: Growth Solutions Group.

[70] Sean Keating (2004) "Public-Private Brinkmanship", *Project Finance*, September: 27–29, cited in The Institute of Chartered Accountants of Scotland supra.

[71] Bob Walker and Betty C. Walker (2000) *Privatization: Sell Off or Sell Out? The Australian Experience*. Sydney: ABC Books.

[72] Linda English and James Guthrie(2003).

As has been pointed out, optimal risk allocation appears to be the essential basis for achieving VFM in PPP projects. Cheung et al.[73] studied the different measures that enhance VFM in PPP projects from three different countries —Hong Kong, Australia and the UK— and found that, of the 18 identified VFM facilitators, efficient risk allocation was the top VFM enabler. They concluded that, when risks are properly handled, fewer pitfalls are experienced and that efficient risk allocation is vital in determining whether VFM can be achieved in PPP projects.

### 5.6.3 United States, Canada, Denmark and the Netherlands

Relatively few PPPs have been implemented in the USA; therefore, it is difficult to come to a credible conclusion on the success of PPPs in achieving VFM.[74] Nevertheless, there is evidence that PPPs in the USA have been successful.[75]However, Bloomfield et al. found PPPs lease purchasing financing arrangements to be wasteful and more expensive than conventional general obligation financing.[76] A study in Canada found an average of 24 % in cost savings on PPP projects in Canada between 2006 and 2010.[77] Greve, on the other hand, painted a very depressing picture of a major PPP project in Denmark, opining that the project outcomes were devastating for all parties involved. According to him,

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[73] Ibid.

[74] Dorothy Morallos, Adjo Amekudzi, Catherine Ross and Michael Meyer "Value for Money Analysis in U.S. Transportation Public-Private Partnerships", (online), available at: http://people.ce.gatech.edu/~aa103/valueformoney.pdf (last accessed 12 October 2015).

[75] National Council for Public Private Partnerships, "Testing Tradition: Assessing the Added Value of Public-Private Partnerships", available at http://www.ncppp.org/wp-content/uploads/2013/03/WhitePaper2012-FinalWeb.pdf (last accessed 12 October 2015).

[76] Pamela Bloomfield, David Westerling and Robert Carey (1998) "Innovation and Risks in a Public-Private Partnership Financing and Construction of a Capital Project in Massachusetts", *Public Productivity and Review*, 21 (4): 460–471.

[77] Aaron Toppston (2012) "Alternative Construction Delivery", Paper presented at Aon DC Construction Forum, Washington, DC, 2 April 2012), cited in National Council For Public Private Partnerships, "Testing Tradition: Assessing the Added Value of Public-Private Partnerships", available at http://www.ncppp.org/wp-content/uploads/2013/03/WhitePaper2012-FinalWeb.pdf.

it nearly ruined the mayor, the council and the citizenry.[78] However, it is claimed that PPPs are not frequently employed in Denmark because of the country's strong public finances and well-built physical infrastructure.[79] The Netherlands Expertise Centre PPP and Dutch National Audit Office studies were both of the opinion that PPPs in The Netherlands have not been successful.[80]

In summary, it is clear that there is considerable scepticism as to whether PPPs actually lead to VFM. While most official reports are of the opinion that VFM is more or less achieved, opposition has come mainly from academics. However, most empirical studies undertaken to date show that there is considerable achievement of VFM when projects are done through PPPs, rather than through traditional public procurement.

Grimsey and Lewis cite two reports to buttress the superiority of PPPs over traditional procurement in attaining VFM.[81] The first is the study conducted by Flyvbjerg, Holm and Buhl that examined 258 large transport infrastructure projects spanning 20 countries, the majority of which projects were developed using conventional procurement.[82] Costs were found to have been underestimated in over 90 % of the projects. In a study commissioned by the UK Treasury, Macdonald reviewed 50 large projects in the UK, 11 of which were undertaken under PPP.[83] It was found that, on the average, the PPP projects were concluded within time compared with 17 % which ran over time. The cost overrun for PPP projects averaged at 1 % compared with a 47 % cost overrun for traditional procurement. These reports, in the absence of controvertible empirical studies, show that VFM is being achieved in the majority of PPP projects.

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[78] Carsten Greve, (2003) "When Public–Private Partnership Fail. The Extreme Case of the NPM-inspired Local Government of the Forum in Denmark", Paper for the EGPA conference 3–6 September, Oerias, Portugal, cited in Tahir Nisar (2007) "Risk Management in Public-Private Partnership Contracts", *Public Organization Review*, 7: 1–19.

[79] Ole Helby Petersen (2011) "Public-Private Partnerships as Converging or Diverging Trends in Public Management? A Comparative Analysis of PPP Policy and Regulation in Denmark and Ireland", *International Public Management Review*, 12(2): 1–37.

[80] Netherland Audit Office, cited in T. Nisar (2007).

[81] Grimsey and Lewis (2005).

[82] Bent Flyvbjerg, Mette S. Hol and Soren Buhl (2002) "Underestimating Costs in Public Works Projects: Error or Lie?", *Journal of the American Planning Association*, 68(3):. 279–295.

[83] Mott MacDonald (2002) *Review of Large Public Procurement in the UK*. London: HM Treasury.

## 5.7 Conclusion

In conclusion, it is perhaps a little early to make definitive judgments on the attainment of VFM in the majority of countries due to the relatively early stages of PPPs in some of them. In these countries, therefore, it may perhaps be more useful to wait a little longer before a more thorough evaluation can be undertaken.[84] However, from the foregoing, there seems to be a preponderance of evidence suggesting that the number of countries achieving VFM in the majority of projects is greater than those who have not succeeded. In Nigeria, it might be safe to assume that, provided PPP projects are undertaken properly, there is a higher possibility of attaining VFM than otherwise, as the majority of public works projects already suffer from severe cost overruns and even complete abandonment. The possible high transaction costs and higher capital costs of PPP projects will definitely be offset by the assurance and efficiency that the private sector will bring to the projects.

[84] IPPR (2001) Building Better Partnerships. London: Institute of Public Policy Research.

# 6

# Risks in PPP Projects in Nigeria

## 6.1 The Concept of Risk

The definition of risk is controversial,[1] primarily because the choice of a definition can affect the outcome of policy debates, the allocation of resources and even the distribution of political power in society.[2] A number of writers have looked at risk solely from the perspective of a negative event. For instance, Akintoye and Macleod defined risk as the likelihood of unforeseen factors occurring, which would adversely affect the successful completion of a project in terms of cost, time and quality.[3] The Royal Society also defined risk as the probability that an adverse event occurs during a stated period.[4] However, risk is not always negative. From a project management point of

[1] Baruch Fischoff, Stephen Watson and Chris Hope (1984) "Defining Risk", *Policy of Sciences*, 17: 123–139.

[2] Ibid.

[3] Akintola Akintoye and Malcolm Macleod (1987) "Risk Analysis and Management in Construction", *International Journal of Project Management*, 15(1): 38–39; see also the following: Robert M. Widerman (1992) *Project and Program Risk Management*, PMI; Kiyoshi Niwa (1989) *Knowledge Based Risk Management in Engineering*, New York: John Wiley & Sons; John C. Chicken and Tamar Posner (1998) *The Philosophy of Risk*, London: Thomas Thelford Publishing.

[4] Royal Society (1991) "*Report of the Study Group on Risk*; *Analysis*, *Perception and Management*" (Group coordinator Sir F. Warner), London: Royal Society, p. 2, cited in Peter J. Edwards and Paul



G. Nwangwu, *Public Private Partnerships in Nigeria*,
DOI 10.1057/978-1-137-54242-7_6

view, risk also reflects the underlying uncertainty of developing and operating projects. It is when risk is viewed as an uncertain event that it reflects the possibility of both threats and opportunities.[5] For instance, Al-Bahar took this approach by examining both the negative and positive aspects of risk by combining both risk and uncertainty.[6] According to Al-Bahar, risk is the exposure or chance of the occurrence of events adversely or favourably affecting project objectives as a consequence of uncertainty.[7]

Similarly, Conrow and Shishido opine that risk is often used incorrectly to represent probability. When used correctly, risk represents the combined effect of probability and consequence. They defined risk as the probability or likelihood of failing to achieve a particular cost, performance and schedule objectives, and the consequence of failing to achieve those objectives.[8] Akintoye et al. agree with this definition, and insist that the two attributes of probability and consequence must always be considered when risks are dealt with.[9] From the analysis of these definitions, it is posited that risk is the probability of a particular event occurring multiplied by its corresponding impact level.[10]

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A. Bowen (1998) "Risk Management in Construction: A Review of Future Directions and Research". *Engineering*, *Construction and Architectural Management*, 5(4) pp. 339–349.

[5] Julie Froud, "The Private Finance Initiative: Risk Uncertainty and the State", (2003) *Accounting Organizations* & *Society*, 28(6): 567–589.

[6] Jamal F. Al-Bahar, (1989) "Risk Management in Construction Projects: A Systematic Analytical Approach for Contractors", PhD. Thesis, University of California, Berkeley; see also the following: Jamal F. Al-Bahar and Keith C. Crandall, "Systematic Risk Management for Construction Projects" (1990) *Journal of Construction Engineering and Management*, 106 (3): 533–546; John Raftery (1994) *Risk Analysis in Project Management*, London: E & FN Spon; Christopher B. Chapman "A Risk Engineering Approach to Project Risk Management" (1990) *International Journal of Project Management*, 8(1): 5–16; Emmett J. Vaughan (1997) *Risk Management*, USA: John Wiley & Sons Inc.

[7] Jamal F. Al-Bahar and Keith C. Crandall (1990).

[8] Edmund H. Conrow and Patricia S. Shishido (1997) "Implementing Risk Management on Software Intensive Projects", *IEEE Software*, 14(3): 83–89.

[9] Akintola Akintoye, Craig Taylor and Eamon Fitzgerald (1998) "Risk in Private Finance Initiative Projects" in Luiz Montanheiro and Mirjam Spiering (eds.) *Public and Private Sector Partnerships: The Enterprise Governance*, Sheffield: Sheffield Hallam University Press.

[10] Rui Cunha Marques and Sanford V. Berg (2010) "Risks, Contracts and Private Sector Participation in Infrastructure", *Journal of Construction Engineering and Management*, available at http://warrington.ufl.edu/purc/purcdocs/papers/0925_marques_risks_contracts_and.pdf (last accessed 13 October 2015).

Risk is characterised by three essential components: the risk event—that is, what might happen to the detriment or in favour of the project; the probability of its occurrence; and the potential loss or gain—that is, the impact of the risk.[11] Martin and Heaulme added "time and occurrence" as a fourth component.[12]

While seeking a coherent understanding of the different ways in which the concept of risk has been defined, Vlek and Stallen[13] analysed and distilled the different definitions of risk from relevant professional literature, and came up with various ways in which risk has been used. These include:

- risk as a probability of a loss;
- risk as the size of a possible loss;
- risk as a function, mostly the product of probability and size of loss;
- risk as equal to the variance of the probability distribution of all possible distributions of a risky course of action;
- risk as the semi-variance of the distribution of all consequences, taken over the negative consequences only, and with respect to some adopted reference value; and
- risk as a weighted linear combination of the variance and expected value of the distribution of all possible consequences. This definition is consistent with the view that risk involves both positive and negative consequences. This is the position also adopted in this book.

It is important to note that risks arise in all projects, whether achieved through traditional public procurement or through PPPs. In traditional public procurement, while it is sometimes erroneously assumed that risks are solely borne by the public sector, in reality they are merely passed on to the public as customers and taxpayers. Large-scale public works are more risky than other business activities because of the complexity of coordinating a

[11] K.C. Iyer and Mohammed Sagheer (2011) "Risk and Uncertainty Assessment in PPP Infrastructure Projects: Need for a Systems Dynamic Framework", available at: http://www.indianjournals.com/glogift2k6/glogift2k6-1-1/theme_5/Article%2011.htm (last accessed 13 October 2012); see also Al-Bahar (1989), n. 6.

[12] J.E Martin and P. Heaulme (1998) "Risk Management: Techniques for Managing Project Risks" in D.I. Cleland (ed.) *Field Guide to Project Management*, New York: Van Nostrand Reinhold.

[13] Charles Vleck and Pieter-Jan Stallen (1981) "Judging Risks and Benefits in the Small and in the Large", *Organizational Behavior and Human Performance*, 28: 235–271.

wide range of disparate and interrelated skills and activities.[14] This complexity is further compounded by the fact that public sector projects tend to have multiple stakeholders whose objectives and interests differ, and is due also to the fact that the infrastructure is user specific.[15]

Risk is also fundamental to project management. In fact, it has been suggested that the main purpose of project management is to manage the risks in a project.[16] Nonetheless, while risk has always played an important role in project management, awareness of risk has increased greatly under PPPs due to the inextricable link between risk and PPPs. Indeed, the centrality of risk to PPPs has raised the awareness of project risks to a level which public procurement has not been able to do to date.[17] PPP project risks may, nonetheless, be distinguished from the risks arising from other types of projects due to the unique peculiarities arising from the partnership between the public and private sectors. However, the central concern in every project, however carried out (traditional procurement, PPP or other means), remains whether the project will be profitable, taking into consideration all the risks that are inherent in it.[18]

The management of risk is therefore crucial to the success of PPP projects. This involves:

- *Risk identification*: the process of identifying all the risks relevant to the project;
- *Risk assessment*: the determination of the degree of likelihood of the risk and the possible consequences if the risk occurs;
- *Risk allocation*: assignment of the responsibility of the consequence of the risk to one or more of the contracting parties; and
- *Risk mitigation*: the process of controlling the likelihood of occurrence of the risk and the consequence of the risk.[19]

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[14] L. Shen., A. Platten and X.P. Deng (2006) "Role of Public Private Partnerships to Manage Risks in Public Sector Projects in Hong Kong", *International Journal of Project Management*, 24(7): 587–594.

[15] Ibid.

[16] Stephen Grey (2005) *Practical Risk Assessment for Project Management*, Chichester: John Wiley & Sons, p. ix.

[17] Darrin Grimsey and Mervyn K. Lewis (2007) *Public Private Partnerships*: *The Worldwide Revolution in Infrastructure Provision and Project Finance*, Cheltenham, UK: Edward Elgar Publishing, p. 136.

[18] Ibid.

[19] Department of Economic Affairs (2006) *National Public Private Partnership Handbook*, Department of Economic Affairs, Ministry of Finance, Government of India, pp. 1–246.

These processes are discussed in greater detail in subsequent paragraphs of this chapter.

## 6.2 Risk and PPPs

One of the major advantages of PPP over other procurement models is the transfer of risk from the public sector to the private sector. However, this declaration is quite simplistic as, in reality, it is not feasible or wise to transfer all the risks that may arise in a project to the private sector. The essence of the "partnership" in PPP is the fact that parties are able to share the risks and rewards, so that the party best able to assume a particular risk shoulders it. Transferring all the risks to the private sector would greatly impair the profitability and, consequently, the feasibility of the project. This will either lead to the abandonment of the project by the private sector, or escalate the cost of the project, thereby reducing its economic viability, as the private sector will cost every risk allotted to it and charge a premium for them.

Consequently, this is why there is a strong correlation between the proper transfer and management of risk and the improvement of value for money in projects. The reason for this is simply because parties now become more aware of these risks and are able to reduce either the probability of the risk occurring, or the financial consequences if it does, or both.[20] Accordingly, it is important, and it is strongly proposed, that every PPP project strives towards the proper allocation of risk between the public and private sectors.

It is customary and good practice for the parties to the PPP project to make a checklist of all the risks likely to affect the project at each phase and properly apportion them between the parties. The most common tool used for this exercise is the risk matrix. A risk matrix is useful at the conception of a project, even before actual tendering commences, as it is vital for, among other things, the proper costing of the project. It is also helpful during contract negotiations, as it can act as a checklist to ensure that all risks are accounted for and apportioned. Also, after the signing of the contract, it can be a useful summary of all the risk allocated and dealt with in the contract.[21]

[20] Ibid.

[21] United Nations Economic Commission for Europe (2008) "Guidebook on Promoting Good Governance in Public-Private Partnerships", *United Nations Publication*, Sales No. 08.II.E.1, p. 36.

The allocation is initially made on the basis that the party best able to assume a particular risk should bear it. However, even after the risks have been apportioned, it may make social, political and, sometimes, commercial sense for the public sector to mitigate some of the risks that had been allocated to the private sector by taking some elements of these risks back. This is notwithstanding the fact that the private sector may choose to mitigate a number of its contractually assumed risks by, for example, buying insurance to cover them, or passing them to other parties via subcontracts. The reason for risk mitigation by the public sector is because mitigation by the private sector is more likely increase the cost of the project. Therefore, it is advised that where socially, politically or commercially desirable, the public sector should mitigate some of the risks allocated to the private sector, as the viability of the project might ultimately depend on this.[22]

Also when the construction phase of the project is completed and the private sector begins the operation of the services, the public sector must also put in place a risk monitoring system to ensure that the services are delivered to the public according to the contracted performance specifications.[23] This will ensure that parties continue to assume allocated risks and therefore guarantee the continued viability of the project.

## 6.3 Nature and Categorisation of Risks in PPPs

There is no agreement on the exact nature and number of risks that a project may face. The reason is simply because risks vary from project to project and, even within the lifespan of the same project, is likely to change from time to time. Also, many of the so-called categories of risks overlap with one another. Risk factors may be categorised from different perspectives, some from more general perspectives and others from more precise formulations. There is also a lack of uniformity in the use

[22] It has been argued in some quarters that this effectively makes the public the guarantors of the private sector. See Ellen Dannin (2011) "Crumbling Infrastructure, Crumbling Democracy: Infrastructure Privatization Contracts and their Effects on State and Local Governance", *Northwestern Journal of Law and Social Policy*, 6.

[23] United Nations Economic Commission for Europe (2008).

of semantics in making the classifications, resulting in the use of different labels for the same types of risk by different scholars. Despite these difficulties, it is, however, agreed that some form of classification or categorisation of project risk is needed in order to understand clearly what types of risks are to be shared by the parties in a PPP.

United Nations Industrial Development Organisation divides project risks into two broad categories: general risk and specific risk. While general risk refers to a risk over which the project sponsors have no control—for example, political and economic factors, and the legal environment of the host country, specific risks are those over which the private sector project entity does have control—for example, construction risk.[24] For the purposes of contractual design, project risks have been classified as either global or elemental. Global risks are those that are normally allocated through the project agreement—such as political risks, legal and regulatory risks, commercial risks and environmental risks, while elemental risks are those associated with the construction, operation, finance and revenue generation of the project.[25]

Dias and Ioannou are of the opinion that risks are either pure risk or speculative risk. Pure risks occur when there is the possibility of financial loss but no possibility of financial gain, and speculative risk involves the possibility of both gains and losses.[26] Ng and Loosemore also classify risk into two main groups: general risk and project risk. Project risks arise from the way a project is managed, or from events in its immediate microenvironment; in contras, general risks are not directly associated with project strategies, yet are capable of having significant impact on the outcome of the project.[27] Marques and Berg's classification comprises

[24] UNIDO (1996) "*Guidelines for Infrastructure Development Through Build-Operate and Transfer Projects*", Vienna: United Nations Industrial Development Organisation; see also K.C. Iyer and Mohammed Sagheer (2011).

[25] Darrin Grimsey and Mervyn K. Lewis (2002) "*Evaluating the Risk of Public Private Partnerships for Infrastructure Projects*", *International Journal of Project Management*, 20: 107–118; M.A. Merna and N.J. Smith (1996) *Privately Financed Concession Contract*, Vols. 1 and 2. 2nd edn, Hong Kong: Asia Law and Practice.

[26] A. Dias and P. Ioannou (1995) "Debt Capacity and Optimal Capital Structure for Privately Financed Infrastructure Projects", ASCE *Journal of Construction Engineering and Management*, 121(4): 404–414.

[27] A. Ng and Martin Loosemore (2007) "Risk allocation in the Private Provision of Public Infrastructure", *International Journal of Project Management*, 25: 66–76.

three categories: production, commercial and contextual risks.[28] While production risks are usually borne by the private partner, the allocation of the commercial and contextual risks is mixed.[29]

Extant literature has categorised risks according to type. Miller and Lassard classify risks into three categories: market-related risk, completion risk and institutional risk.[30] Risks have also been classified using a meta-classification approach, on the basis of three levels of risk factors. Li et al. classified risk into macro level risk, meso level risk and micro level risk.[31] A macro level risk refers to risks that are sourced exogenously—that is, external to the project—but which impact on the project; for example, political and legal conditions. A meso level risk occurs endogenously—that is, within the project itself; this involves risks such as project demand usage, design and construction. A micro level risk represents risks found in the stakeholder relationships formed in the procurement process. While these risks are also endogenous, they differ from meso risks because they are party-related, arising because of the different project objectives of the contracting parties. While the public sector is driven by its social responsibility, the private sector is driven by its profit-making motive.[32]

According to Li et al., the advantage of the classification of risk is that it facilitates a strategic approach to risk management; it may also indicate situations in the risk management process where common approaches to risk analysis, treatment and monitoring can be adopted. Slazmann and Mohammed, in their analysis of international BOOT arrangements, grouped risks into four categories, host country risk, investor's risk, project risk and project organisation risk.[33] Xenidis and Angelides analysed the manner risk has been classified in several pieces of literature and concluded that they are able to decipher two major types of risk classification: the

[28] Rui Cunha Marques and Sanford Berg (2010).

[29] Ibid.

[30] Donald R. Lassard and Roger Miller (2001) "Understanding and Managing Risk in Large Engineering Projects", MIT Sloan Working Paper No. 4214-01.

[31] Li Bing, A. Akintoye, P.J. Edwards and C. Hardcastle (2005) "The Allocation of Risk in PPP/PFI Construction Projects in the UK", *International Journal of Project Management*, 23: 25–35.

[32] Ibid.

[33] Angela Walker and Sherif Mohammed (1999) "Risk Identification Frameworks for International BOOT Projects" in Stephen Ogunlana (ed.), *Profitable Partnering in Construction Procurement*, CIB W92 Proceedings Publication 224, pp. 475–485, ISBN 0-419-24760-2.

first, based on the life cycle phase, a risk that occurs during the PPP contract period, the second, according to the source or origin of each risk.[34]

The advantage of the broad grouping of risks that was discussed in the preceding paragraphs is that it may ease the management of risks. This is because risks within the same category or group may be treated, allocated or managed in the same way, since they share the same characteristics. However, in practice, these groupings are usually dispensed with. Generally, most academics tend to discuss the different risk factors individually without any recourse to which category or broad groups they fall into. The reason for this is probably because, indeed, no two types of risk are truly the same. They may share certain common characteristics, but it is doubtful whether all their characteristics always align so that they can be treated in the same way in different projects every time they occur.

Typically, most commentators divide the risk associated with projects into five major categories.[35] For instance, the UK Department of Defence sees risk as covering five broad areas: design and development, construction, finance, co-operation and ownership.[36] However, these risks usually overlap and can often be further sub-divided into up to 61 factors.[37] The International Monetary Fund divides risk into five categories:

- *Construction risk*: this is related to design problems, building cost overruns and project delays;
- *Financial risk*: this is related to variability in interest rates, exchange rates and other factors affecting financing costs;
- *Availability risk*: this is related to the continuity and quality of service provision (which, in turn, depends on the "availability" of an asset);

[34] Yiannis Xenidis and Demos Angelide (2006) "The Financial Risk in Build Operate and Transfer Projects", *Construction Management and Economics*, 23: 431–441.

[35] R. W. Bakar (1986) "*Handling Uncertainties*", *International Journal of Project Management*, 4(3): 205–210.

[36] Department of Defence UK (2001) Private Financing Manual, Organisational Effectiveness Branch, Interim version, 25 February.

[37] A.D. Ibrahim, A.D.F. Price and A.R.J. Dainty (2006) "The Analysis and Allocation of Risk in Public Private Partnerships in Infrastructure Projects in Nigeria", *Journal of Financial Management of Property and Construction*, 11(3): 149–164.

- *Demand risk*: this is related to the ongoing need for services; and
- *Residual value risk*: this is related to the future market price of *n* asset.[38]

According to Grimsey and Lewis, who divided risks into eight categories, project risks include:

- *Technical risk*: due to engineering and design failures;
- *Construction risk*: because of faulty construction techniques and cost escalation, and delays in construction;
- *Operating risk*: as a result of higher operating costs and maintenance cost;
- *Revenue risk*: for example, because of traffic shortfall or failure to extract resources, the volatility of prices and the demand for products and services leading to revenue deficiency;
- *Financial risk*: arising from inadequate hedging of revenue streams and financing costs;
- *Force majeure risk*: involving war and other calamities; acts of God, changes and unsupportive government policies;
- *Environmental risks*: because of adverse environmental impacts and hazards;
- *Project default*: as a result of failure of the project from a combination of any of the above.[39]

As can be seen from the analysis above, the classifications or the number of risks that affect a project lack precision and, sometimes, classifications generally depend on the objectives of the individual doing the classification. These different approaches are all important for the purposes of this research because the different studies analysed and undertaken in the subsequent chapters of this book employ either one or a combination of these classifications. Therefore, a general recognition and understanding of the various classifications of risk is important for the understanding of the discussions that follow in subsequent chapters.

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[38] International Monetary Fund (2005) "Public Private Partnerships, Government Guarantees, and Fiscal Risk", prepared by staff team of the IMF led by R. Hemming, Washington, DC: IMF Multimedia Services Division.

[39] Darrin Grimsey and Mervyn K. Lewis (2007) *Public Private Partnerships*: *The Worldwide Revolution in Infrastructure Provision and Project Finance*, Cheltenham, UK: Edward Elgar Publishing, p. 172.

## 6.4 Risk Assessment

The technique for risk assessment can be classified into two broad groups: quantitative and qualitative techniques. Quantitative techniques are used to assess the risks and represent the likelihood and impact of the risk in terms of either time or money. Two of the commonly used quantitative techniques are the deterministic and the probabilistic approaches.[40] Sensitivity analysis is the most representative approach among the deterministic methods of analysis.[41]

Qualitative techniques are predominantly used to list the likely sources of risks and their consequences. Some of the commonly used qualitative techniques are risk registers and probability impact tables. Risk registers have a tabular form to compile all the risks relevant to the projects, along with information necessary for management of the risk. In probability impact tables, the probability and impact of the risk are subjectively assessed using qualitative scaling factors. These scaling factors are then converted into values and weights, and the scores of all the risks are computed by multiplying the values of probability and impact.[42]

## 6.5 Allocation of Risks

One of the essential roles of PPP is to achieve optimal risk allocation. Under traditional procurement, the risk assumed by the public sector when it owns and operates an infrastructure asset is often unvalued. What PPP ensures, through the involvement of the private sector, is that risk is adequately and properly identified and priced, and is then transferred to the party that is best able to manage it.

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[40] H.-W. Alfen S.N. Kalidindi, S. Ogunlana, ShouQing Wang, M.P. Abednego, A. Frank-Jungbecker, Yu-Chien Amber Jan, Yongjian Ke, YuWen Liu, L. Boeing Singh and GuoFu Zhao, "An Introduction to PPP Concept" in *Public-Private Partnership in Infrastructure Development: Case Studies from Asia and Europe*, Bauhaus Universitat Weimar, (online), available at http://e-pub.uni-weimar.de/volltexte/2009/ (last accessed on 13 October 2015).

[41] Ibid.

[42] Ibid.

In simplistic terms, the concept of risk transfer from the public sector perspective would be to remove all risk from a project. In other words, the public sector would transfer all the risks to do with the project to the private sector, leaving the public sector merely as purchaser of risk-free services. As mentioned earlier, this will not work well in practice, as the private sector, with its profit-making mind set, will always price the risk and charge a risk premium for whatever risks it assumes. Therefore, if the transfer of risk is total, the private sector will, if on the unlikely event that it decides to continue with the project, charge too much premium, making the project too expensive and economically unviable. The notion of value for money, which is central to the viability of PPPs, would be defeated. At all times, it is essential to ensure that the public benefit of risk transfer to the private sector outweighs any increase in financial cost associated with the risk bearing.[43] Therefore, the objective of the public sector must not be to seek to maximise risk transfer at any price but, rather, to seek optimal risk transfer.

Max Abrahamson recommends five cases in which a contracting party may bear project risks:

- if the risk is a loss due to his or her own wilful misconduct or lack of reasonable efficiency or care;
- if he can cover a risk by insurance and allow for the premium in settling his charges, and it is the most convenient and practicable option for the risk to be dealt with in this way;
- if the preponderant economic benefit of running the risk accrues to him;
- if it is in the interest of efficiency to place the risk on him;
- if, when the risk eventuates, the loss happens to fall on him in the first instance, and there is no reason under any of the above circumstances to transfer the loss to another, or it is impracticable to do so.[44]

[43] John Quiggin (2004) "Risk, PPPs and the Public Sector Comparator" *Australian Accounting Review*, 14(2): 51–61.

[44] M. Abrahamson (1973) "Contractual Risks in Tunneling: How They Should Be Shared", *Tunnels & Tunneling*, November: 587–598.

According to Ward et al., even though these guidelines by Max Abrahamson have received wide support and are a useful first step in addressing the problem of risk allocation, they do not provide a complete solution.[45] The reason for this view is that the guidelines fail to recognise the pricing of risk or the differing attitudes to risk by the contracting parties. Also, they offer little help in allocating risks that are uncontrollable or are controllable to a degree by more than one of the contracting parties. The possibility of risk sharing, which is vital for the success of PPPs, is therefore not contemplated by the guidelines.[46]

Accordingly, for Ward et al., parties who bear project risks have four basic response options:

- pass the risk to a third party; or
- continue to bear the risk and manage it for profit, but accept liabilities; or
- if a downside risk eventuates, try to recover costs from other parties including the public partner; or
- if a downside risk eventuates, meet liabilities reluctantly, walk away from the contract, or go bankrupt.[47]

It is assumed that the bearers of risk will be motivated to use the first option, provided that it is cost effective.[48]

In the spirit of partnership, which is core to PPPs, the public sector usually bears some of the risks that it feels that it is in the best position to assume, otherwise it gambles on the possibility of an unsuccessful project. If a project collapses due to a flawed risk allocation process, the consequences can be quite grave, especially in public utility projects, as the public sector will have no other option but to step in and rescue the project, inadvertently assuming the entire risk in the project.

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[45] Stephen Ward, Chris Chapman and Bernard Curtis (1991) *On the Allocation of Risk in Construction Projects*, *Discussion Papers in Accounting and Management Science*: 91–98, Southampton, UK: University of Southampton.

[46] Ibid.

[47] Stephen Ward, Chris Chapman and Bernard Curtis (1991).

[48] Ibid.

There are certain agreed rules that guide risk allocation in PPPs. It is agreed that risk should only be allocated to a party who:

- has been made fully aware of the risks they are taking;
- has the greatest capacity to manage risk effectively and efficiently (and charge the lowest risk premium);
- has the capability and resources to cope with the risk eventuating;
- has the necessary risk appetite to want to take the risk;
- has been given the chance to charge the appropriate premium for taking the risk.[49]

According to Ng and Loosemore:

> Not following these simple rules will compromise the success and efficiency of the project since it will produce higher risk premiums than necessary, increase the chance of the risk arising and the consequences if they do arise. Further inefficiencies can arise from confused responsibility for monitoring and responding to risks; resentment for being forced to take them and; denial, conflict and dispute to avoid responsibility when they do arise. In effect, by not following the above rules, the public sector is merely gaining the illusion of risk transfer, since it is likely that the risk will be transferred back to them in the form of higher risks, risk premiums and project problems.[50]

While most risks are within the control of either party, there are certain risks that are outside both parties' control. In practice, such risk is priced by the private party and the public party decides whether it is cheaper for it to assume the particular risk, taking into consideration the likelihood of the risk eventuating and how it may be able to mitigate its impacts. The other option will be for the parties to decide to share the risk through various risk sharing mechanisms.[51] It is one thing to say that risk should be allocated to the party that is best able to bear it, but the dilemma is what to do with risk that neither party can control, such as force majeure risk.[52]

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[49] A. Ng and Martin Loosemore (2007).

[50] Ibid.

[51] Darrin Grimsey and Mervyn K. Lewis (2004), p. 179.

[52] Tahir M. Nisar (2007) "Risk Management in Public-Private Partnership Contracts", *Public Organization Review*, 7(1): 1–19.

It is important that the risk in a project is identified at an early stage, because it enables project constraints and appropriate cost estimates to be determined sufficiently early. This also helps focus project management attention of ways of controlling and allocating risk.[53] There are two dimensions to risk allocation. The first is qualitative in nature, concerned with the type of risk that is allocated and to whom.[54] The second dimension is quantitative and is concerned with determining how much of the risk is allocated.[55] This second aspect involves mathematical solutions.[56]

According to Nisar, allocation of risk in PPP projects can either be done implicitly or explicitly.[57] Risk transfer to the private sector is implicit in a normal PPP arrangement and is usually directly proportional to the level of responsibility assumed by the private sector. For instance, in a typical DBFO, transfer of the risk of the level of occupancy or usage of the asset is implicit in the PPP arrangement. Also, the degree to which demand risk can be transferred varies depending on the extent to which the public sector directly controls the flow of users and revenue; for example, the difference between schools at one extreme and roads at the other. Explicit transfer of risk may occur in two ways: The first is through the payment mechanism used to pay the private sector for services rendered, the second through contract terms. For example, with respect to the provision of custodial services, the prison operator is paid for "available" prison cells (the payment mechanism) but is specifically penalised in the event of the escape of prisoners (the contract term).[58] An analysis of risk should strongly influence the choice of method of payment and the form of contract.[59] This fact is most vital when allocating demand risk, as evident from the analysis in Chap. 8 of this book.

It is pertinent to note that not everyone agrees that risk transfer to the private sector always leads to positive outcomes. Indeed, it is claimed that

[53] Stephen Ward, Chris Chapman and Bernard Curtis (1991).

[54] See, for example, Li Bing, Akintola Akintoye and Cliff Hardcastle, "VFM and Risk Allocation Models in Construction PPP Projects" in Akintola Akintoye, Champika Liyange and Suresh Renukappa (eds), "Public Private Partnership", CIB TG 72ARCOM Doctoral Workshop 12 October 2011, University of Central Lancashire, UK, p. 16.

[55] See, for example, Hiroaki Yamaguchi, Thomas E. Uher and Goran Runeson (2001) "Risk Allocation in PFI Projects", 17th Annual Conference Salford Vol. 2. pp. 885–894.

[56] Li Bing, Akintola Akintoye, and Cliff Hardcastle, ibid.

[57] Ibid.

[58] Ibid.

[59] Stephen Ward, Chris Chapman and Bernard Curtis (1991).

risk management practices could be highly variable, intuitive, subjective and unsophisticated.[60] A major criticism of the management of risk in practice is that PPP contracts usually involve lengthy and complex contract tendering procedures with a large number of stakeholders participating in the process. Therefore, it is argued that the complex nature of PPP arrangements actually increases public sector risk rather than reducing it, increases service costs for the public and represents a barrier to the entry of small companies, which is patently uncompetitive.[61]

It has also been argued that, in some situations, PPPs are not economically viable for the private sector without exorbitant risk-related service charges, which are saddled on the public.[62] Also, due to the long-term nature of PPP contracts and the changing nature of risks over the term of the PPP contract, there are doubts that parties will be able to fully conceive of all probable risks that will eventuate during the life span of the contract. Therefore, in order to compensate for these unknown risks, the private sector consortium demands high-risk premiums that are eventually transferred to the public in the form of high user fees.[63]

However, despite these criticisms, there is superior literature and arguments as discussed above to the effect that it is more desirable and rewarding to engage in the proper management of risks in PPPs.[64]

## 6.6 Valuation/Pricing of Risk

The steps involved in the valuation of risk are:

- *Identification*: all potential risks that can occur in the context of the project are first identified;

[60] Akintola Akintoye (2001) *Framework for Risk Assessment and Management of Private Finance Initiative Projects*, Glasgow, Scotland, UK; Glasgow Caledonia University, cited also in A. Ng and M. Loosemore (2007).

[61] A. Ng and M. Loosemore (2007); see also William B. Moore and Thomas Muller (1989) "Impacts of Development and Infrastructure Financing", ASCE *Journal of Urban Planning and Development*: 95–108.

[62] Ibid.

[63] Ibid.

[64] See also Darrin Grimsey and Mervyn K. Lewis (2004).

- *Consequence assessment*: the consequence and impact of each of the identified risks is then assessed;
- *Risk probability calculation*: the assessment of the probability of each risk occurring;
- *Contingency factor*: this accounts for the unobservable costs that could lead to the undervaluation of identifiable and observable risks;
- *Value calculation*: the value of the risk is calculated by multiplying the consequence and probability of occurrence, and then adding that product to the contingency factor.[65] Value of risk = consequence × probability of occurrence + contingency factor.

The mechanics for risk's first assumption is that nothing is free. When bidding for a project, the private sector partner, being naturally risk averse, evaluates the risks potentially associated with the project and then estimates their potential impacts on the project. The private sector partner then sets premiums to protect itself from the financial consequences in the event of the occurrence of the risk.[66] The premiums are then averaged across the projects the private sector is involved in, and are weighted according to the probability and consequences of various kinds of events. The risk premium hereby calculated is seen as a form of self-insurance. For the public sector, the basic question is whether the risk premium offered by the private sector is appropriate; that is, whether it is value for money. Where it is considered not to be good value for money, the public sector would assume the risk itself.

In order to assume this responsibility, the public sector needs to have a risk management plan.[67] According to Grimsey and Lewis, the plan involves:

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[65] Dorothy Morallos, Adjo Amekudzi, Catherine Ross and Michael Meyer (2009) "Value for Money Analysis in US Transportation Public-Private Partnerships", *Journal of Transportation Research Board* 2115, Washington, DC, National Academy Press.

[66] See Allyson Pollock and David Price (2004) *Public Risk Transfer for Private Gain? The Public Audit Implications of Risk Transfer and Private Finance*, London: UNISON. In a study carried out on behalf of UNISON, the authors show that the structure of PPP deals obscures the relationship between risk and the risk premiums for two reasons: first, the SPV is merely a shell company and transfers risk to other companies through a variety of complex financial mechanisms, which makes it difficult to assess its value.

[67] Ibid.

- identifying all the project risks, including the general risk (which feature in the risk matrix) and project specific risks (e.g. the risk to public health in a water project);
- determining the core services which are provided by government and in respect of which the risk cannot be transferred to the private party;
- examining each risk and identifying those which government is best placed to manage as a result of the level of control it exercises and those which may otherwise not be optimal to leave with the private party; these should, in each instance, be taken back by the government;
- ascertaining whether any of the remaining risks should be shared because of market convention or specific factors relating to the project; and
- adjusting the risk allocation inherent in the basic PPP adjustment structure and using the contract to reflect that adjustment and allow for any power imbalance between parties arising from special government powers.[68]

It is good practice to design a risk matrix as a framework for the allocation of risk in a project. A risk matrix has two objectives: the first is that it aids optimal risk management and provides the impetus to achieve it because it ensures that the party best able to control the risk is allocated the risk. The second objective is that it ensures value for money,[69] because the party that is best able to assume a particular risk is usually more able to do it at the least cost.[70] It is important to note that these matrixes are merely useful guides and suffer several limitations. This is apparent when viewed against the backdrop of the changing nature of risks throughout the life span of the project. It is therefore advocated that risks should best be considered on a project-by-project basis.[71]

[68] Ibid.

[69] It is common practice to determine whether the value for money requirement has been met by comparing the benefits of financing a project through the use of PPPs or doing so through direct public procurement. This is usually achieved by using a PSC; that is, whether more value for money could have been better achieved if the project were done solely through public sector finance.

[70] Ibid, p. 179.

[71] Darrin Grimsey and Mervyn K. Lewis (2004); A. Ng and Martin Loosemore (2007).

## 6.7 Mitigation of Risks

It is important to note that risk transfer does not eliminate the risk; it only reduces its economic cost.[72] After risk has been allocated to the parties in a PPP, there might still be need for the government to reduce the severity of the risks assumed by the private sector by taking back some of the risks. This is important in order to stimulate the private sector to invest in projects which it would not otherwise have considered for investment. Another reason may be to reduce costs to the private sector and, consequently, reduce tariffs and other burdens on its citizens.

In the first instance, the private sector tries to mitigate some of its assumed risks by taking out insurance policies against them. Those risks that cannot be insured against are inevitably provided for through the use of special clauses in the contract to mitigate their impact. For example, the private sector may protect itself against severe demand risk by insisting that non-compete clauses be inserted into the agreement. However, as already pointed out, these types of contractual clauses, if used indiscriminately, invariably stifle economic and social development. The best solution is for the government either to take back some of these risks, or share them with the private sector. For example, the government may provide the private sector with assurances of minimum revenue guarantees to limit the private sector's exposure to demand risk. There are certain other risk mitigating techniques, most of them suggested by the United Nation's Guide Book on Promoting Good Governance in Public-Private Partnerships.[73] These are public loans, loan guarantees, equity participation, subsidies, sovereign guarantees, tax incentives, viability gap funding, protection from competition, payment mechanisms and annual operating subsidies.

### 6.7.1 Public Loans

The government can offer the private sector loans at very low or zero interest rates. This will lower the project cost. The loans may come as subordinated loans that supplement senior loans obtained from commercial

[72] Rui Cunha Marques and Sanford Berg (2010).

[73] United Nations Economic Commission for Europe (2008).

banks to enhance the financial terms of the project. Also, the loans may be structured in a way that the private sector only becomes entitled to such a loan if certain project risks materialise.

### 6.7.2 Loan Guarantees

The public sector may decide to guarantee the loans of the private sector. This has the effect of lowering interest rates.

### 6.7.3 Equity Participation

Direct or indirect equity participation of the government in the project company has two advantages: such participation strengthens the assurance of the public and other stakeholders about the project, thereby helping the project achieve a better equity:debt ratio.

### 6.7.4 Subsidies

Where the actual cost of providing the service by the private sector is too high and is likely to affect the demand for the service, the government may pay tariff subsidies to the private sector. The payment may be structured in such a way that it becomes payable only where income generated by the private sector falls below a certain minimum level. An alternative way of doing this is to allow private sector operators cross- subsidise one service offerings with another where one route or service in its concessioned network is more lucrative than the others. For instance a service provider may be allowed to charge commercial customers a higher service fee on the condition that poorer private consumers pay lower fees for the same services.

### 6.7.5 Sovereign Guarantees

The government may guarantee the proper behaviour and/or respect for the commitments or obligations entered into by the public sector. The failure of the public sector to respect such commitments or obligations will give rise to a requirement to pay monetary compensation to the private sector. The guarantee may come in the form of an

"off-take guarantee", where the public sector guarantees that it will buy an agreed quantity of the service or product provided by the private sector. This is usual in power purchase agreements where the government or the off-taker agrees to pay capacity payments.

### 6.7.6 Tax Incentives

Government may decide to give tax exemptions, tax holidays, rate reductions, tax abatements or tax credits in order to incentivise the private sector to go into certain businesses into which it would not ordinarily have ventured. The exemptions may also extend to duty waivers, and so on. This provides a cash flow cushion for the investor, which makes the project numbers work better. These tax incentives can be directed at specific financial aspects of the project. The problem with tax incentives in a country that operates a federal system of government, as Nigeria does, is that it is likely there will be conflicts between the national, state and local authorities, who also have autonomy regarding tax within their respective jurisdictions.

### 6.7.7 Viability Gap Funding

This is a capital subsidy provided by the government to make projects which would otherwise not be viable if left exclusively to the private sector to finance. For instance, the government of India has a scheme whereby the viability gap in PPP infrastructure projects is supported up to the tune of 20 % of the cost of the project. In addition, the state government or agencies that own the project are also allowed to contribute an additional grant out of their own budget not exceeding a further 20 % of the cost of the project.[74] Nigeria is currently developing its own viability gap scheme.

### 6.7.8 Protection from Competition

This comes in the form of an assurance given by the government to the private sector investor that it would not develop any competing

[74] Gujarat Infrastructure Development Board "Public Private Partnership" found at <http://www.gidb.org/cms.aspx?content_id=96> (last accessed on 30 March 2012).

infrastructure within a given period within the perimeter of the private sector's asset. For instance, in a toll road project, the government may undertake not to build an alternative road that will compete or undercut the revenues of the private sector. Given the long-term nature of PPP agreements and the likelihood of constant population growth, this may be capable of stifling infrastructure growth and is quite patently anticompetitive. In Nigeria, for instance, the use of this mitigating technique in the financing of the new local airport terminal in Lagos has led to public anger and resentment.

### 6.7.9 Payment Mechanism

Government grants may be combined with a payment mechanism to cover some of the capital cost. This may allow the required user charge to be kept at a level that is affordable to end-users. It may also be useful if the total project funding requirement is larger than the market appetite for funding projects of such nature. This process has been used in light rail projects in the UK and in Gautrain projects in South Africa. Such payments may also be performance linked.

### 6.7.10 Annual Operating Subsidies

The difference between this and capital grants is that the use of subsidies may increase overall project costs, since the project SPV has to fund the entire project cost. Where the government decides to provide any form of guarantee, such guarantee must be provided with absolute care because, if it is misused, the public sector may be inadvertently creating a guarantee culture where the private sector seeks guarantees as an alternative to managing the risk itself.[75] The use of guarantees may mean that the risk previously assumed by the private sector reverts back to the public sector.[76]

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[75] United Nations Economic Commission for Europe (2008).

[76] Ana B. Alonso-Conde, Christine Brown and Javier Rojo-Suarez (2007) "Public Private Partnerships: Incentives, Risk Transfer and Real Options", *Review of Financial Economics*, 16(4): 335–349.

There is also the possibility that the cost and risk of such guarantees are neither transparent nor well understood by the PPP stakeholders.[77] It is also good practice to ensure that, where these guarantees are used, provision should be made for the use of claw-back clauses. These clauses ensure that the private sector gets only the benefits they need to make the project work and ensures that excess benefits are creamed off and given back to the taxpayers. The reasoning behind this is simply the notion that, if risks are to be shared, then benefits should also be shared.

## 6.8 Conclusion

This chapter is important because it provides the foundation on which the remaining chapters of this book rest. It allows for the understanding of the concept of risk generally and then, specifically, in relation to PPPs. First, this chapter engaged in a critical discussion of the definition of "risk". It also looked at the different classifications of risk available in the literature and discovered that they are diverse. These different approaches are all important for the purposes of this work because the different studies analysed in subsequent chapters use either one or a combination of these classifications to discuss their findings. For this reason, a general recognition and understanding of the various classifications is important for the understanding of the discussions to follow.

Another finding in this chapter is that the essence of a PPP is to achieve optimal risk allocation. Under traditional procurement, the risk assumed by the public sector when it owns and operates an infrastructure asset is often unvalued. What PPP ensures through the involvement of the private sector is that the risk is adequately and properly priced, and then transferred to the party that is best able to manage it. The idea that risks should be properly mitigated was also discussed. The chapter examined the various risk mitigation measures open to the public and private sector partners. It was noted that risk transfer does not eliminate the risk; it only reduces the attached economic cost. It was also noted that contractual clauses are the basic instruments for the transfer of risk

[77] Ibid.

in a PPP. This chapter therefore looked at how some of the basic project risks can be allocated contractually.

Finally, this chapter emphasised that the few PPP projects concluded so far in Nigeria have not performed very well. Indeed, one of the major objectives of this work is to discover the reasons for this. Importantly, this chapter provides the benchmark against which the Nigerian PPP programme is assessed in subsequent chapters. This assessment will help discover the reasons for the shortcomings in PPP projects in Nigeria and propose the improvements that can be made.

# 7

# Political Risk

## 7.1 Definition of Political Risk

There is little consensus as to what constitutes political risk,[1] with the occurrence of a new event within the class of political risks possibly changing the definition materially.[2] The definition of political risk may be broadly categorised into four types.[3] The first views political risk from the prism of political events or constraints imposed on a specific industry or firm. In this light, political risks have been defined as "managerial contingencies arising from political events and processes".[4]

Second, political risk has been viewed as arising out of government or sovereign action. In this regard, political risk may be described as "any

[1] Jeffery D. Simon (1982) "Political Risk Assessment: Past Trends and Future Prospects", *Columbia Journal of World Business*, 17(3): 62–71; Mark Fitzpatrick (1983) "The Definition and Assessment of Political Risk in International Business: A Review of the Literature", *Academy of Management Review*, 8(2): 249–254.

[2] Claire A. Hill (1998) "How Investors React to Political Risk", *Duke Journal of Comparative and International Law*, 8: 283–313.

[3] Mark Fitzpatrick (1983).

[4] Stephen. J. Kobrin (1981) "Political Assessment by International Firms: Models or Methodologies?", *Journal of Policy Modeling*, 3(2): 251–270.



G. Nwangwu, *Public Private Partnerships in Nigeria*,
DOI 10.1057/978-1-137-54242-7_7

activity of the state resulting in the reduction of companies' value and capital".[5] It may also be defined in this regard as "arbitrary or discriminatory actions taken by home or host governments, political groups or individuals that have an adverse effect on trade or investment transactions".[6] This category of definitions of political risk has been criticised for looking at political risk only from the angle of negative unwanted consequences of political activity from host governments.

The assumption that political risk is always negative may not be a universally valid assumption as the occurrence of a political risk event may also lead to positive outcomes.[7] As Robock explained, "yet as in the case of other types of risks, political risk can result in gains as well as losses".[8] Haendel supports this position in his definition of political risk as "the probability of the occurrence of some political event that will change the prospects for the probability of a given investment".[9] This perception of political risk is consistent with the general appreciation of risk in this book as having both a negative and a positive effect. An example of how a positive outcome can result from the existence of political risk is given by Kobrin regarding the increase in business for companies involved in the armoured car industry as a result of the political instability in Argentina.[10]

The third category of definitions views political risk in terms of changes in the business environment. According to Robock and Simmonds,

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[5] Sinisa Ostojić and Zeljka Unković, (2011) "Insurance and Management of Political Risk Exposure in Developed Economies and Serbia",*South East European Journal of Economics and Business*, 6(2): 79–93.

[6] Daniel Wagner (1999) "Political Risk Insurance Guide", International Risk Management Institute, Dallas TX; see also Franklin Root (1972) "Analyzing Political Risk in International Business" in Ashok Kapoor and Phillip D. Grub (eds.) *Multinational Enterprise in Transition*, London: Darwin Press; Stephen J. Kobrin (1979) "Political Risk: A Review and Recommendation", *Journal of International Business Studies*, 10(1) (Spring–Summer): 67–80.

[7] Stephen J. Kobrin (1979); Kirt C. Butler and Domingo C. Joaquin (1998) "A Note on Political Risk and the Required Return on Foreign Direct Investment", *Journal of International Business Studies*, 29(3): 599–607.

[8] Stefan H. Robock (1971) "Political Risk: Identification and Assessment", *Columbia Journal of World Business*, 6(4), July–August: 6–20.

[9] Dan Haendel, Gerald T. West and Robert G Meadow (1976) "Overseas Investment and Political Risk", *The International Executive*, 18(1): 11–13.

[10] Stephen J. Kobrin (1979). See also Michel H. Bouchet, Ephraim Clark and Bertrand Groslambert (2003) *Country Risk Assessment: A Guide to Global Investment and Strategy*, West Sussex, UK: John Wiley & Sons, p. 10.

political risk in an international investment exists when three factors are present: (1) when discontinuities occur in the business environment, (2) when they are difficult to anticipate, and (3) when they result from political change.[11]

The fourth viewpoint classifies political risk from an environmental perspective, but differs from the third category because there is no detailed searching for a definition of political risk by proponents of this theme. This faction only acknowledges a source of risk to international business that is generated from the business environment within a host country.[12] This group tends to look at political risk more holistically and their work has led to a new line of literature, which sees political risk as being encompassed in "country risks".

The definition offered by Meldrum is a good exposition of the philosophy of this group.[13] According to the author:

> All business transactions involve some degree of risk. When business transactions occur across borders, they carry additional risks that are not present in domestic transactions. These additional risks, called country risks, typically include risks arising from a variety of National differences in economic structures, policies, socio political institutions, geography and currencies[14]

The argument for looking at traditional political risk in this manner is that it is important to take into consideration all the different sources of political risk, or even risk generally. This is because all the sources of political risk interact with one another and possibly affect all sectors of the economy, if they eventuate.[15]

The success of PPPs depends on a stable political environment. The reason is simply that most countries, particularly developing ones, rely on

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[11] Stefan H. Robock and Kenneth Simmonds (1973) "International Business and Multinational Enterprise", *The International Executive*, 15(3): 5–6.

[12] Mark Fitzpatrick (1983).

[13] Duncan H. Meldrum (2000) "Country Risk and Foreign Direct Investment", *Business Economics*, 35(1), January: 33–40; See also Robert Stobaugh Jr. (1969) "How to Analyze Foreign Investment Climates", *Harvard Business Review*, 47(5), September–October: 100–107.

[14] Ibid.

[15] Michel H. Bouchet, Ephraim Clark and Bertrand Groslambert (2003).

the influx of private capital from overseas to finance infrastructure under PPPs. It makes sense that the private sector will not invest in a country unless it is satisfied that the political environment is conducive for its investments to flourish. If the private sector decides to invest regardless of the existence of political risk, it will usually demand a large premium, whether in the form of guarantees, discounts or larger profit margins for assuming the risk.

The need to ensure the recovery of capital is even more crucial in PPPs than other investments. This is because PPPs are completed primarily through non-recourse financing, where a syndicate of banks and other financial institutions typically provide loans and other investments. Such funds are normally recoverable from the project cash flow and not from any other form of collateral or security from the private sector investor, which is more often than not, a mere SPV. Therefore the SPV, which is often led by financial institutions, will try to ensure that these funds are not at risk.

Like a number of authors, Reside concludes, after an analysis of events affecting many PPP projects around the world, that the single-most important and most influential risk driving project outcome is political risk.[16] Political risk is not always independent of other project risks and is usually positively correlated with other PPP risks. In essence, political risk may be triggered by the occurrence of other project risks and have consequences that include the prompting of subsequent discretionary actions by host governments that put private capital at risk.

In summary, the exercise of political power is the root cause of political risk. Political risk is a significant and amorphous category. It contains virtually all "risks associated with business or investment in a country which would not be present in another country with a more stable and developed business and economic climate and regulatory regime". Some of the components of political risk are currency incontrovertibility and transfer restrictions, expropriation, breach of contract, political violence, legal matters, regulatory and bureaucratic risks, and non-governmental

[16] Renato Reside (2009) "Global Detriments of Stress and Risk in Public-Private Partnerships (PPP) in Infrastructure", *Asian Development Bank Institute Working Paper Series* No.133, available at http://www.en.kyushu-u.ac.jp/aslea/apapers/Global%20Determinants%20of%20Stress%20and%20Risk%20in5asleab4.pdf (last accessed 23 August 2012).

action risks. Investors will avoid countries where there is a high incidence of these factors. This is why it is said that political risks have an impact on a country's development.[17]

For the purposes of this book, the constituents of political risk are defined, as widely as possible, as referring to any action by government, agencies of government or government employees that adversely affect PPP transactions. It is also acknowledged that political risk is very wide in scope; it can range from a revolution in which all foreign businesses are disrupted and eventually nationalised (macro political risk) to a revision of tax law that negatively affects an individual company's profit margin (micro political risks).[18]

Adopting the classification put forward by Tilmann Sachs et al., political risks can be roughly classified under six broad headings:

(A) *Currency inconvertibility and transfer restriction*: This is any action of the host government restricting the conversion and transfer of currency outside the host country.
(B) *Expropriation*: This is any legislative or administrative action from the host government that has the effect of depriving an investor of ownership or control of, or substantial benefit from, its investment.
(C) *Breach of contract*: This is any repudiation or breach of a contract by a host government, when either there is no recourse to a judicial or arbitral forum to determine the claim, or a decision by such forum is not rendered within a reasonable period of time, or such decision cannot be enforced.
(D) *Political violence*: This includes acts of war, civil war, insurrection/civil disturbance, terrorism, sabotage, or landowner and/or indigenous people's disturbance in the host country.
(E) *Legal, regulatory, and bureaucratic risks*: These risks within the administrative process that cannot be directly attributed to any of the previous categories. These include the legal enforceability and execution of laws; conflict of authority; corruption; transparency; the issuing of approvals

[17] Tillmann Sachs and Robert Tiong (2007) "The Impact of Political Risk on Public-Private Partnership (PPP) Opportunities in Asia", *Civil Engineering Research*, 20, ISSN: 0219–0370: 20–23; also available at http://www2.ntu.edu.sg/ResearchPaper/ODR/2006/Impact%20of%20political%20risk%20on%20PPPs%20-%20CEE.pdf (last accessed 13 October 2015).

[18] See Stefan H. Robock (1971) and Jeffery D. Simon (1982).

and consents; a change of government causing changes in law, policy, and taxation; and obstruction during an arbitration process.

(F) *Nongovernmental action*: This category comprises risks over which the government has no direct influence and which do not fall within any of the above categories. They include actions by environmental and union activists, religious fundamentalism, ethnic tensions, and so on.[19]

## 7.2 Theoretical Basis for Political Risk

There is no single principle or theory on which the discipline of political risk rests. The journey in theory building in this area has been one of a compilation of types of non-economic conditions and events—both government and, at times, even societal—as well as internally or externally based events that can affect or influence foreign business activity and profitability in a host country. Jarvis sums up the situation succinctly. According to the author, "most methodological and theoretical approaches to political risk analysis have been discursive and discrete, emblematic of the episodic interest in the area and discipline based research approaches that have tended to produce scattered clustering's of theory".[20]

It is posited that, without a theoretical framework for political risk, even an agreeable definition of the concept will be arduous because it will be difficult to define its ambit. Due to the disparate nature of the risk, there will be a tendency to view each political risk situation as unique to a particular country. A theoretical framework, on the other hand, provides the string that ties the concept together because it makes it easier to identify and bring together recurring patterns and trends of political risk across nations under one umbrella.[21] This will make its forecast, identification, assessment and management easier.

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[19] Tillmann Sachs, Robert Tiong and ShouQing Wang (2007) "Analysis of Political Risks and Opportunities in Public Private Partnerships (PPP) in China and Selected Asian countries: Survey Results", *Chinese Management Studies*, 1(2): 126–148.

[20] Darryl Jarvis (2008) "Conceptualising, Analyzing and Measuring Political Risk: The Evolution of Theory and Method", *Lee Kuan Yew School of Public Policy Research Paper* No. LKYSPP08-004, July, (online), available at http://www.lkyspp.nus.edu.sg/docs/fac/jarvis/Political%20Risk.pdf (last accessed 24 August 2012).

[21] Ibid.

Let us now highlight some of these strands of political risk. First, is the fact that political risk is dependent on certain specific characteristics in a host country. This strand of theory was first championed by Root,[22] who viewed political risk as arising out of the attitudes and behaviour of host governments. He focused on certain country-specific characteristics which affect political risk, some of which were transfer risk (relating to the transfer of funds, products, technology and people), operational risk (relating to uncertainty about policies, regulations and government administrative procedure which could hinder operations) and risk on control of capital (which involves discrimination against foreign firms, expropriation and forced shareholding).[23]

Second, is that political risk is linked to country-specific political events that cause unanticipated discontinuities in the business environment.[24] Some of these sources, according to Robock, include political unrest and disorder, and new international alliances generated by foreign governments or their agencies which led to breaches or unilateral revisions of contracts.[25] This approach has been criticised because it only linked one cause of political risk to a single group through which it can be generated when, in fact, certain risks (such as expropriation or breaches of contract) can arise from different sources and can be generated by a number of different groups.[26]

A third school of thought is that issues such as national interest or national sovereignty are the motivating factors behind a host government's restrictions on foreign business activities.[27] The proponents urged corporations not only to cope with, but also actually to take advantage of a government's move towards nationalistic policies.[28] This is also consistent with the position of Kobrin, who argues that government interference may not always be negative.[29]

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[22] Franklin Root (1972).

[23] Franklin Root (1973) Analysing Political Risks in International Business, in Ashok Kapoor and Philip D. Grub (eds.), *Multinational enterprise in Transition*, Princeton: Darwin Press, cited in Ephraim Clark and Radu Tunau, "Evolution of International Political Risk 1956–2001", (online), available at http://repec.org/mmfc05/paper37.pdf (last accessed 13 October 2012).

[24] Stefan Robock and Kenneth Simmonds (1973).

[25] Stefan Robock (1971): 6–20.

[26] Jeffery D. Simon (1982).

[27] Jean Boddewyn and Etienne F. Cracco (1972) "The Political Game in World Business", *Columbia Journal of World Business*, January–February: 45–56.

[28] Jeffery D. Simon (1982).

[29] Stephen J. Kobrin (1974) "Political Risk: A Review and Reconsiderations", *Journal of International Business Studies*, 5: 51–71.

The fourth approach is the theory based on the principle of relative deprivation. This theory may be linked to the work of Knudsen,[30] who posits that the level of national frustration can be a key determinant of expropriations, with the host government using a multinational enterprise as a scapegoat for the country's problems.[31]

The fifth theory is based on the argument that the type of government affects political risk. While analysing the relationship between modernisation and radical political change, Green classified types of government according to their tendency for radical political change. The assumption here is that the more democratic a government is, the slimmer the chance that it would expropriate (compared with the likelihood of this occurring with new independent states).[32] This theory has been criticised for being rather limited because it ignores other variables that also affect radical political change or irregular turnovers in government, such as ethnic/religious conflict, foreign government intervention economic stress. Also, radical political change is only one type of political risk among many others.[33]

Lastly, the relationship between host and home countries has also been said to affect the political actions and reactions of host countries.[34]

## 7.3 Political Risk Assessment

Studies have shown that most firms do not have any systematic method of assessing political risk.[35] There are different tools that have been used in conducting political risk assessment including forecasting, trend analysis

[30] Harold Knudsen (1974) "Explaining the National Propensity to Expropriate: An Ecological Approach", *Journal of International Business Studies*, Spring: 51–71.

[31] Ibid.

[32] Robert T. Green (1974) "Political Structures as a Predicator of Radical Political Change", *Columbia Journal of World Business*, 9(1): 28–36.

[33] Jeffery D. Simon (1983).

[34] Ibid.

[35] Franklin Root (1968) "US Business Abroad and Political Risk", *MSU Business Topics* (*Winter*), 73–78; Stephen J. Kobrin, John Basek, Stephen Blank and Joseph La Palombara (1980) "Assessment and Evaluation of Non-Economic Environments by American Firms: A Preliminary Report", *Journal of International Business Studies*, Spring–Summer: 32–47; Charles Pahud de Mortanges and Vivian Allers (1996) "Political Risk Assessment: Theory and Experience of Dutch Firms",

and prediction. Mortanges and Allers have categorised the methods of forecasting political risk broadly into qualitative unstructured methods, qualitative structured methods and quantitative methods.[36] Qualitative unstructured methods involve either reliance on the judgment and intuition of managers, or the use of expert opinions. The qualitative structured method is the use of Delphi techniques. This may involve the use of statistical analysis of the opinion of experts; a standardised checklist where managers review all items on the checklist; and, third, the formulation of possible scenarios occurring in a country.

The quantitative method involves the use of data for analysis. This approach reduces the bias of the subjectivity of qualitative methods and increases precision in the analysis. The disadvantage, of course, is that the data that is being used may be out of date, especially where the data originates from a developing country host state.[37]

There is no evidence that any of these methods has yielded desired results because political risk is not easy to predict, due largely to the heterogeneous nature of the risk.[38] The profile and characteristics of political risk is in a constant flux, changing along with world events. For instance, during the Latin American crisis the most feared political risks were nationalisation and expropriation but, recently, with the increasing economic instability in the world compounded by increasing globalisation of markets, currency and exchange control risks are now more prominent in investors' minds.[39]

Most of the literature on political risk identification and assessment is concerned with whether an overseas investor should make an investment in a foreign country. However, in reality, political risk affects not only foreign direct investment but also domestic investments. Besides, it may be overly simplistic to try and draw a clear distinction between foreign investments and domestic investments with the advent of globalisation

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*International Business Review*, 5(3): 303–318; J.D. Simon (1994) "A Theoretical Perspective on Political Risk", *Journal of International Business Studies*, 15(3): 123–143.

[36] Charles Pahud de Mortanges and Vivian Allers (1996).

[37] Ibid; Tillmann Sachs, Robert Tiong and ShouQing Wang (2007) "Political Risk Quantification using Fuzzy Set Approach", *Journal of Financial Management of Property and Construction*, 12(2): 107–126.

[38] Claire A. Hill (1998).

[39] Ibid.

and the global flow and mix of capital. It is thus becoming increasingly difficult to classify the origin of a particular investment as either foreign or domestic. For instance, financing structures of PPPs are often complex, involving investors who hold interest in the project either as equity or as debt financiers. Typically, the investors are a syndicate of banks or lenders from different jurisdictions including the home country. In such situations, it is difficult to classify the capital as either "foreign" or "domestic".

However, this section of the book is not concerned solely with the decision by a firm whether or not to invest in a particular location, but also on the issue of allocation of political risk after the decision to make the investment has been made and how the likelihood of the occurrence of political risks is effectively mitigated.

## 7.4 Political Risk Mitigation

There are a number of instruments available for the mitigation of political risk depending on the nature of the particular risk event. For instance, it is generally agreed that while the first four items listed in the categorisation by Tilmann Sachs et al. (p. 000) are insurable, the other items are not.[40] In the case of the latter, alternative mitigation techniques need to be employed. There are different ways of mitigating political risks some of which are the observance of good project governance and the use of contractual clauses; also, some of the risks can be tackled through the purchase of risk mitigation instruments.

### 7.4.1 Good Project Governance

The bedrock of a good project governance process is the employment of a transparent procurement process.[41] Any "fast track arrangement" favouring a particular firm or bidder may lead to public suspicion of corruption

[40] Ibid.

[41] United Nations Economic and Social Commission for Asia and the Pacific (UNESCAP), Transport Division, *Public-Private Partnership in Infrastructure Development*: *A Primer*, Bangkok, June 2008, p. 79.

and underhand deals. This toxic public opinion may force the hands of host governments, especially successive governments, to nullify the tainted deals in order to score political gains with the public. It is therefore essential that clear and unambiguous rules and regulations should be put in place prior to the commencement of the procurement phase. Such regulations should be strictly adhered to in order to avoid undue benefits accruing to any particular entity.

## 7.4.2 Contractual Clauses

A PPP contract, if properly negotiated, is a good tool for mitigating political risk. Some of the contractual clauses or provisions that may be employed for this purpose are arbitration clauses, multilateral/bilateral investment treaties and free trade agreements, government guarantees, force majeure clauses and stabilisation clauses.

### 7.4.2.1 Arbitration Clauses

The use of arbitration clauses is one of the commonly used contractual remedies. Most disputes arising out of the occurrence of a political risk event are usually referred by the contract to arbitration. More potency may be added to the arbitration clause by the use of a "favourable jurisdiction clause" and the use of a "favourable governing law clause", which may suggest, for instance, the application of a neutral law and jurisdiction for the resolution of disputes between the parties. However, the agreement to refer a dispute to arbitration is itself a contract that can also be breached and is, in most cases, difficult to enforce.

### 7.4.2.2 Multilateral, Bilateral Investment Treaties and Free Trade Agreements

According to the International Institute for Sustainable Development (IISD), there exist approximately 3000 investment treaties, including bilateral investment treaties, regional agreements and investment

protection provisions in free trade agreements.[42] The typical clauses found in an investment treaty are "(a) Clauses providing for rules on indirect expropriation (b) clauses on fair and equitable treatment of foreign investors; and (c) clauses on the protection of investment agreements concluded between a foreign investor and a host country ('umbrella clauses')".[43]

The major advantage of investment treaties and free trade agreements is that a private sector party who suffers or anticipates a violation of its contractual rights under the treaties may have recourse to arbitration through, for instance, the International Centre for the Settlement of Investment Disputes (ICSID), rather than subjecting itself to the courts of the host state.[44] The uniqueness of these treaties is that, even though they are entered into between states, private sector entities can enjoy the benefit of the treaties. These treaties have, however, been criticised for their tendency to limit the sovereignty of host states and may result in reverse discrimination to the detriment of investors who are nationals of a host state as they contain only rights for foreign investors.[45]

#### 7.4.2.3 Government Guarantees

The government may also be compelled by the private sector to issue guarantees to mitigate political risk and reduce the financial cost of the private sector assuming some of the risks. However, guarantees have been criticised because they create contingent liabilities for the government. It has been suggested that providing for impartial arbitration, regulatory independence and/or renegotiation can lower the probability that political guarantees will be called.[46]

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[42] International Institute for Sustainable Development, available at http://www.iisd.org/investment/law/treaties.aspx (last accessed 13 October 2015).

[43] Rudolf Dolzer (2004–2005) "The Impact of International Investment Treaties on Domestic Administrative Law", *New York University Journal of International Law and Politics*, 37: 953–957.

[44] Ibid.

[45] Ibid.

[46] IMF (2006) "Public Private Partnerships, Government Guarantees, and Fiscal Risk", Prepared by a staff team led by Richard Hemming, Washington, DC: International Monetary Fund.

#### 7.4.2.4 Force Majeure Clauses

The creative use of force majeure provisions in contracts may also contribute to the mitigation of political risks. For instance, certain political events, such as strikes by sector unions, may be categorised as a force majeure event, the occurrence of which will bring the contractual relationship between the parties to an end and compel the host government to pay the private sector partner compensation. This device is commonly used in power purchase agreements.

#### 7.4.2.5 Stabilisation Clauses

These clauses are risk management devices used to stabilise the expectations of investors, for instance, preventing changes in the laws from adversely affecting the investment contract during the term of the investment. Depending on which side of the contract you are, stabilisation clauses are either an absolute necessity or outright dubious. For foreign investors, it protects them from sovereign risks in the host states, such as nationalisation, expropriation or an obsolesce deal.

There are different types of stabilisation clauses which, for the purpose of this book, are broadly categorised into three groups. They are freezing clauses, consistency clauses and economic equilibrium clauses. Freezing clauses "freeze" (or restrict) the laws of the host countries by ensuring that the domestic law applicable to the contract is the one in force at the time the contract is concluded to the exclusion of subsequent legislation. Consistency clauses stipulate that it is only the domestic legislation of the host state that is consistent with the investment contract that should apply to the project. Therefore, new legislation will only be applicable to the project if it would not adversely affect the contract. Finally, economic equilibrium clauses permit regulatory changes as long as any adverse effects to the investor are negated, by taking action to restore the economic equilibrium of the project. These clauses link alterations of the terms of the contract to a renegotiation of the contract in order to restore its economic equilibrium or, in the absence of this, to the payment of compensation.

Stabilisation clauses have been criticised for making the public the guarantor or insurer of the private contractors expected revenues and also

clothes private contractors with quasi-governmental status with powers to influence new laws, judicial decisions and other government actions.[47] Thus, these clauses might unwittingly delegate government's constitutional powers to the private sector.

## 7.5 Formal Risk Mitigation Instruments

Risk mitigation instruments come in the form of either guarantees or insurance products. A guarantee contract assures the holder of a debt or other obligation the timely payment of the debt (including principal and interest) when due or if the guaranteed event should occur. If there is a default of the debt service obligation, the guarantor pays the amount due under the guarantee. This is done through a simple guarantee call procedure.[48] An insurance contract, on the other hand, insures payment to the holder of the debt obligation or the equity investor once the insurer evaluates the claim and determines that it is liable.[49] As noted previously, guarantees may be deceptive because they do not demand immediate cash outlays from the government but, rather, the government assumes certain contingent liabilities which, if agreed to recklessly, may unduly burden the country in the future because they often have potentially significant fiscal consequences.[50] It is therefore advised that governments should be especially careful in the use of guarantees because a guarantee may be put to dubious use to bypass imposed fiscal constraints. Due to the discretionary nature of a guarantee, their use can undermine good governance and may lead to a guarantee culture where the private sector seeks guarantees as an alternative to engaging in the proper management of project risks.[51]

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[47] Ellen Dannin (2009) "Infrastructure Privatization Contracts and their Effect on Governance", Pennsylvania State University, The Dickson School of Law, *Legal Studies Research Paper* No. 19. Electronic Copy available at http://ssrn.com/abstract=1432606; Ellen Dannin (2011) "Crumbling Infrastructure, Crumbling Democracy: Infrastructure Privatization Contracts and Their Effects on State and Local Governance", *Northwestern Journal of Law and Social Policy*, 6(1), Winter: 1.

[48] Tomoko Matsukawa and Odo Habeck (2007) "Recent Trends in Risk Mitigation Instruments for Infrastructure Finance: Innovations by Providers Opening New Possibilities", *Gridlines*, Note No. 20, May.

[49] Ibid.

[50] IMF (2006).

[51] Ibid.

Two of the most popular instruments of this type are political risk insurance and political risk guarantees (PRG).[52] These instruments typically cover losses arising from the breach of a host government's contractual obligations to private sector investors. In summary, they cover risks such as expropriation, breach of contracts, sovereign debt default and currency transfer or controvertibly risk. Some of the providers are government export credit agencies (e.g. Export Development Canada, Overseas Private Investment Corporation USA), the World Bank (MIGA) and private insurers (e.g. Zurich, AIG). When multilateral institutions offer these instruments, they are usually complementary to the credits offered to the host countries by these agencies. They have the advantage of upgrading the host government's credit rating and lowering the financing costs of the project because the premium placed on the insured or guaranteed risk by the private sector when pricing the risk is considerably lower.

The disadvantage of these instruments is that they usually have limited coverage. For instance, they do not cover political violence and do not extend to all projects and countries. Thus, it has been suggested, "Risk mitigation instruments are no panacea. However, they will help bridge the gap while a country establishes a sound legal and policy framework that will reduce the risk and even afterwards can support efficient risk sharing."[53] It is therefore obvious that the long-term and most effective mitigation instrument for political risk is the enactment of a sound regulatory framework.

## 7.6 Case Study: Concession of 26 Federal Ports

In 2006, the federal government of Nigeria commenced the reform of the ports sector in the country. That reform has been described as one of the most ambitious port concessioning programmes ever attempted[54] and one of the biggest infrastructure concessioning programmes undertaken

[52] PRG is also used as an abbreviation for a similar instrument called a partial risk guarantee.

[53] Tomoko Matsukawa and Odo Habeck (2007).

[54] PPIAF (2007) "Port Reform in Nigeria", *Gridlines*, Note No. 17, March: 1–4.

anywhere in the world.[55] The reforms in the sector became imperative due to the low level of efficiency existing in the ports, resulting in long turnaround times for vessels and container dwell time, rampant incidence of theft, excessive port charges, over centralisation of decision making in the ports, inefficient labour practices and the lack of funds to develop infrastructure within the ports.[56] Royal Haskoning BV of The Netherlands was commissioned by the Nigerian government through the Ministry of Transport with funds received from the World Bank to advise it on how to resolve these issues. Royal Haskoning presented its report in 2002 (the Haskoning Report).[57] The Report pointed out that the root causes of all these problems was that the ports sector in Nigeria was over-centralised; the Nigeria Ports Authority (NPA) acted as both regulator and operator of port services, and required approvals from the Minister of Transport before carrying out any key operations decisions.

The Report recommended three major institutional reforms of the Nigerian port sector to resolve these issues. The first recommendation was that the Minister of Transport should be primarily responsible for developing broad policies within the sector and no longer be concerned with the day-to-day operations of the ports. Second, that the NPA should be divided into several autonomous ports authorities along geographical zones in line with the location of the ports. Also, it was recommended that the NPA should now play the role of "landlord" of the ports, limiting its functions to ownership and administration of the ports, port planning, the development of port infrastructure, the leasing and concessioning of port land, the development of a tariff policy and the provision of nautical services, such as vessel traffic management. Finally, the private sector should be responsible for actual port operations and services, such as terminal operations, cargo handling, stevedoring, warehousing and delivering, including investments in port infrastructure and equipment, and assume all the commercial risks for operation.[58]

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[55] Ibid.

[56] PPIAF (2007); Royal Haskoning (2002) "Technical and Financial Assessment of the Nigerian Port Sector: Recommendations for Port Reform", Report to the Federal Ministry of Transport, Nigeria.

[57] Ibid.

[58] Arif Mohiuddin (2002) "Technical and Financial Assessment of the Nigerian Port Sector: Recommendations for Port Reform", Report to the Federal Ministry of Transport, PPIAF,

The first two aspects of the reform required some type of legislative backing because the extant NPA Act did not contemplate any of these institutional arrangements.[59] Naturally, the government assumed the duty of putting the appropriate legislation in place and, therefore, the political risk resided with it. The BPE, in conjunction with the Federal Ministry of Transport, engaged consultants to draft new legislation that revoked the existing legislation and incorporated the recommendations of the Haskoning Report. They also drafted a new Transport Sector Policy that was approved by the National Council on Privatisation (NCP). Since 2005, when this Bill was presented to the federal legislature, it has not passed into law despite the various political concessions that have been made by the NCP and the executive arm of government.

It is noteworthy that the existing Port Act did not completely bar the granting of concessions, as the Act permits the NPA to grant leases with the consent of the president for a period not exceeding five years.[60] Based on this provision, the government decided to enter into concession agreements with the different private sector concessionaires. This arrangement was meant to be temporary at the time, as BPE always assumed that the new law would subsequently regulate the relationship between the parties. Indeed, the Concession Agreement signed by the parties defined the word "Act" to mean "the Nigerian Ports Authority Act No.38 of 1999 Cap N126 Laws of the Federation of Nigeria or such other law governing port authorities or port operations applicable to the Port as may supersede or succeed the same from time to time".[61] Unfortunately, no new legislation has been passed by the National Assembly to date.

Despite the relative success of the limited port reforms—such as reduction in the ship turnaround times, elimination of theft and increase in cargo throughput, the concession has created a number of anomalies and confusion in the sector. In the absence of an appropriate enabling

Washington, DC; Peter Kieran (2005) "CPCS Transcom Unleashing Finance and Infrastructure for Africa", 25 April, Reform and Restructuring of Nigerian Ports.

[59] Nigerian Ports Authority Act No. 38 of 1999, Cap N126, Laws of the Federation 2004.

[60] Ss. 25(1) and (2) of the Nigerian Ports Authority Act, CAP. N126, Laws of the Federation of Nigeria 2004.

[61] Article 1.1 of the Lease Agreement.

legislation to regulate the port reforms, the parties have, by and large, been regulated through contract vide the tripartite lease agreements entered into by the NPA, BPE and the private sector concessionaire. Effectively, the NPA now performs the multiple functions of landlord, technical and economic regulator, and other marine functions. This was never the intention of the reforms. The absence of a credible independent regulator has severely diminished the success of the reform project.

The federal government of Nigeria had assumed a number of responsibilities under the lease agreements with the concessionaires which it has not been able to meet. Subsequent government administrations have simply lacked the political will to carry out those covenants entered into by the reforming administration that preceded them. For example, under the concession agreement, it is the duty of the government through the NPA to maintain the berths and all navigational aids within the port and to maintain maritime approaches, canals, turning circles, breakwaters and other ancillary services.[62] Also, Article 9.5 of the Agreement provides that failure to provide pilotage, towage, berthing, unberthing and shifting of vessel services may lead to the throughput fee payable by the lessee to the lessor to be withheld as compensation. Article 9.6 of the Agreement also provides that the lessor (the government) shall be responsible for the dredging of the channel to the port.

The government, in several instances, has not been able to comply with these provisions of the Agreement and consequently has lacked the moral authority to demand compliance from the private sector with its own obligations. For these reasons, it has been difficult for the government to ensure effective regulatory control of the private sector concessionaire.[63]

There is also no independent regulator that would compel the parties to perform their respective obligations. The only option open to the parties to resolve their contractual dispute would have been to activate the dispute resolution mechanisms in the contracts, but the parties have not done this to date. The NPA is not only a party to the agreement, it is also the regulator. This situation, in practice, has led to conflict of interest and

[62] Article 4.4 of the Lease Agreement.

[63] This is the view of government officials interviewed during the course of the semi-structured interviews.

some of the regulatory decisions taken by NPA are said to have been for its own selfish advantage.[64]

Thus, while the executive arm of government in Nigeria, at the time these concessions were agreed, had the political will to carry out the reforms conclusively, it has not been possible to convince the legislative arm to buy into this policy and, therefore, the reform of the ports sector in Nigeria is presently at a standstill. The deficiencies inherent in using the various lease agreements to regulate the entire port sector in Nigeria became very apparent immediately after the signing of the Agreements. There was an increase in the number of regulatory and security agencies flooding the ports; this increased bureaucracy and inefficiency at the ports.[65] This led to a reversal of most of the gains that had earlier been recorded, as it became more expensive and took a longer period of time to clear goods from the ports. The extant regulation did not confer any body with authority to manage these kinds of issue, and it took the intervention of the President who set up a special task force to take care of these problems.

## 7.7 Other Issues with Political Risk in PPP in Nigeria

The case study in the previous section also revealed other pertinent issues that should be tackled in order to ensure the proper management of political risk in Nigeria. Some of these issues and proposed solutions are discussed in this section.

1. Strong political support is imperative for the success of PPP in Nigeria. Privatisation was a relatively successful government policy because of the existence of a "political champion", in the form of the successive vice-presidents who were handed the responsibility under the Privatisation Act. Also, no long-term project can proceed successfully

[64] This is the view of some of the private sector operators of the concessioned terminals obtained from semi-structured interviews.

[65] This information was obtained from the semi-structured interviews. The government had also set up a presidential committee on port decongestion as a result of this.

without the continued support of government. However, it is very difficult to continue to receive this support in Nigeria over the long term, especially after any change in government administration, whether or not the executives are from the same political party. New governments come in with their own policies. Also, the complex and unique sociopolitical context within Nigeria and most of the developing world ensures that subsequent administrations are suspicious of those that preceded them and assume that the previous government might have unduly benefited from any transaction negotiated during the term of that administration.

2. There is a lack of coordination between the different arms of government and the different agencies of government in issuing guarantees, warranties and other commitments to the private sector. This ultimately leads to the nonfulfilment of obligations. The Ministry of Finance recently issued a blanket restriction on the issuance of guarantees. This should contribute to the reduction of the indiscriminate issuing of sovereign guarantees. However, there are fears that the decision might hinder PPP transactions. There must therefore be a means of ensuring that transactions which deserve such guarantees benefit from them.

   A classic example of government authorities entering into obligations unilaterally on matters requiring the consent of another department of government is the warranty by the Federal Airports Authority of Nigeria (FAAN) under S. 2.2 (e) of the Concession Agreement in respect of MMA2, where the agency undertook to give the concessionaire the first right of refusal in event that the BPE decides to privatise the airport terminal. The BPE was not a party to that agreement and so could not have been aware of such obligation. Therefore, in the event of subsequent privatisation of the asset, there is a serious doubt that that the obligation would have been honoured. There is hope that this situation will improve, since the government has 2013 created a central unit within the Ministry of Finance that is charged with the responsibility of tracking government's contingent fiscal obligations in PPP transactions. This will ensure that government is not indiscriminately committed with obligations that it is unable to meet, as well ensuring that, where those commitments are made, appropriate budgetary provisions are provided to meet them.

3. The government agencies usually make "politically correct" decisions to the detriment and success of PPP transactions. A number of projects in Nigeria have failed because government agencies have been too cautious of public perception and therefore refused to take bold decisions for the ultimate benefit of the country. For instance, government agencies have, in some instances, refused to accept lower financial bids from the private sector which were more sustainable in favour of excessive and even outrageous bids that they were probably aware were not sustainable. An example is the various privatisation attempts of NITEL (a government-owned telecommunications company). On several occasions during the privatisation exercise, the winning bids were sometimes over four times the value of government's reserved price, yet the government agency accepted the higher unrealistic bid from unknown inexperienced investors in favour of more realistic bids from more reputable international telecommunications companies. At the end of transactions, the preferred bidders were unable to raise funding to pay for the asset, as the bidders could not justify the viability of their bids to financiers. This apprehension and fear of public perception by government agencies is possibly born out of the lack of trust between the citizens and the government, which has accumulated over the years.
4. Parties to the contract must have a realistic and honest perception of what each of the parties is able to bring to the transaction and therefore ensure that the parties' offers are in tune with the realities on the ground. The government, in particular, must desist from making overambitious promises that it is incapable of redeeming. The result of doing this, as shown from the case study, is that, in situations where the government is unable to fulfil its bargain, it loses the moral right to demand compliance from the private sector.
5. There is need to put in place independent sector regulators. The situation where the government, which is an interested party in the contract too, is acting as regulator does not promote equity and fair play. Government should put in place fair policies and legislation, and also allow independent third party regulators to oversee the relationship between it and the private sector. Several of the transport sector bills pending before the National Assembly, including the National Transport

Commission Bill, had proposed this. The Port Sector Bill also adopts this position. However, these bills are yet to be passed into law even though several years have passed since they were presented to the National Assembly.

6. Corruption is pervasive in the Nigerian public service. This increases the cost of doing business in Nigeria drastically. It therefore becomes very expensive for private sector investors to receive the necessary government support to sustain their business in the long term. This has a tendency of draining profits and, sometimes, the efficiency of the private sector is compromised. This also detracts from the credibility of the process and scares away a number foreign investors.
7. Lack of capacity in the public sector is a major problem in Nigeria and this has usually resulted in the government assuming risks and obligations during negotiations to which it would not ordinarily have acceded if the public officers negotiating on its behalf were better aware at the time. When the government finds out, in subsequent years, that it did not get a fair deal, it is usual for government to renege on its obligations to the private sector and try to force the private sector to renegotiate the terms of the agreement. This has happened in a great number of transactions. The MMA airport concession is before the court for this reason. Also, in March 2012 the Ministry of Aviation and FAAN requested the renegotiation of the Agreement it signed with Maevis Limited, a private sector integrated airport management system provider at the airport because, according to the organisation, it was not making enough money from the contract which it signed in 2007.[66] Despite the issue being before the court, FAAN took forceful possession of the Maevis data centre and transferred operations to another provider. The public authority had, once more, discovered after nearly five years of entering into a contract with the private sector that the terms of the agreement were not favourable and sought forceful renegotiation. The same is the case with the concession between FAAN and I-Cube West Africa, the company that won the concession

[66] Daniel Eteghe (2012) "Concession-FAAN, Maevis Part Ways at Last", *Vanguard* newspaper, 2 April, available at: http://allafrica.com/stories/2012042020725.html (last accessed 13 October 2015).

to manage the FAAN toll gate. Due to the fact that FAAN is trying to terminate the concession, these parties are also before the court asking for the refund of over NGN 2.8 billion, being money paid upfront to FAAN as bank guarantees.[67]

The solution is simply for the government to ensure that it builds up the capacity of its workforce. On the other hand, the private sector should also desist from taking undue advantage of the naivety of the public sector and try as far as possible always to seek equitable "win–win" deals. This is because only equitable deals are likely to be sustainable in the long term.

8. The inadequacy and multiplicity of the federal legislation on PPP is also a major problem. It is a fact that the best method of mitigating political risk is through the enactment of an appropriate enabling legal framework that supports PPP and eliminates loopholes for the manipulation of the system. It is anticipated that, if the issues discussed earlier in this book in relation to the current legal framework for PPPs are addressed, the severity of political risk will be curtailed.

## 7.8 Conclusion

In conclusion, the most effective and sustainable way to deal with political risk is by ensuring the enactment of a legislative framework that will promote a political environment which is conducive to the conducting of business. Such legal framework should create institutions and processes that provide and promote stability and appropriate guarantees to the private sector investor so that the PPP project will not be adversely affected by political decisions that were never contemplated by the investor at the time when the investments were made. Nigeria does not presently have such legislation in place.

Consequently, it is strongly advocated that Nigeria enacts new PPP legislation that will revoke and replace both the existing ICRC Act and the Privatisation Act. A primary purpose of this new law should be the

[67] Kelvin Osa Okunbor (2011) "Aviation Concessionaires, Govt Set for Battle Over Pacts", *The Nation* newspaper, 26 October: 6.

resolution of the conflicting extant legislation and the merger of the two major institutions involved in PPPs in Nigeria; that is, the BPE and ICRC. The existence of multiple laws and institutions is doing more harm than good. Apart from exacerbating confusion in the system, it is also unduly expensive to run both agencies due to the duplication of staff and resources. Furthermore, the efficacy and the legality of the use a policy document to bridge the gap in an enabling legislation is inappropriate. It is imperative that suitable PPP legislation that will match the country's ambitions is developed to boost the confidence of the private sector, both local and foreign, when considering investment in infrastructure development in Nigeria.

# 8

# Demand Risk

## 8.1 Demand Risk and PPPs

Demand volume is one of the principal determinants of project viability. The level of demand from users that a project is able to attract is one of the most significant factors in determining the project's cash flow and, consequently, determines how the project company meets it debt service repayments and returns to shareholders. Indeed, demand risk has been said to be one of the most critical risks facing project partners regardless of the country or the sector.[1] Interestingly, there are claims that demand risk is not perceived as an important risk factor affecting PPPs in Nigeria. Akerele and Gidado argue that Nigeria has a large and increasing population, and so an abundance of skill and natural resources. There will therefore always be a large number of consumers to patronise PPP services.[2]

[1] Norton Rose (2006) *Infrastructure PPP in Asia*, (online), available at: http://ebookbrowse.com/nortonrose-infrastructure-ppp-in-asia-2006-pdf-d5316336 (last accessed 26 November 2012).

[2] Damilola Akerele and Kassim Gidado (2003) "The Risks and Constraints in the Implementation of PFI/PPP in Nigeria"in D.J. Greenwood (ed.), *19th Annual ARCOM Conference*, 3–5 September 2003, University of Brighton, UK, *Association of Researchers in Construction Management*, 1: 379–91, also available at: http://www.arcom.ac.uk/publications/procs/ar2003-379-391_Akerele_and_Gidado.pdf (last accessed on 1 January 2012).



G. Nwangwu, *Public Private Partnerships in Nigeria*,
DOI 10.1057/978-1-137-54242-7_8

This observation is, however, limited by the failure of the authors to make two cogent observations. First, they failed to consider demand risk from an economic perspective; that is, to determine what portion of the large population could afford the services. Second, and more relevant to this work, they failed to consider that consumers may have the option of substitutes. Indeed, most products and services have substitutes and, sometimes, factors outside the control of the private sector service provider determine which substitute the end user patronises. This assertion is even more factual where the substitute is within the control of the public sector, such as the provision of most essential infrastructure-related services. In such cases, the private sector will try to protect the demand for its services, or mitigate the demand risk arising from these external factors. This situation is the more challenging issue with demand risk because, if the private sector does not mitigate the risk, the project will likely fail despite any initial positive projections regarding viability of the project. However, where it mitigates, the measures adopted might distort the initial risk allocation framework, leading to disastrous consequences for the project and, sometimes, even the infrastructure development of the country.

It is an accepted fact of commerce that demand for a product or service is subject to the normal exigencies of trade and therefore will increase or decrease during the lifespan of the business. As this is a natural occurrence, demand risk should be allocated to the private sector. It is a commercial risk that is tied to the operational efficiency of the private sector partner and, besides, the private sectors' feasibility study should have reasonably predicted the demand for the product or service. The private sector would have also factored in such demand projections in preparing its cash flow and other financial projections. However, where demand for a service is affected because of issues external to the private sector or non-natural causes, but within the control of the public sector, the private sector would naturally refuse to assume, or be or be sceptical about assuming, the demand risk. This can happen where, for instance, the government constructs a road duplicating the route of a tolled road, or even renovates, develops or even subsidises other means of transportation to compete with the concessioned road.

The refusal of the private sector to assume demand risk in any of these situations could be considered as proper, because the factors determining

demand for the services have been effectively taken out of its control. This is also contrary to the basic rule for risk allocation that suggests that a particular risk should be allocated to the party in control of the factors that lead to it eventuating. Where the public sector insists on forcing the demand risk on the private sector in these situations, the private sector will protect its revenues by mitigating the occurrence of this risk with "protective" contractual clauses. However, as pointed out, these protective contractual clauses in most instances cause more harm than good for the long-term sustainability of the project.

Consequently, it is a major contention of this book that the foremost problem with demand risk in Nigeria arises where the private sector tries to mitigate the risk by protecting itself from factors outside of its control and market forces. Certainly, one of the high profile disputes relating to PPPs in Nigerian courts, the MMA2 case, confirms this fact.[3] This dispute has adversely impacted on investment and further PPP projects in the Nigerian aviation sector.

## 8.2 Allocation of Demand Risk

The principal means through which demand risk is allocated is the payment mechanism specified in the contract. Using the payment mechanism as a basis for classification, there are two main contract types for delegating public services to private operators. These are contracts where the private sector bears no demand risk, known as "availability" contracts, and those where the private sector bears all or some of the demand risk, known as "user charge" or "concession" contracts.[4]

In availability contracts, services are paid for directly by the public sector procuring agency based on the provision of the services according to

[3] *Bi-Courtney Limited v. Attorney General of the Federation* (unreported), Suit No. FHC/ABJ/CS/50/2009.

[4] Elisabetta Iossa and Daniel Martimot identify three payment mechanisms in PPPs; these are user charges, usage payments and availability payments. The usage payments are technically variants of the user charge and availability payments. See Elisabetta Iossa and Daniel Martimot(2008), "The Simple Micro-Economics of Public-Private Partnerships", Working Paper, available at http://papers.ssrn.com/paper.taf?abstract_id=1318267 (last accessed on 5 May 2012).

contract specifications.[5] The private sector's remuneration is, in this case, directly related to the quality and quantity of services it provides. This, it has been argued, provides less incentive to the private sector to pursue user satisfaction.[6] However, in user charge contracts, the private sector provider of the services sells its services directly to the public and receives remuneration through charges to the end-users. Thus, the private sector's remuneration in this instance is dependent on the demand by the public for the services.[7]

There are also mixed forms of both types of contracts where, for example, end-users pay charges to the private sector contractor in an availability contract; in this case, the private sector collects such user fees on behalf of the government. The second is the use of shadow tolls, which are, in reality, concession contracts. This is because, despite the fact that users do not pay fees in shadow toll contracts, demand risk is borne by the concessionaire as payments to it by the government are dependent on the frequency of the use of the facility. In concrete terms, these mixed contractual arrangements fall into one of the two broad classifications of either concession or user charge contracts, where the demand risk is borne by the private sector, or availability contracts, where demand risk is borne by the public sector. For this reason, subsequent analysis in this chapter will be based primarily on these two broad classifications.

The level of demand for a facility or service is very difficult to predict.[8] It is even more testing under long-term contracts like PPPs. Usually, due to the competitive procurement process typically employed in selecting

[5] This is common in PFI contracts in the UK and *Contrats de partenariat* in France. Several other countries have started to use this contract type exclusively, irrespective of the sector.

[6] Julie De-Brux and Claudine Desrieux (2012) "Public Private Partnerships and the Allocation of Demand Risk: An Incomplete Contract Theory Approach", available at http://extrant.isnie.org/uploads/isnie2012/de-brux_desrieux.pdf (last accessed 13 August 2012).

[7] Laure Athias (2007) "Political Accountability, Incentives, and Contractual Design of Public Private Partnerships", MPRA Paper No. 17,089, available at http://mpra.ub.uni-muenchen.de/17089/ (last accessed 13 October 2015).

[8] For example, so many factors may affect the continued use of a tolled road; for example, a shift in the use of mass transit, an increase in the cost of petrol and the relocation of people from a particular area. While the use of air transport in Nigeria, even locally, depends on economic conditions as, in lean times, passengers are likely to turn to cheaper forms of transport such as buses . This is also true in periods after air mishaps, where people abandon air transportation in preference to other competing means of transport.

a concessionaire, there is a tendency for bidders to be overly optimistic, reckless or even predatory in their estimation.[9] This has led to renegotiations[10] and failure of a number of PPP projects.[11] Due to this unpredictability of demand, the private sector and their financiers are usually wary of participating in projects unless the government pledges guarantees against demand risks.[12] The disadvantage of these guarantees is that concessionaires are able to renegotiate and shift losses to taxpayers whenever they get into financial trouble,[13] or walk away from deals to the detriment of the public.[14] This trend has led to the increased worldwide use of availability contracts, as opposed to concession contracts, as a means of shielding the private sector from demand risks.[15]

However, the widespread use of availability contracts in place of concession contracts does not resolve all the problems due to the fact

[9] HM Treasury (2003) "Green Book, Appraisal and Evaluation in Central Government", London: HM Treasury, p. 85; Mott MacDonald (2002) "Review of Large Public Procurement in the UK", London: HM Treasury; Robert Bain and Jan. W. Plantagie (2003) "Traffic Forecasting Risk: Study Update 2003", London: Standard & Poor's; Robert Bain and Jan. W. Plantagie (2004) "Traffic Forecasting Risk: Study Update", London: Standard & Poor's; Robert Bain and Lidia Polakovic (2005) "Traffic Forecasting Risk Study 2005: Through Ramp-Up and Beyond", London: Standard & Poor's.

[10] Jose M. Viegas (2010) "Questioning the Need for Full Amortization in PPP Contracts for Transport Infrastructure", *Research in Transportation Economics*, 30(1): 139–144.

[11] Jae-ho Choi, Jinwook Chung and Doo-Jin Lee (2010)_ "Risk Perception Analysis: Participation in China's Water PPP Market", *International Journal of Project Management*, 28(6): 580–592.

[12] For instance, in Chile, in nine out of ten highways franchised, the government provided a guarantee that the revenue will equal 70 % of the construction and maintenance costs. See E.M.R.A. Engel, R.D. Fischer and A. Galetovic (2001) "Least Present Value of Revenue Auctions and Highway Franchising", *Journal of Political Economy*, 109(5): 993–1020.

[13] For instance, in Spain, where three firms went bankrupt as a result of traffic projections being less than one-third of original projections, government permitted toll increases and term extensions. Also, in Mexico most of the concessions were renegotiated after cost overruns and low revenues at the cost of US$6 million to the government. See E.M.R.A. Engel, R.D. Fischer and A. Galetovic (2001).

[14] This might not necessarily lead to a loss to the private sector as the private sector may be paid reasonable compensation for transferring the asset back to the public sector. See, for instance, Elisabetta Iossa, Giancarlo Spagnolo and Mercedez Vellez (2007) "Best Practices on Contract Design in Public-Private Partnerships", Report Prepared for the World Bank available at http://www.gianca.org/papersHomepage/Best%20Practices%20on%20Contract%20Design.pff (last accessed 19 November 2012).

[15] Laure Athias (2007) "Political Accountability, Incentives and Contractual Design of Public Private Partnerships: Demand Risk on Private Providers or Public Authorities", available at http//mpra.ub.uni-muenchen.de/10,538/1/ATHIAS_Political_accountability_dec.pdf (last accessed 13 October 2015).

that PPPs are incomplete contracts. The argument for the use of availability contracts is that due to their long-term nature, PPPs are basically based on ex post unanticipated adaptations, rather that ex ante screening.[16] This therefore makes it nearly impossible to predict the demand for a service throughout the duration of the contract term, or to write verifiable objectives into the contract for all possible contingencies occurring during the life span of the contract. The argument, therefore, is that it is better for the government to bear the demand risk, since it is difficult to determine at the beginning of the contract. Also, this situation encourages the renegotiation of contracts where the demand risk is borne by the private sector, which portends some negative consequences.

However, despite this argument, it is a fact that where the government bears the demand risk, it leads to the exertion of lower effort by the private sector. This is consistent with the theory that the incentive of a party to be efficient is weakened when it does not bear demand risk in incomplete contracts.[17]

## 8.3 Incomplete Contract Theory

The origin of incomplete contract theory can be traced to the theory of the firm. A 21-year-old undergraduate student of the London School of Economics had asked a simple question on why transactions still took place between firms despite the market being an efficient method of resource allocation? In other words, his question was that if the price mechanism was so good at allocating resources, why did firms still exist?[18]

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[16] Patrick Bajari, Stephanie Houghton and Steve Tadelis (2006) "Bidding for Incomplete Contracts: An Empirical Analysis", National Bureau of Economic Research Working Paper available at http://www.nber.org/papers/w12051.pdf?new_window=1 (last accessed 13 October 2015).

[17] Laure Athias and Raphael Soubeyran (2012) "Demand Risk Allocation in Incomplete Contracts: The Case of Public Private Partnerships", *Conference on Economics PPPs*, IESE, Barcelona, 20–21 April, available at http://www.iese.edu/en/files/20_Athias_tcm4-80532.pdf (last accessed 13 October 2015).

[18] Philippe Aghion and Richard Holden (2011) "Incomplete Contracts and The Theory of the Firm, What Have We Learned Over the Past 25 Years", *Journal of Economic Perspectives*, 25(2), Spring: 181–197.

This question was later further explored in his essay written in 1937 raising questions about the boundaries of the firm.[19]

Williamson[20] tried to answer this question through the use of the transaction cost theory, which is based on the principle that market transactions can become very costly when agents have to make relationship-specific investments.[21] For instance, when a strong bilateral interdependence exists in a relationship, vertical integration enables one of the parties to protect its investments against the potential hold-up that the other party's opportunistic behaviour could generate due to the fact that the contracts are incomplete.[22] The concept is predicated on the tripod that parties to trade fear opportunistic behaviour, that insufficient contractual safeguards against such opportunistic behaviour can result in inefficient levels of investment from parties, and that avoidance of such inefficiencies provide a key element in the boundaries of the firm.[23] Williamson later shared a Nobel Prize in 2009 for his work relating to this theory.

However, Williamson's theory raised further questions: The first is whether there are no costs to vertical integration as opposed to just benefits that could explain why firms have boundaries? Second, why were all transactions not taking place within a single firm?[24] In 1986, Grossman and Hart answered this question and also extended transaction cost theory by using the theory of incomplete contract to explain the benefits of vertical integration to a firm.[25] According to them, economic actors are only boundedly rational and cannot anticipate all possible contingencies; therefore, it is possible that certain states of nature or actions cannot

[19] Ronald Coase (1937) "The Nature of the Firm", *Economica*, 4(16): 386–405.

[20] Oliver Williamson (1985) *The Economic Institutions of Capitalism*, New York: Free Press; Oliver Williamson (1991) "Comparative Economic Organization: The Analysis of Discrete Structural Alternatives", *Administrative Science Quarterly*, 36(2): 269–296.

[21] Philippe Aghion and Richard Holden (2011).

[22] Eric Brousseau and M'hand Fares (2000) "Incomplete Contracts and Governance Structures: Are Incomplete Contract Theory and New Institutional Economics Substitutes or Complements?" in Claude Menard (ed.), *Institutions, Contracts, Organisations, Perspectives from New Institutional Economics*, Aldershot: Edward Elgar Publishing.

[23] Bruce R. Lyons (1996) "Incomplete Contract Theory and Contracts between Firms: A Preliminary Empirical Study", *Centre for Competition and Regulation* Working Paper, CCR 01-1.

[24] Philippe Aghion and Richard Holden (2011).

[25] Sanford J. Grossman and Oliver D. Hart (1986) "The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration",*Journal of Political Economy*, 94(4): 691–719.

be verified by third parties before they arise and thus cannot be written into an enforceable contract—that is, these contracts are incomplete.[26] Subsequently, incomplete contract theory has been extended and is used extensively for analysing economic efficiency in relationship-specific investments like PPPs.[27]

There are no clear definitions of incomplete contracts.[28] An incomplete contract has, however, been defined as one whose contractual obligations are observable to contractual parties but not verifiable ex post by third parties—typically, say, a judge or arbitrator to whom parties might eventually refer to when controversies arise.[29] A complete contract is therefore one for which the list of conditions on which the actions are based is expressly exhaustive.[30] Care must be taken to emphasise that there are slight dissimilarities between the nature of the incompleteness referred to by the economist and the perspective from which a lawyer would view an incomplete contract. While an economist views a contract as being incomplete or complete from an efficiency viewpoint, a lawyer looks at an incomplete contract strictly as one which has gaps regarding the obligations of the parties. Robert Scott and George Triantis aptly analyse this difference thus:

> The incompleteness of a contract has a different meaning to an economist than to a lawyer. To a lawyer, a contract may be incomplete in failing to describe the obligations of the parties in each possible state of the world. Should a State of the world materialize that falls within the gap, the enforcing court must choose either to decline to enforce the contract or to fill the gap with a default obligation. Economists use incompleteness in a different sense. A contract is incomplete if it fails to provide for the *efficient* set of obligations in *each* possible state of the world. Such a contract is

[26] Philippe Aghion and Richard Holden (2011).

[27] Ibid.

[28] See Patrick Schmitz (2001) "The Hold Up Problem and Incomplete Contracts: A Survey of Recent Topics in Contract Theory" *Bulletin of Economic Research*, 53(1): 1–17.

[29] Antonio Nicita and Ugo Pagano (2002) "Incomplete Contracts and Institutions" in Fabrizio Cafaggi, Antonio Nicita, Ugo Pagano (eds.), *Legal Ordering and Economic Institutions*, London: Routledge, p. 145.

[30] Ibid.

> "informationally incomplete" even though it is "obligationally complete" in the sense that it does not contain any gaps.[31]

Incomplete contracts can either be exogenous or endogenous. Exogenous incomplete contracts are unverifiably independent of the parties' actions, while endogenous incomplete contracts refer to the idea that the degree of unverifiability could also be determined explicitly by contracting parties who may deliberately decide to leave unspecified some essential contractual terms in the presence of uncertainty. The distinction between exogenous and endogenous incomplete contracts is important because it shows clearly the distinction between opportunism and adaptation, which are central to incomplete contract theory. According to Antonio Nicta and Ugo Pagano, when the degree of unverifiability is exogenous, it weakens the probability that parties will achieve a contractual agreement in the first instance, given that at least one party could be exposed to a counterpart's post-contractual opportunism at the renegotiation stage (opportunism). Second, when parties explicitly agree on the degree of unverifiability, it may support contract formation and encourage the parties' performance (adaptation).[32] The reasons for the unverifiability of these contractual terms may be due to circumstances such as parties' bounded rationality, uncertainty concerning events and high transaction costs incurred in writing the contract, and so on.[33]

## 8.4 Incomplete Contract Theory and Demand Risk

Incomplete contract theory has been used to analyse PPP contracts because, under such contracts, public authorities cannot fully specify the quality of services provided by the private sector; neither can they write verifiable objectives for all possible contingencies occurring in the long

[31] R.E. Scott and G.G. Triantis (2005) "Incomplete Contracts and the Theory of Contract Design", *Case Western Law Review*, 56(1): 1–15. Electronic copy (online) available at http://law.bepress.com/uvalwps/olin/art23 (last accessed 6 October 2012).

[32] Antonio Nicita and Ugo Pagano (2002).

[33] Ibid.

run. Using incomplete contract theory as a basis for analysis, the point which is made here is that, due to the fact that long-term PPP contracts are incomplete, without a process for renegotiation, parties try to protect themselves by requesting guarantees and other incentives for situations not covered by ex ante agreements. These guarantees, instead of eliminating the risk, merely transfer it to the other party, thereby distorting the initial risk allocation framework.

PPPs involve a degree of asset specificity, which creates a lock-in effect against the private sector party once it has made the investments for the provision of infrastructure. This exposes the private sector to economic dependency.[34] This lock-in effect generates the risk of opportunistic behaviour by the public sector;[35] this leads to the first hold-up problem.[36] It is these risks of asset specificity and the likelihood of opportunism that would prevent the private sector from investing in a particular project without proper assurances. The private sector usually seeks protection from the likelihood of hold-up or opportunistic behaviour by demanding the insertion of protective clauses in the contract. When the government consents to these clauses, the demand risk shifts to the public sector party with the government bearing the risk of being the victim of the opportunistic behaviour of the private sector, leading to the second hold-up.

Using the analogy of Antonio Nicta and Ugo Pagano, these mitigation clauses transfer all the ex post bargaining power to the private sector party.[37] The party that bears the demand risk usually has more hold-up

[34] The degree of asset specificity is defined as the degree to which an asset cannot be redeployed to alternative uses and by alternative users without sacrifice to productive value; see Antonio Nicita and Ugo Pagano (2002).

[35] Ownership of the asset matters when contracts are incomplete because the owner has residual control rights. Since the government owns the PPP asset, it makes all decisions concerning the asset not included in the contract; for instance, it can build another road to compete with an existing toll road managed by the private sector. See O. Hart (2003) "Incomplete Contracts and Public Ownership: Remarks, and an Application to Public Private Partnerships", *Economic Journal*, 113(486): C69-C76.

[36] Hold-up occurs, for example, when parties renegotiate the incomplete contract. During renegotiation, the party in the better position is the one who can potentially hold-up the other party and therefore obtain better pay-offs or better conditions. See, for example, S. Ping Ho and Chun-Wei-Tsui (2009) "The Transaction Cost of Public-Private Partnerships: Implications on PPP Governance Design", available at http://www.academiceventplanner.com/LEAD2009/papers/Ho_Tsui.pdf (last accessed 13 October 2015).

[37] Antonio Nicita and Ugo Pagano (2002).

opportunities. This is the conundrum that PPPs face, especially in relation to demand risk. This is in line with the position of Williamson, that inefficiencies that lead to incomplete contracts occur where investments have to be made regarding specific assets and at least one agent in the investment contract is opportunistic.[38]

While it is not possible to draw up a complete contract that deals with demand risk because of its unpredictability, a detailed contract nevertheless also comes with some disadvantages. It is more likely to reduce opportunism but will inhibit future efficiency, leading to possible future renegotiation of the contract. In designing a framework for demand risk allocation and mitigation, the task is therefore to provide a structure that provides the private party appropriate safeguards against the initial opportunism of the public sector without unwittingly shifting contractual dependency, or the risk of it, to the public sector at a future date.

## 8.5 Concession Contracts versus Availability Contracts

There are advantages to be gained from the use of concession contracts over the use of availability contracts. The reason for this is that in concession contracts the private sector has more incentive to take users' satisfaction into account, as this will influence the number of people using its service and therefore lead to the increase of its revenue. It is also argued that it will motivate the public sector to be more responsive to public demands, as the consumers are better empowered.[39] The consumers have the power to oust the private sector provider by refusing to use the service, depending on the availability of alternative options. It is believed that this will compel the private sector to better innovate and therefore increase the quality of service provided.[40]

However, the consequence of the use of concession contracts is that the private sector will always try to protect its investment and ensure

[38] Oliver Williamson (1985).

[39] Laure Athias (2007).

[40] Julie De-Brux and Claudine Desrieux (2012).

that the actions of the public sector do not negatively affect the demand for its services and, therefore, its revenue. For instance, in a road project it might be disastrous to the private sector's projected revenue in situations where the government decides to build an alternative road close to a private sector operated tolled road; this will certainly drive demand away from the tolled road. For these reasons, the private sector concessionaire will ensure the insertion of safety clauses in the contract like "non-compete", "demand guarantee" and "compensation events" clauses. These clauses have potentially serious consequences for the government.

It has been suggested in some quarters that these clauses have the effect of making the government the insurer and guarantor of the earnings of the private sector, and destroys competition and consumer choice.[41] More disturbing, however, is the likelihood that these clauses may stunt economic growth and even lead to stagnation in the development of infrastructure in a country. For instance, the net effect of the use of these clauses might be to forbid the government from the building of competing infrastructure near the location of the private sector managed facility in order to guarantee the revenue streams of the private sector. In a country like Nigeria, where the population continues to grow rapidly and where the government is ambitious in achieving rapid economic growth, this may become a major issue following the end of the concession, as the citizens could be left with obsolete infrastructure, unless government is willing to breach its agreement with the private sector.

In the majority of PPP transactions to date in Nigeria, there has been a preference for the use of concession contracts over availability contracts. For instance, the MMA 2 BOT contract under study in this chapter is a concession contract. Apart from the lack of government funds to pay the private sector if the availability contract model were chosen, the other reason for the use of the concession model in Nigeria is that PPPs have been sold to the citizens with the erroneous, or even on occasion somewhat rather deceptive, notion that the government is not going to pay for the asset or contribute in any way, and therefore

[41] Ellen Dannin (2011) "Crumbling Infrastructure, Crumbling Democracy: Infrastructure Privatization Contracts and Their Effects on State and Local Governance", *North Western Journal of Law and Social Policy*, 6(1), Winter: . 47.

it becomes politically expedient to transfer all risks, especially demand risk, to the private sector.

It is obvious that availability contracts and concession contracts each have their advantages and disadvantages. The nature of the project should ultimately determine the choice of the demand contract that is entered into by both parties and, therefore, who bears the demand risk. There is a consensus that availability contracts should be used when there cannot be revenue receipts from the users of a facility, or where the government is in control of the demand for the facility—such as a prison or school, for instance. It is the government that determines the number of inmates that are sent to prison and the specific prison to which particular inmates will be sent. However, it is argued that availability contracts should also be used in certain instances where the use of concession contracts will whittle down the powers of the government to continue to provide for its citizens due to the insistence of the private sector for the insertion of certain risk mitigation clauses into the contracts.

If we follow the basic rule that the party in control of an event should bear the risk arising from that event because that party is likely to make more effort to prevent the risk from eventuating then, in determining who should bear the demand risk, it follows that the party responsible for control of the demand for the service should shoulder the risk. For instance, it would be ineffectual to ask the private party to bear demand risk in a prison or school PPP where usage mainly reflects government policy in the sector. Also, certain types of transactions, especially where the welfare of the citizens is paramount, should be undertaken through availability contracts, while other transactions, where there are credible user alternatives, can be undertaken through concession contracts. Where, however, the public authority is insistent on using concession contracts, then it must ensure that its use does not stunt the economic development of the country, or fetter its right to provide adequately for its citizens.

The position discussed in the preceding paragraph goes to the root of the proper pricing of risk and the value for money question in PPPs. If the consequence of the private sector assuming the demand risk is properly priced at inception, including the social and political costs, then the public sector would be in a better position to make an informed decision

on whether it is able to bear the consequences of its decisions, or even be able to make contingency arrangements where that is possible. In essence, the public sector should be more realistic and better informed in determining whether it is cost effective and whether value for money is served by allocating demand risk to the private sector.

The case study that follows determines how demand risk has been treated in PPP contracts in Nigeria by analysing the MMA2 concession. This project was chosen because it was the first major BOT project in Nigeria, and also because of the multitude of disputes and court cases that have emanated from that single transaction. The question asked is whether these disputes would have arisen if the demand risk in the project was handled differently?

## 8.6 Case Study of the Concession of Murtala Mohammed Airport, Terminal 2 (MMA2)

Since the commencement of operations of the MMA 2 local airport in Lagos, there have been at least five suits in court that have directly questioned the legality of the concession, or the duration of the concession, or breach of the concession contract. A number of the suits have been filed by either the public sector (the Ministry of Aviation) or private sector partners (Bi-Courtney Limited) (BCL) against each other, or by FAAN, the sector regulators, against BCL (the concessionaire). Others suits have been instituted against BCL by the private sector users of the airport (Arik Air, a local airline), as well as the worker's union at the airport.[42] What was supposed to have been the first major PPP project in Nigeria in

[42] *Tell* Magazine, Tuesday 26 June 2012. Some of the major cases which are all reported in *This Day* newspaper, Wednesday, 31 October 2012 are *Bi-Courtney Limited v. Attorney General of the Federation* (unreported), Suit No. FHC/ABJ/CS/50/2009; *Ojemaie Investments Limited (Claiming as Landlords to Arik Air) v. Bi-Courtney Limited* (unreported), Suit No. CA/A/141/M/2009; *Safiyanu Dauda Mohammed and National Union of Air Transport Services, Air Transport Services Senior Staff Association of Nigeria (ATSSAN) v. Bi-Courtney Limited* (unreported), Suit No. CA/A/141/M/09 (This was an action filed by the workers union); *Arik Air v Bi-Courtney Limited*; *The Federal Airport Authority of Nigeria v. Bi-Courtney Limited & Anor.* (2011) LPELR 19742 (CA) pg.1–57; Suit No: CA/A/239/M/2010 and *Attorney General of the Federation v. Bi-Courtney Limited*, reported in *This Day* newspaper, Wednesday, 31 October 2012.

the transport sector and an advertisement of the readiness of the country to embrace PPP has not worked. With pending lawsuits, the business environment will be uncomfortable, particularly if the decisions favour the private sector partner.[43] With 31 years left on the concession term, the private sector partner will have to continue to deal with an upset partner (FAAN) that happens also to be the regulator of the aviation sector.[44]

It is submitted that the majority of the law suits, disputes, or issues regarding the concession can directly or indirectly be tied to the allocation and management of demand risk in the project. It is further argued that, if the demand risk in this project had been better allocated and managed, it would have led to better project performance and the majority, if not all, of the suits would not have arisen.

### 8.6.1 Project Background

The government entered into three agreements with BCL—the concessionaire—within a period of less than four years. The original agreement was a BOT Agreement signed in April 2003 between FAAN and BCL for a period of 12 years. A supplementary agreement was signed in June 2004 that mainly increased the construction period from 18 to 33 months after the slow pace of work had meant that the earlier agreed construction period was no longer realistic.[45] A third agreement, the Addendum Agreement, was signed in February 2007 and extended the concession period from 12 to 36 years.

Operations commenced at the airport terminal in May 2007. By 2011, the relationship between the public sector and the private sector partners had degenerated to the extent of multiple court cases, legislative hearings and press wars. In summary, it is the case of the government that the concessionaire, BCL, has not remitted to the government the concession fee

[43] The trial court and the Court of Appeal have already decided in favour of the concessionaire. It is possible that FAAN might appeal further to the Supreme Court.

[44] This already manifesting, as there are suspicions that the cancellation of the Lagos– Ibadan road concession granted previously to Bi-Courtney Limited (the concessionaire of MM2) by the government and the subsequent prosecution of the majority shareholder of the company for money laundering is as a result of the dispute.

[45] See the recital to the Supplementary Agreement.

or rent for the use of MMA 2 (which is 5 % of the concessionaire's turnover) as stipulated in the Agreement. Also, the concession is for a period of 12 years and not 36 years (as claimed by the concessionaire) because the Addendum Agreement between the parties which increased the duration of the concession to 36 years was not approved by FEC in line with the mandatory provisions of the ICRC Act. According to FAAN, as at 2012, BCL owes the government US$6.7 million, being 5 % of the concessionaire's annual turnover.

The concessionaire's case is that the concession from the government, which is for 36 years, bars FAAN from renovating or operating any other terminal within Lagos State and that this includes the General Aviation Terminal (GAT), which is a second terminal located a few metres from the MMA2 terminal under concession. Consequently, BCL argues that FAAN is currently operating the GAT terminal in breach of restrictive covenants in the Concession Agreement with the government not to do so, and that this is impacting negatively on its revenue streams because the action of the government agency is drawing demand away from the MMA 2 terminal. Therefore, the concessionaire contends that the government owes it US$73 million, being proceeds from the operation of the GAT.

### 8.6.2 Analysis and Findings

It is evident from the history of contractual negotiations and renegotiations on this transaction that the parties had probably not carried out thorough feasibility studies on the project, otherwise there would not have been any need for the subsequent two renegotiations of the duration of the contract just three years after signing the initial agreement.[46] It is safe to assume that the reason for the subsequent final Addendum Agreement of February 2007 was due to the realisation that the level of demand (and therefore revenue) accruing to the private sector would be insufficient to enable BCL to recover its costs and make sufficient profits within the

[46] It is claimed in some quarters that KPMG recommended the extension of the term of the concession for 36 years, in order to allow the concessionaire to recover its investment. See *Tell* magazine (2012).

initially agreed 12-year period. This is presumably why the duration of the concession was subsequently increased to 36 years amidst speculation that recurrent renegotiations were made possible by undue political influence, collusion and corruption in the procurement of the project.[47]

While conceding that demand risk is difficult to predict, the margin of difference between the term of the concession in the initial contract and that in the subsequent amended Addendum Agreement is considerable (24 years). Despite this accepted difficulty in accurately predicting the demand for the use of these types of services, it is submitted that, if the parties had seriously conducted a demand and revenue analysis of the project prior to completing the transaction, they would have been able to determine, in closer and more realistic terms, the number of years it would take to recover sufficient revenue from the project. Contract duration in this type of case should be determined with the primary purpose of providing appropriate investment incentives. The duration of the contract must therefore always have a correlation with the future certain payments and the funds invested in the project by the private sector partner.[48] The residual value of the asset may also be taken into consideration. It is unacceptable that a second feasibility study would determine that an initial study had not accounted for two-thirds of the period it will take the private sector to recover its investments.

### 8.6.3 The Allocation and Mitigation of Demand Risk

The payment mechanism under the contract was the "user charge" or concession model, as opposed to the availability payment model. Based on our prior analysis, this means that the demand risk under the contract was transferred to the private sector partner, BCL. Article 11 of the concession agreement reinforces this fact. Article 11.1 of the agreement provides that:

[47] Editorial, "Power Tussle Over MMA2" *Vanguard* newspaper, Monday 11 August 2013: p. 11.

[48] Note that it may also be argued that there is an inverse relationship between the service charge and the duration of the concession contract; that is, the lower the service charge, the longer the concession.

> The Concessionaire shall throughout the Concession Period be entitled to collect from the Users of the Terminal and retain for its benefit all revenue accruing from specified sources of income ceded to the concessionaire by FAAN.

Article 11.2 goes on to specify the charges that are ceded to the concessionaire as:

(a) passenger service charge collectible from departing passengers including avio-bridge charges;
(b) VIP lounge(s) usage charge;
(c) car park charges;
(d) rents/concession franchise fees;
(e) service charge payable by concessionaires within the Terminal;
(f) advertisement royalties payable by advert concessionaires within the Terminal excluding advertisements along the roads; and
(g) associated revenue derivable from the use of associated facilities in the Terminal

Article 11.4 allows the concessionaire to put in place such tariff/charge collection mechanism or system as it may deem expedient, and to engage any person or entity to collect the said tariff/charge on its behalf.[49] These provisions unequivocally allocate the demand risk to the private sector.

Article 2.2 deals with the mitigation of demand risk in the contract. It provides that:

(a) Save as otherwise provided in Articles 17.4 (rights of lenders) and 20.2 (Assignment by concessionaire) the concession granted to the Concessionaire pursuant to this Agreement is exclusive. The Grantor shall ensure that no part of the concession shall be granted to any other party unless the Concessionaire is in breach of its obligations under this Agreement that would give rise to a right of termination by the Grantor under Article 17 or is in breach of Nigerian Law in relation to the Concession

[49] Article 11.4 of MMA 2 Concession Agreement, 2003.

(b) The Grantor guarantees and assures that it will not build any new domestic terminal in Lagos State and that no existing domestic terminal will be materially improved throughout the Concession Period that would compete with the Concessionaire for the same passenger tariff. Provided that the Concessionaire shall have the right of first refusal in the event that the passenger traffic during the Concession Period necessitates an expansion of the Terminal and the first right of consideration if the Grantor elects to build a new domestic terminal in Lagos State.
(c) The Grantor further guarantees and assures that all scheduled flights in and out of FAAN's Airport in Lagos State shall during the Concession Period operate from the Terminal
(d) FAAN further assures and guarantees that it shall not during the Concession period cause or authorise the erection or development of a shopping mall or any facility(ies) within 200 m from the perimeter of the Site capable of impeding and or threatening the Concessionaires revenue generation
(e) In the event that the Grantor decided to privatise or otherwise dispose of FAAN or the Terminal the Concessionaire shall have the right of first refusal to acquire the Terminal or any other aspect of ownership or right created by the privatisation process under the Public Enterprises (Privatisation and Commercialisation) Act 1990 or any other enabling statute to this effect.

It is clear from this that BCL, having assumed the demand risk under the contract, had tried to protect its revenue stream through the use of guarantee and non-compete clauses. First, the agreement bars the government from building any domestic terminal in Lagos and also implied that the GAT, which was in disrepair at the time of the concession, would not be repaired. If, however, due to congestion, the government decides to build another airport terminal, then BCL should have the first right of refusal to build the terminal. The net effect of these clauses is to ensure that, for the duration of the concession, the government is prevented from improving the airport infrastructure in Lagos State, the country's commercial centre. The only other option would be to request the concessionaire to build another airport if the government can show proof

that MMA2 is congested. This is a win–win situation for the concessionaire because it has effectively secured a second project without going through any form of competitive bidding. The alternative option for the government is not to improve the aviation infrastructure in Lagos State for the duration of the concession period. This is despite the likelihood that the state would soon require an additional airport due to the increase in population. The contract also ensures exclusivity for BCL for any flight leaving Lagos state and for other infrastructure (such as shopping malls, hotels or any facility) near the airport.

It might be conceded that, at the time the initial contract for 12 years was negotiated, the danger of an elongated period of being restrained from developing other facilities would not have been very obvious to the public authority because of the relatively short duration of the contract. However, the public authority ought to have looked at the contract in its entirety when the contract was renegotiated for an additional 24-year period, and should have appropriately priced the risks and benefits of increasing the contract duration. From the transaction documents, especially the reports written by the consultants justifying the increase in the length of the concession and the recital to the Addendum Agreement, it can be deduced that the increase was justified solely on the basis of cash flow and the fact that the construction phase of the contract had taken longer than expected. There was neither costing of the ancillary benefits that are likely to accrue to BCL as a result of the renegotiation of the length of the agreement, including the possibility that it would be entitled to build an additional terminal in Lagos State without competition from other investors, nor consideration of the issue of whether the project still provided value for money for the public sector. Simply, the additional social costs to the public sector and the country were neither considered nor evaluated.

## 8.7 Recommendations for Future Application of Demand Risk in Nigeria

In allocating demand risk in infrastructure projects, parties to PPP contracts, particularly public authorities, must not tie themselves to the use of concession contracts, as was the case in the MMA 2 airport project

and a number of other PPP concessions, to the exclusion of availability contracts. The decision to use either of the two options must be predicated on sound project evaluations. Regarding the MMA 2 project, it is believed that a number of the existing disputes surrounding the project would not have arisen if the availability contract model had been used instead of the concession model.

Several studies have proved that it is erroneous to assume that either contract type is better than the other.[50] The key is to understand when to use one option in favour of the other. According to Julie de Brux and Claudine Desrieux, the decision whether to use either of them depends on a number of factors.[51] This includes, first, whether it is a captive market where users of the service are forced to use the service because of the lack of an alternative. There might be no incentive for the private sector to innovate in terms of quality in service delivery and price. It is suggested that availability contracts are more suitable in these situations.

Second, the sensitivity of users to quality variations and user fees is also a significant determinant. If the demand is elastic to the quality of service and level of fees, then users of the service play a more prominent role. This influences the private sector operators to improve service quality, reduce service fees and invest more in the project. In this case, concession contracts are preferred. If the case is reversed, then availability contracts are a better option.

A third determinant is whether the quality of output is contractible. In situations where it is possible to prescribe the standards of the quality of service to be provided by the private sector, then it is possible to use availability contracts. Otherwise, it would be difficult to find a benchmark on which availability payment could be made, as payments in availability contracts are tied to the private sector party meeting predetermined standards.

Finally, the existing social and political norms in the society where the project is located could determine the type of demand model adopted. Since the availability model, due to its characteristics, will increase access to the service, as it is assumed that the government will be interested in

[50] Julie De-Brux and Claudine Desrieux (2012); Laure Athias and Raphael Soubyeran (2012).
[51] Ibid.

encouraging as many citizens as possible to use the service, it should be used when there is a need to accommodate as many users as possible. The concession model, however, incentivises the private sector to improve the quality of service and should be used where the quality of service is a priority and there are competing providers of the same service.

For the avoidance of doubt, there is generally nothing wrong with the public sector passing demand risk to the private sector. Indeed, it is commonly accepted that there are advantages in doing this, some of which are the incentives it gives the private sector to innovate, improve service delivery and reduce price as the realisation that its revenues are inextricably tied to the willingness of the public to patronise the service pushes it in that direction. However, all these advantages are only realisable where there are real and competitive options available to users.

As we have seen in the MMA2 case study, to be able to pass on this risk adequately, the private sector will demand and the public sector must be willing to provide sufficient incentives to the private sector to assume this risk. The public authority must also assess whether it is able to live with the consequences of such decisions, instead of resorting to breach of contract as in the case study. This requires a conscious evaluation and pricing of the risk, including non-commercial factors like the satisfaction of citizens, both in the short and long term.

In situations where the government decides that it will transfer demand risk to the private sector, there are other less onerous methods of achieving this than was the case in the MMA2 concession. These techniques will ensure the protection of the interest of the private sector and also guarantee equity between the parties, instead of resorting to the use of non-compete and similar clauses. These methods are basically demand risk mitigation instruments that have been used around the world and are now discussed in more detail.

## 8.8 Demand Risk Mitigation

For countries like Nigeria, where government is bent on using concession contracts, especially in the transport sector as with the MMA2 concession, the most common strategies used to mitigate traffic demand risk is

to allow either the term of the concession or the revenue accruable to the concessionaire to adjust with demand realisations. The three most common mechanisms are: "modification of the economic balance" of contracts; "traffic guarantee" contracts; and, "duration adjusted" contracts.[52]

### 8.8.1 Modification of the Economic Balance of Contracts

This method is thought to have originated in France[53] and subsequently applied in Spain with certain variations.[54] Under this approach, if the internal rate of return (IRR) of the project falls below a minimum threshold stipulated in the contract, then the "economic balance" of the concession is re-established. In most cases, a minimum IRR is accompanied by a maximum IRR. This ensures that the concessionaire's profits are limited or clawed back if traffic is much higher than expected.

Generally, the compensation measures to be adopted for re-establishing the economic balance of the contract are not pre-determined but, rather, are negotiated when the IRR falls above or below the target levels.[55] The nature of the compensation may take the form of change in toll levels, adjusting the contract length, or the provision of other public subsidies. These subsidies may take the form of capital expenditure contributions (capex), which can either be in the form of loans or equity as capital grants to the private sector.[56] The problem with this approach is that it involves a long and tiresome renegotiation process between the concessionaire and the government, since the way to re-establish the economic balance of the contract is not fully specified upfront. Also, the concessionaire has no

[52] Transport Research Centre (TRANSYT) (2007) "Evaluation of Demand Risk Mitigation in PPP Projects", p. 8.

[53] Ibid; see also Jose A. Gomez-Ibanez and John R. Meyer (1993) *Going Private: The International Experience with Transport Privatization*, Brookings Institution, Washington, DC.

[54] Jose M. Vasello and Juan Gallego (2005) "Risk Sharing in New Public Works Concession Law in Spain", *Transport Research Record* 1932, p. 1–8; Jose M. Vassallo (2006) "Traffic Risk Mitigation in Highway Concession Projects: The Experience of Chile", *Journal of Transport Economy and Policy*, 40(3): 359–381.

[55] Jose M. Vasello (2006).

[56] See Elisabetta Iossa, Giancarlo Spagnolo and Mercedez Vellez (2007), for a discussion of these subsidies.

incentive to reduce operating costs when the project IRR is close to the lower limit, since falling below the limit allows a renegotiation of the contract.[57]

### 8.8.2 Traffic Guarantee Contracts

This approach involves guaranteeing either the traffic or revenue levels in the contract. The failure to reach the minimum levels triggers compensation from the public sector. Many countries, such as Korea, Colombia, Chile, the Dominican Republic, Malaysia and Spain, have used this method.[58] In many contracts, the lower limit is often complemented with an upper limit above which the revenues are "clawed back" and shared between the government and the concessionaire.

The main problem of the guarantee approach is that it cannot ignore the strong correlation between the volume of traffic and economic growth; thus, the guarantee can have very negative consequences for the public budget if the country suffers an economic downturn, as in Nigeria during the period of falling oil prices. Nevertheless, it has been shown that the method has worked quite well in some countries, such as Chile, where, even during an economic recession, only 4 out of 29 transport concessions in operation at the end of 2004 performed below the minimum income guarantee band. This meant a subsidy from the government of only US$6.24 million compared with the US$350 million invested. Surprisingly, however, it did not reduce pressure from the concessionaires for contract renegotiations.[59] This mechanism has not worked so well in more unstable countries, such as Colombia, where traffic volume turned out to be lower than guaranteed levels for many of the concessions in that country.[60] In situations

[57] Transport Research Centre (TRANSYT) (2007).

[58] Timothy Irwin (2003) Public Money for Private Infrastructure: Deciding When to Offer Guarantees Output Based Subsidies and other Fiscal Support, World Bank Working Paper 10, Washington, DC; Transport Research Centre (TRANSYT) (2007); Jose M. Vasello (2006).

[59] Jose M. Vasello and Antonio Solino (2006) "Minimum Income Guarantee in Transportation Infrastructure Concessions in Chile", Transport Research Record, *Journal of the Transportation Research Board*, 1960(1): 15–22.

[60] Transport Research Centre (TRANSYT) (2007).

like this, this mitigation method is capable of becoming a considerable strain on the government's finances.

### 8.8.3 Duration Adjusted Contracts

This method, which has been adopted in several countries, involves matching the duration of the concession to a predefined verifiable target, usually related to traffic or revenues. This approach was first applied in 1990 in the concession of the Second Severn Crossing in the United Kingdom. Although the government initially decided that the maximum period for the concession should be no longer than 30 years, the concessionaire—Severn River Crossing Plc—proposed the basis of the length of the concession be pegged to a fixed target of "Required Cumulative Real Revenue".[61] This way, total project revenue was established at 1989 prices (NPV), which, once collected from tolls income, would end the concession. Based on actual traffic levels during the early years of the operation of the concession, it is now expected that the concession duration is ultimately likely to be 22 years, considerably less than initially predicted.[62] Another similar concession was awarded in Lusoponte, Portugal, at the end of the 1990s. The concession agreement was designed in order for the concession to expire no later than March 2028, or at a total cumulative traffic flow of 2250 million vehicles; if the traffic is higher than expected the concession will finish earlier than the projected 2028.[63]

A good enunciation of this mechanism is called "Least Present Value of the Revenues (LPVR)" and has been extensively developed by Engel, Fischer and Galetovic.[64] The authors were of the opinion that fixed-term

[61] D. Foice (1998) "Second Severn Crossing", Proceedings of the Seminar *PPP Risk Management for Big Transport Projects*, Ministerio de Fomento, Spain.

[62] Transport Research Centre (TRANSYT).

[63] T. de Lemos, D, Eaton, M. Betts and L. Tadeu de Almeida (2004) "Risk Management in Lusoponte Concession: A Case Study of the Two Bridges in Lisbon, Portugal", *International Journal of Project Management*, 22: 63–73.

[64] Eduardo M.R.A. Engel, Ronald Fischer and Alexander Galetoric (1997) "Highways Franchising Pitfalls and Opportunities", *American Economic Review*, 87: 68–72; Eduardo M.R.A. Engel, Ronald Fischer and Alexander Galetoric (2001) "Least Present Value of Revenue Auctions and Highway Franchising", *Journal of Political Economy*, 109(5): 993–1020.

contracts do not allocate demand risks optimally. They therefore advocated for a least present value of revenue auction, instead of the bidding process being based on the length of the toll period. Under this procedure, the lowest bid wins (i.e. the bidder who offers the least present value of accumulated revenues, discounted according to the discount rate fixed in the contract) and the concession comes to an end when that lowest bidded amount has been recovered by the concessionaire. Therefore, the concession comes to an end earlier if the demand is high and has a longer duration when the demand is low. Engel, Fischer and Galetovic also claim that significant welfare gains can be made from using LPVR auctions.

Another major advantage is that since the concession term adjusts to demand realisations in LPVR auctions, the concessions are less sensitive to demand information and thus more cost-oriented than fixed-term concessions. However, this mechanism has been implemented with minimal success in Chile.[65] The major reason for this is said to be the lukewarm reception of the method by concessionaires.[66] An advantage of this option is that, apart from being a method of demand risk mitigation, LPVRs provides the public sector authority with a price with which to buy out the concession. A fair compensation for the concessionaire is the difference between the winning bid and the revenue collected thus far, unlike in fixed-term contracts where compensation is based on estimates of expected profits during the remainder of the concession period, which calculation is always subject to dispute.[67] It is presumed that this will act as a disincentive to a private sector party seeking to renegotiate a concession, since the public authority can opt to buy out the concession.[68]

The major criticism of the LPVR method is that it does not provide sufficient incentive for the concessionaire to exert effort in enhancing the quality of service.[69] It has been suggested that this could be overcome by complementing the method with other regulatory inventions, such as the

[65] It was used in the Santiago–Valparaiso Vina del Mar Concession in Chile.
[66] Jose M. Vasello (2006).
[67] Eduardo M.R.A. Engel, Ronald Fischer and Alexander Galetoric (2001).
[68] Jose M. Vasello (2006).
[69] Eduardo M.R.A. Engel, Ronald Fischer, Alexander Galetoric (2001).

appointment of third parties who verify the minimum quality standards and exact appropriate fines for non-compliance with those standards.[70]

There is also an interesting suggestion put forward by Quiggins that PPPs will be improved by the inclusion of "put and call" options in contracts which allow either contracting party to terminate after a predetermined period, which Quiggins proposed should be every seven years, with the public sector having an option of buying off the remainder of the unamortised period by the private sector.[71] In a similar vein, Viegas argues that concessions are better designed in successive shorter-term contractual cycles of a maximum of 15 years each, each cycle involving a revision of objectives, policies, technological standards and demand forecasts. This is aimed at the partial amortisation of the private sector party's investment. At the end of the concession period, the concessionaire would collect a payment equivalent to the value of the unamortised payments.[72] The government does not need to have recourse to funds from the budget to make these payments. It may raise the money by organising a subsequent concession for another period of similar duration without the cost of a new construction. It can be done in a manner that allows the new rent to cover the exit payment of the first concessionaire.[73]

It is suggested that, in projects like the MMA 2 concession, the use of this method may have given the government the flexibility to pay a predetermined compensation if it decides to opt out of the contract and also be able to build a new facility without being in breach of contract.

If the uses of availability contracts are preferred to concession contracts, then the public sector must ensure that payments are only made according to predefined and measurable outputs in the contract. These outputs must act as targets, with which the private sector must comply.[74]

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[70] Jean Tirole (1997) "Comentario a la propuesta de Engel, Fischer y Galetovic sobre licitación de carreteras", *Estudios Públicos*, 65, Winter 1997: 201–14, cited in E.M.R.A. Engel *et al.* (2001).

[71] See John Quiggins (2005) "Public Private Partnerships: Options for Improved Risk Allocation", *Australian Economic Review*, 38: 445; John Quiggins (2006) "Public Private-Partnerships: Options for Improved Risk Allocation" *University of New South Wales Law Journal*, 29(3): 289.

[72] Jose M. Viegas (2010)"Questioning the Need for Full Amortisation in PPP Contracts for Transport Infrastructure", *Research in Transport Economics*, 30: 139–144.

[73] Ibid.

[74] Elisabetta Iossa and David Martimot (2008).

To compel adherence to the standards of the specified output and encourage efficiency from the private sector, the contract should provide for deductions to penalise any failure to comply with specified standards and where complete failure of availability occurs. It is suggested that, when making provisions for deductions, a scale to measure the degree of service unavailability should be specified in the contract, where possible.[75] In the same vein, bonuses may also be introduced for instances where the private sector records performances above the target levels. This will encourage the private sector partner to continue to innovate. The use of bonuses will also partially address the issue of lack of incentive to improve service quality that is normally attributed as one of the disadvantages of availability contracts.

From the private sector point of view, in order to consummate a successful PPP project in the transport sector, the goal should be to prepare a painstaking and sophisticated cost-benefit and competition analysis which ensures the long-term viability of the project without the need for government financial support, whether in the form of capital expenditure contributions, guarantees, or other forms of concessions.[76] The government should also be able to commission consultants to do the same on its behalf. It is not acceptable if such studies are not properly undertaken and the consequences can be grave, as the MMA 2 case study revealed. This is said to be one of the major shortcomings of another airport concession undertaken in April 2013: the Kassel-Calden local airport PPP project in Germany.[77]

## 8.9 Conclusion

This chapter critically evaluated the management and mitigation of demand risk in Nigeria. First, it argues that demand risk is one of the most important risks which PPP projects face in the country. The problem with managing demand risk arises mostly when the private sector

[75] Ibid.

[76] European Commission (2004) *Resource Book on PPP Case Studies*, Brussels: EU.

[77] Ibid.

tries to mitigate the risk by protecting itself from factors outside of its control and from market forces through the use of non-compete clauses or similar risk mitigating devices. This distorts the allocation of the risk and is, consequently, harmful to the success of the project, and even the country's infrastructure in the long run.

This problem is exacerbated due to the fact that PPPs are incomplete contracts; that is, that due to its long-term nature, it is nearly impossible to predict the demand for a service throughout the duration of the contract term. Therefore, using the incomplete contract theory as a basis for analysis, the point which this book makes is that, due to the fact that long-term PPP contracts are incomplete, without a process for renegotiation, parties try to protect themselves by requesting guarantees and other incentives for situations not covered by ex ante agreements. These guarantees, instead of eliminating the risk, merely transfer it to the other party, with serious consequences if it eventuates.

Second, it was observed that the principal means through which demand risk is allocated is the payment mechanism specified in the contract. These are contracts where the private sector bears no demand risk, known as "availability contracts", and those where the private sector bears all or some of the demand risk, known as "user charge" or "concession" contracts. It was argued that, in allocating demand risk in infrastructure projects, parties to PPP contracts, particularly the public authorities, should not tie themselves to the use of concession contracts to the exclusion of availability contracts. The decision to use either of the two options must be predicated on sound project evaluations.

In the case study in this chapter, the manner in which demand risk has been treated in PPP contracts in Nigeria was discussed by analysing the MMA2 concession. This project was chosen because it was the first major BOT project in Nigeria, and also because of the multitude of court cases that have emanated from the transaction. The conclusion is that these disputes would not have arisen if demand risk in the project had been handled differently.

# 9

# Stakeholder Opposition Risk

## 9.1 Definition of Stakeholders

This chapter uses the term "stakeholder opposition risk" as opposed to "public opposition risk" because the phrase "public opposition" seems very limited in scope, as it does not take into consideration the wider range of individuals or organisations that affect, influence or oppose a PPP project. The use of the word "stakeholder" resolves this defect and also aligns the concept of engaging people affected with a project with its theoretical foundations, stakeholder theory, which has its origins in the discipline of business ethics and company law. However, it is not uncommon to see the use of the words "public opposition risk" instead of "stakeholder opposition risk" in PPP literature. Even though this book adopts the phrase "stakeholder opposition risk", it is, however, admitted that the most important stakeholders are members of the public in their role as citizens and end-users of the infrastructure services, and this is reflected in most of the analysis in this chapter.

While project management literature is replete with discussions on the influence of stakeholders on projects, very little attention has been paid to



G. Nwangwu, *Public Private Partnerships in Nigeria*,
DOI 10.1057/978-1-137-54242-7_9

the consideration of stakeholder opposition as a risk.[1] Nevertheless, there exists literature that identifies public opposition as a risk in PPPs, albeit that these discussions are limited.[2] This work recognises the gap in the literature and aims to make a valuable contribution to extant literature that critically analyses the role of stakeholder opposition risk in PPP projects.

The available definitions of "stakeholder" in literature have been predicated on different factors, such as the nature and extent of stakeholder involvement in a project, the nature of their relationship with the project, the nature of the stakeholder claim and its position regarding the project, the stakeholders role in the project and the degree to which a stakeholder's behaviour towards the project can be anticipated.[3]

Stakeholders have therefore been defined as those whose interests may be positively or negatively affected as a result of project execution.[4] Smith et al. define stakeholders as representatives, direct and indirect, who may have an interest in and can make a contribution to the proposed project.[5] This definition is consistent with project management parlance, which tends to look at the stakeholder group from a wider perspective, encompassing people or groups that have, or believe they have, legitimate claims

[1] See, however, the following, where brief mention has been made: Michael F. Farrel (2003) "Principal-Agency Risk in Project Finance", *International Journal of Project Management*, 21(8): 547–561; Elmar Kutsch and Mark Hall (2005) "Intervening Conditions on the Management of Project Risk: Dealing with Uncertainty in Information Technology Projects",*International Journal of Project Management*, 23(8): 591–599; L.-Y. Shen, (2006) "Role of Public Private Partnerships to Manage Risks in Public Sector Projects in Hong Kong",*International Journal of Project Management*, 24(7): 587–594; K.T. Yeo, and Robert L.K. Tiong (2000) "Positive Management of Differences for Risk Reduction in BOT Projects",*International Journal of Project Management*, 18(4): 257–265.

[2] See the following, where this has been mentioned as one of the PPP project risks: Nur A. Karim (2011) "Risk Allocation in Public-Private Partnership (PPP) Project: A Review on Risk Factors", *International Journal of Sustainable Construction Engineering & Technology*, 2(2): 8–16.

[3] Krisi Aaltonen, "Stakeholder Management in International Projects", PhD Thesis, Aalto University School of Science and Technology Department of Industrial Engineering and Management, available at http://lib.tkk.fi/Diss/2010/isbn9789526033440/isbn9789526033440.pdf (last accessed 13 October 2015).

[4] G.F. Jergeas, P. Eng, E. Williamson, G.J. Skulmoski and J.L. Thomas (2000) "Stakeholder Management on Construction Projects", *AACE International Transaction*, pp. 12.1–12.5; PMI (1996) *Project Management Body of Knowledge*, Newton Square, PMI PA.

[5] Jim Smith, Peter E. O. Love and Ray Wright (2001) "To Build or Not to Build? Assessing the Strategic Needs of Construction Industry Clients and their Stakeholders",*Structural Survey*, 19(2): 121–132.

against the substantive aspects of a project.[6] These may even include the project team's families, people who buy the product or are affected by the end product, and the local community at large.[7] There have also been attempts at including the environment as a stakeholder.[8]

Winch's definition is closer to the way the concept is used in this book. He defines stakeholders as those actors who will incur a direct benefit, or loss, as a result of the project.[9] Winch goes on to classify stakeholders as either internal or external.[10] The internal stakeholders are people who have access to the project proponent, such as employees and financiers. External stakeholders are groups that are not formal members of the project coalition but may affect or be affected by the project.[11] External stakeholders have also been referred to as "non-business" stakeholders, or secondary stakeholders,[12] and can be either public or private. Public stakeholders are regulatory agencies and other agencies of government. The members of the public belong to the external stakeholders who may be in favour, against, or indifferent towards a project. In a PPP, it is pertinent to point out that the government is more of an internal stakeholder than an external one.

Stakeholders have also been classified into primary and secondary stakeholders.[13] The term "primary stakeholders" refers to groups whose support is necessary for the firm to exist and to whom the firm has

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[6] Rodney J. Turner (1999). *The Handbook of Project-Based Management*: *Improving the Processes for Achieving Strategic Objectives*, 2nd edn., London: McGraw-Hill; K. Moodley (1999) "Project Performance Enhancement-improving Relations with Community Stakeholders" in Stephen Ogunlana, (ed.), *Profitable Partnering in Construction Procurement*, London: E&F Spon.

[7] Roshana Takim (2009) "The Management of Stakeholders' Needs and Expectations in the Development of Construction Projects in Malaysia", *Modern Applied Science*, 3(5): 167–175.

[8] Mark Starik (1995) "Should Trees have Managerial Standing? Towards Stakeholder Status for Non-Human Nature", *Journal of Business Ethics*, 14: 207–217; E. Orts and A. Strudler (2002) "The Ethical and Environmental Limits of Stakeholder Theory Business", *Ethics Quarterly*, 12: 215–233.

[9] Graham M. Winch (2002) *Managing Construction Projects*: *An Information Processing Approach*, Oxford: Blackwell Science Ltd.

[10] See also Charles Eesley and Michael J. Lenox (2006) "Firm Responses to Secondary Stakeholder Action",*Strategic Management Journal*, 27(8): 765–781.

[11] Aaltonen, Krisi, PhD Thesis, available at http://lib.tkk.fi/Diss/2010/isbn9789526033440/isbn9789526033440.pdf.

[12] BeRnard Cova, Pervez Ghauri and Robert Salle (2002) *Project Marketing: Beyond Competitive Bidding*, Chichester, UK: John Wiley & Sons Ltd., p. 179.

[13] Max B.E. Clarkson (1995) "A Stakeholder Framework for Analyzing and Evaluating Corporate Social Performance",*Academy of Management Review*, 20(1): 92–117.

special duties. Secondary stakeholders, on the other hand, have no formal claim on the firm and management has no special duties to them.[14] Stakeholders have also been classified as either claimants or influencers,[15] and also as strategic and moral stakeholders.[16] Strategic stakeholders are those that are able to affect the project and therefore the management of their interests is said to be essential for the success of the project. Moral stakeholders are those who are affected by the project but whose claim to the project is merely moral, as opposed to legal.

The discussion of stakeholders in this book appreciates that the public qua citizens or end-users of the project are the major and most important stakeholders of a PPP project.[17] However, it is also understood that the public interact within a social milieu and the roles of the public take different shapes and forms during that interaction. These different roles of the "public", or citizens who are capable of influencing a project, are users of the infrastructure, owners, ratepayers, NGOs, social institutions, environmentalists, community-based organisations and even the media. As noted earlier, this is consistent with the definition offered by Winch.

Consistently, project management literature has realised the link between the success of projects and a project manager's ability to forge a fruitful alliance between these stakeholders and the end product, which is the project.[18] It is recognised, for instance, that, if stakeholders are not properly managed, the project proponents might not even understand a clear and comprehensive definition of the project. The project manager

[14] Archie B. Carroll and. Ann K. Bucholtz (1993) *Business & Society*: *Ethics & Stakeholder Management*, Cincinnati, OH: Western Publishing; Kevin Gibson (2000) "The Moral Basis of Stakeholder Theory", *Journal of Business Ethics*, 26: 254–257.

[15] Grant T. Savage, T.W. Nix, C. Whitehead and J.D. Blair (1991) "Strategies for Assessing and Managing Stakeholders", *Academy of Management Executives*, 5(2): 61–75.

[16] Jeff Frooman (1999) "Stakeholder Influence Strategies", *Academy of Management Review*, 24(2): 191–205.

[17] See, for example, the empirical study undertaken by Jan T. Karlsen (2002) "Project Stakeholder Management", *Engineering Management Journal*, 14(4), December: 14(4): 19–24. This study determined that a client's end-users are the most important stakeholders.

[18] See, for example, G.F. Jergeas, P. Eng, E. Williamson, G.J. Skulmoski and J.L. Thomas (2000); see also Marjolein C. Achterkamp and Janita F.J. Vos (2008) "Investigating the Use of the Stakeholder Notion in Project Management Literature:A Meta-analysis", *International Journal of Project Management*, 26: 749–757.

may therefore end up attaining project goals that were never intended by the stakeholders[19] and this will lead to negative reactions to the project.[20]

## 9.2 Theoretical Basis for Stakeholder Engagement

The theoretical foundations for stakeholder engagement can be traced to stakeholder theory, which is adopted here as a basis for discussing stakeholder opposition risk. The reason is that, due to the public nature of the services provided under PPPs, the need for partnership towards stakeholders is more pronounced. Also, the concept is the central theoretical perspective used in studying the influence and management of stakeholders in projects, and extant research on the management of stakeholders draws almost exclusively from this theory. To ignore stakeholder theory would, therefore, be to do away with valuable insights and rich contributions developed over the years in managing stakeholders in complex projects such as PPPs.

### 9.2.1 The Stakeholder Approach

The foundation of stakeholder theory is based on morality and pragmatism; that is, that involving stakeholders in project decision making is morally the right thing to do and that, by doing this, the project manager is assured of the success of the project.[21] These principles also apply to the management of end-user rights in PPPs. Social science stakeholder theory focuses on the concepts of justice, equity and social rights having a major impact on the way that stakeholders exert moral authority over project development.[22] The basis of stakeholder theory itself is the

[19] Roshana Takim (2009); Jack R. Meredith and Samuel J. Mantel (2003) "Project Management: A Managerial Approach", 5th edn., New York: John Wiley, p. 34.

[20] Ken Black (1996) "Causes of Project Failure: A Survey of Professional Engineers", *PM Network*, 10(11), November: 21–24.

[21] Kevin Gibson (2000).

[22] Ibid.

principle that firms ought to be managed to take care of the interests of their various stakeholders, which include shareholders, employees, customers, suppliers and communities in contrast to the erstwhile notion that managers are fiduciaries for and ought to manage firms in the sole interest of shareholders.[23]

Ever since the concept of the stakeholder was made prominent in management literature through the seminal work of Freeman[24] in 1984,[25] discussions about stakeholder theory have taken the discipline of business ethics by storm.[26] According to Donald and Preston, by 1995 there were about a dozen books and more than 100 articles with primary emphasis on the stakeholder concept.[27]

There are three dominant aspects of stakeholder theory: the descriptive approach, the instrumental approach and the normative approach.[28] The descriptive approach describes the corporation as a constellation of corporate and competitive interests possessing intrinsic value, and describes whether stakeholder interests are being taken into account in the management of the corporation. The instrumental approach is based on the interaction between stakeholders and managers of the firm. It assumes that corporations practising stakeholder management will be relatively successful; that is, stakeholder management will be instrumental to their success.[29]

The normative approach is used to interpret the functions of corporations, including the identification of moral or philosophical guidelines

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[23] Alexei Marcoux, "A Fiduciary Argument against Stakeholder Theory" (2003) *Business Ethics Quarterly*, 13(1): 1–24,also available at http://www.jstor.org/stable/3857856; R.E. Freeman (1984) *Strategic Management: A Stakeholder Approach*, Englewood Cliffs, NJ: Prentice Hall, p. 8.

[24] R.E. Freeman (1984).

[25] Freeman notes that Dill was the first to extend the stakeholder concept beyond such groups as shareholders and customers. See William R. Dill (1975) "Public Participation in Corporate Planning: Strategic Management in a Kibitzer's World", *Long Range Planning*, 8(1): 57–63.

[26] Rogene A. Buchlolz and Sandra B. Rosenthal (2005) "Towards a Contemporary Conceptual Framework for Stakeholder Theory",*Promoting Business Ethics*, *Journal of Business Ethics*, 58(1/3), April–May: 137–148.

[27] Thomas Donaldson and Lee E. Preston (1995) "The Stakeholder Theory of the Corporation: Concepts, Evidence and Implications", *Academy of Management Review*, 20(1): 65–91.

[28] Ibid.

[29] Kevin Gibson (2000); Thomas Donaldson and Lee E. Preston (1995); J. Kaler (2003) "Differentiating Stakeholder Theories",*Journal of Business Ethics*, 46(1): 71–83.

for the operation and management of corporations. It specifies the obligations that companies owe to their stakeholders. This strand of stakeholder theory is predicated on the principle that corporations ought to consider stakeholder interests even in the absence of any apparent benefits. Donaldson and Preston[30] claim that the normative branch of stakeholder theory is the central core of the theory and that all other parts play a subordinate role.[31]

Jones and Wicks have, however, argued for a unification of these theories in what is widely referred to as the "convergent" stakeholder theory. This is based on their conviction that there are important connections between the different strands of stakeholder theory and that the differences between the different features of the theory are not as sharp and categorical as Donald and Preston suggest.[32] Convergent theory stresses the need for project managers to develop mutual trust and cooperative relationships with shareholders, and considers that their actions should be based on ethical standards. Convergent theory has been questioned by a number of commentators[33] for not being practical. However, even though Freeman doubts the usefulness of convergent theory, he supports the fact that all the branches of stakeholder theory have all the elements of the other theories embedded in them and therefore refutes the fact that we can distinguish between the different branches of stakeholder theory.

Stakeholder theory has been variously criticised.[34] First, it is claimed that stakeholder theory is an excuse for managerial opportunism. By providing more groups for whom management may argue their cause,

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[30] Thomas Donaldson and Lee E. Preston (1995).

[31] This is disputed by the convergent theory; see also R.E. Freeman (1984).

[32] Thomas M. Jones and Andrew C. Wicks (1999) "Convergent Stakeholder Theory",*Academy of Management Review*, 24(2): 206–221.

[33] Thomas Donaldson (1999) "Response: Making Stakeholder Theory Whole", *Academy of Management Review*, 24(2): 237–241; Dennis Gioia (1999) "Response: Practicability; Paradigms and Problems in Stakeholder Theorizing",*Academy of Management Review*,24(2): 228–233; Edward R. Freeman (1999) "Response: Divergent Stakeholder Theory", *Academy of Management Review*, 24(2): 233–236.

[34] For extensive discussions and replies to the various criticisms, see the following: R.E. Freeman, J.S. Harrison, A.C. Wicks, B.L. Parmar and S. de Colle (2010) *Stakeholder Theory*: *The State of the Art*, Cambridge, UK: Cambridge University Press.

managers are more likely to engage in self-dealing than if shareholder theory were their sole purpose.[35] In response, it has been stated that stakeholder theory makes managers more accountable, as they have more obligations and duties of care to a greater number of constituencies and are, therefore, less likely to engage in self-dealing.[36] It is also pointed out that much of the current managerial opportunism that has been witnessed in modern times, such as in Enron (2001), and Worldcom (2002), Lehman Brothers and Washington Mutual (2008) occurred under the banner of shareholder maximisation.[37]

Second, it has been argued that stakeholder theory is primarily concerned with the distribution of financial outputs, as it deals primarily with who receives the resources of the organisation. Consequently, it is contended that the theory poses a stark and inherent conflict between shareholders and other stakeholders in terms of who gets what.[38] In response, it is argued that the distribution of resources is only a minor part of what stakeholder theory is about. The critical part of the theory is about process and procedural justice. The type of distribution contemplated by the theory involves more than the distribution of financial resources. Information is also something that can be shared with stakeholders and this does not pit shareholders against other stakeholders.[39]

Third stakeholder theory is criticised on the grounds that its efficacy requires changes to current legislation. The reason for this argument is that anything other than shareholder management is illegal, and that if stakeholder theory is to be practised without violating the law, there is a need to amend present legislation to accommodate the theory.[40] The contrary argument presented is that while there may be useful reasons to consider various changes to the law to give efficacy to the theory, stakeholder theory does not necessarily advocate changes to present laws;

[35] R.E. Freeman, J.S. Harrison, A.C. Wicks, B.L. Parmar and S. de Colle (2010).

[36] Ibid.

[37] Ibid.

[38] Ibid.

[39] Ibid; R.E. Freeman and Robert A. Phillips (2002) "Stakeholder Theory: A Libertarian Defense", *Business Ethics Quarterly*, 12(3): 331–349.

[40] Ibid; R.E. Freeman, J.S. Harrison, A.C. Wicks, B.L. Parmar and S. de Colle (2010).

rather, it works under the present legal regimes by the use of, for instance, principles such as the business judgement rule.[41]

### 9.2.2 Stakeholder Accountability Theory Approach

It is obvious that conventional stakeholder theory will not fit into the realm of PPPs without adjustments because the theory has its origins in the theory of the firm and is widely used in the discipline of business ethics; therefore, it relates principally to corporations. It considers the relationship between the firm and other claimants or influencers of its business interests who are not shareholders, whereas PPPs also involve the government or public sector as active players.

In PPPs, the government and private sector jointly assume the position of the managers of the firm under stakeholder theory and the firm, in this instance, would be the infrastructure project or services. For this reason, and also the vital nature of the infrastructure services provided under PPPs, it is safe to conclude that the government or public authority has an interest, if not a more overriding interest, in the success of the project; therefore, any appropriate theory in this area must effectively capture this element. The fact that PPP is a partnership between the public sector and the private sector means that both parties are joint project owners and must collectively look after stakeholder interests. Indeed, the fact that the public authority (the government) is usually elected to look after these very stakeholder interests places a greater burden on the government.

The accountability stakeholder theory is derived from the stakeholder approach but is shaped by the unique interplay of relationships existing in PPP projects. The importance of the type of infrastructure projects completed through PPPs to the wellbeing of citizens cannot be overemphasised; in fact, the provisions of some of these infrastructure services may be equated to the status of fundamental human rights, or at least fundamental services which guarantee those rights, such as water, electricity and healthcare. The provisions of these services therefore form the

[41] Richard Marens and Andrew Wicks (1999) "Getting Real: Stakeholder Theory, Managerial Practice & the General Irrelevance of Fiduciary Duties Owed to Shareholders", *Business Ethics Quarterly*, 9(2): 272–293.

bedrock of the social contract between the government and its citizens.[42] The nature of representative democracy that is prevalent in most countries around the world is predicated on elected representatives being completely representative of and accountable to the electorate. Since provisions of fundamental services are one of the cardinal reasons for the election of the government as the representative of the people, it is accountable to the people on how it provides these services. When the government decides to delegate these responsibilities to the private sector, it must also be accountable to the people on how it intends to do this. An agent (the government, in this case) cannot sub-delegate its responsibilities without the consent of the principal (the citizens) and consent that is not based on full disclosure and understanding is not deemed valid consent.[43]

The duty of the government to account to and involve the citizens in decision making is based on social contract and agency theories, and the right of the citizens to be involved and informed can be said to be constitutional. It is based on these principles that this book argues that stakeholders' (at least, the public qua citizens) involvement in PPP is a constitutional right, and differs from other stakeholder theories because it should not be pursued merely because it is morally desirable to do so, or because it guarantees the success of projects like the other business ethics stakeholder theories. Rather, it is accepted that both the private sector and the government ought to pursue stakeholder accountability because it is morally desirable, necessary for successful project delivery and also legally, or even constitutionally, obligatory on the part of government.

The advantages of stakeholder accountability theory are that it extends the extant stakeholder theory, as it recognises the government as an active participant in the business of providing infrastructure and, therefore, also in the process of informing and engaging stakeholders. The current practice, consistent with the theory of the firm, is that this responsibility is left solely in the hands of the private sector contractor, since the private

[42] Social contract theory is based on the fact that government only exists to serve the will of the people and that the people are the source of all political power enjoyed by the government. The origin of social contract theory can be traced from the writings of Plato, Thomas Hobbes, Jean Jacques Rousseau, John Locke, John Rawls and, more recently, David Gauthier.

[43] Stakeholder accountability theory can also be explained using agency theory.

sector is the operator of the services. The theory also gives the citizens a legal as well as moral right to be consulted and informed.

Presently, stakeholder theory has manifested in the principles of corporate social responsibility (CSR) and the law has attempted some form of codification of the principle through the use of codes and regulations in different jurisdictions that target its optimisation. It is expected that PPP legislation would also follow suit and enshrine the principles of stakeholder accountability theory into law. As a note of caution, it must be mentioned here that, in legislating for stakeholder accountability, PPP legislation must delimit the extent of the responsibilities and the boundaries of the right of citizens to be accounted to so that, for instance, vindictive stakeholders, motivated by other considerations that are not altruistic, do not hold the PPP transaction process captive.

## 9.3 Stakeholder Opposition Risk

It is not uncommon to hear that PPP projects failed due to opposition from stakeholders.[44] By its very nature, a PPP is very political and controversial, primarily because it pursues the divesting of public control and the operation of public assets to a private sector operator. The citizenry usually does not take kindly to the divesting of "public treasures" in any way, whether through privatisation or PPPs. There is a need, therefore, to gauge the acceptance of the public for a project properly and to find ways of mitigating any apprehension before the commencement of a project. It is for this reason that it is advocated that parties to a project must identify the risk that the public might be opposed to the project, evaluate it and allocate it appropriately. The public and private sector parties to the project must then commence a process of mitigating the risk by designing a stakeholder inclusion and consultation programme.

The present tendency is for the parties to allocate this risk to the private sector, who suffer from reduced demand for the services in situations where

[44] Stefan Olander and Anne Landin (2005) "Evaluation of Stakeholder Influence in the Implementation of Construction Projects", *International Journal of Project Management*, 23: 321–328.

the risk eventuates and therefore they are usually entrusted with the sole responsibility on consulting with the stakeholders. However, this is not in accordance with stakeholder accountability theory, which presupposes the allocation of stakeholder risk between both parties. The reason is simply that, in PPPs, the public sector and private sector partners have different priorities in the project and this extends to the management of stakeholder interests. According to a study carried out in Malaysia, while the government favoured social and political matters as the most important aspects of managing stakeholder needs, the private sector was of the view that forming project coalitions and employing lobby tactics mechanisms was the best way to manage stakeholder needs.[45] This is consistent with the views canvassed in this book that, for the private sector, it is a moral obligation and business necessity to engage the public or end-users, while, for the government, it is also a moral as well as a legal duty. In essence, it is a risk that is better shared and mitigated jointly by both parties.

In his report to the United Nations Human Rights Council, John Ruggie, the UN Special Representative on Business and Human Rights, stressed the significant costs associated with stakeholder resistance to companies' operations. According to him, stakeholder challenges may lead to significant project delays, higher costs for financing and even project cancellations.[46] The risk of stakeholder opposition is therefore very real. This risk becomes further exacerbated under PPPs, as these transactions also involve the public sector as partners of the private sector and therefore change the dynamics of public accountability in government decision making and project delivery. Most often, the mere fact that private sector companies are taking over government functions may trigger public resistance. For instance, the Trans-Texas corridor transportation PPP project came under severe public opposition because of the equity involvement of foreign corporations.[47]

[45] Roshana Takim (2009).

[46] United Nations General Assembly (2010) Report of the Special Representative of the Secretary-General on Issues of Human Rights and Transnational Corporations and Other Business Enterprises, John Ruggie, "Business and Human Rights: Further Steps Towards the Operationalization of 'Protect, Respect and Remedy' Framework", A/HRC/14/27, April 2010.

[47] John Forrer, James Edwin Kee, Kathryn E. Newcomer and Eric Boyer (2010) "Public Private Partnerships and the Public Accountability Question", *Public Administration Review*, May/June: 475–485.

According to Chan et al., one of the most significant risk factors for PPPs in China is public opposition risk.[48] The authors define public opposition risk as the various reasons leading to public interests being unprotected and damaged which, in consequence, causes public opposition to the project's success. According to Li et al., this risk should be allocated to the public sector. According to them, this is because the chance of the risk eventuating in the UK is more remote than in most developing countries.[49] Ibrahim et al., in their analysis of risk perception in PPPs in Nigeria, ranked public opposition to PPP projects as the 53rd most important risk factor in Nigeria out of the 61 risk factors considered, and opined that the allocation of the risk to either the private or public sector should be project dependent.[50] The facts on the ground, however, do not support this conclusion, as the public has shown resistance to a number of privatisation projects. This has also included a PPP project—the Lekki toll road which is the subject of the case study in this chapter.

Public opposition to projects has occurred in many other projects in several countries. For examples, in Argentina, Aguas del Aconquija, a subsidiary of Vivendi, won a 30-year concession to run the water supply system in Tucumán in 1995. The private partner doubled water tariffs within a few months of taking over the concession in order to meet the aggressive investment requirements specified in the concession by the government. Eighty % of residents stopped paying their bills. In October 1998, the government terminated the concession.[51]

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[48] Albert P.C. Chan, John F.Y. Yeung, Calvin C.P. Yu, ShouQing Wang and Yongjian Ke (2011) "Empirical Study of Risk Assessment and Allocation of Public-Private Partnership Projects in China", *Journal of Management Engineering*, 27(3), July: 137, available at http://www.meng-pm.org/wsq/Paper/AlbertChang-RiskAssessAndAllocationOfChinaPPPrisk.pdf (last accessed 13 October, 2015).

[49] Li Bing, A. Akintoye, P.J. Edwards and C. Hardcastle (2005) "The Allocation of Risk in PPP/PFI Construction Projects in the UK",*International Journal of Project Management*, 23(1): 25–35.

[50] Ahmed D. Ibrahim, Andrew F. Price and Andrew J. Dainty (2006) "The Analysis and Allocation of Risks in Public Private Partnerships in Infrastructure Projects in Nigeria",*Journal of Financial Management of Property and Construction*, 11(3): 149–163.

[51] "Support and Opposition of Public-Private Partnerships", *The Encyclopedia of Earth*, (online), available at: http://www.eoearth.org/article/Support_and_opposition_of_public-private_partnerships#gen15 (last accessed 13 October 2015).

In 1999, the Bolivian government granted a 40-year concession to run the water system to a consortium led by Italian-owned International Water Limited and US-based Bechtel Enterprise Holdings. Rate structures were immediately modified, putting in place a tiered rate and rolling in previously accumulated debt. As a result, many local residents received increases in their water bills. The private sector company maintained that the rate hikes would only have a large impact on industrial customers; however, the poor peasants claimed that increases as high as 100 % were experienced. In October 1998, groups gathered in protests which escalated into an outbreak of violence. During the protests, the Bolivian army killed as many as nine, injured hundreds and arrested several local leaders. Subsequently, the government cancelled its contract.[52]

In Senegal, a national privatisation programme came to halt in 1994 after meeting with considerable resistance from society at large. Stakeholders were not properly informed and therefore had concerns about the redistributive use of privatisation proceeds, among other issues.[53] In Bangladesh in 1990, the government neglected to involve local workers in the decision making process to privatise a dockside warehouse; uniformed workers who feared losing their jobs opposed this move vehemently. The government's first communication with the workforce came too late and this led to the entire transaction stalling for years.[54]

## 9.4 Case Study: Lekki Toll Road Concession

### 9.4.1 Background

The Lekki Toll Road Concession Project was awarded to the Lekki Concession Company (LCC), a special purpose vehicle set up by an indigenous finance company, Asset Resource Managers, with Macquarie

[52] Ibid.

[53] Campbell W. Oliver and Bhatia Anita (1998) *Privatization in Africa. Directions in Development Series*, World Bank, Washington, DC, (online), available at http://siteresources.worldbank.org/INTFINDINGS/685507-1161268713892/21098649/find132.htm (last accessed on 13 October 2015).

[54] Daniele Calabrese (2002) "Public Communication Programs for Privatization Projects: A Toolkit for Task Team Leaders and Clients", World Bank, Washington, DC.

Bank of Australia and Old Mutual of South Africa also as shareholders. The project was completed under the now repealed Lagos State Roads, Bridges and Highway Infrastructure (Private Sector Participation) Development Act (2004)[55] at a total project cost of US$340 million.

The project was designed as a 30-year build operate and transfer project for the upgrade, expansion and maintenance of approximately 49.4 km of the Lekki–Epe expressway (Phase 1) and the construction of 20 km of coastal road (Phase 2). It was proposed that the new road would eliminate traffic congestion around the area, ensure shorter journey times and enable better law enforcement around the project area. The project was financed using long-term debt and equity, and the project cost is to be recovered principally through charging of user tolls.

The project was enabled by the provision of a NGN 6.5 billion abridged works guarantee and a NGN 5 billion mezzanine loan to LCC pledged by the Lagos state government. Also, the state government waived all state taxes, charges, stamp duties and consent fees under the Land Use Act. The federal government also weighed in with a sovereign guarantee and federal support agreement to ensure the bankability of the project.

By January 2011, LCC had completed the 4 km stretch of road from the Law school end of Ozumba Mbadiwe to the Maruwa bus stop and set up a toll at the Admiralty Road end. However, LCC was initially unable to collect any tolls. The residents in the Lekki area simply refused to pay any. Toll collection was supposed to begin on 3 January 2011 and was to relate only to the completed portion of the road. After several protests by the residents, two weeks after its initial announcement of the commencement of the operation of the toll facility, the Lagos state government announced the indefinite suspension of the collection of tolls on the road.[56] Since then, several splinter stakeholder groups[57] have emerged either threatening to sue the government or have actually commenced

[55] This law was repealed by the Lagos State Roads (Private Sector Participation) Authority Law (2007) which, in turn, was repealed by the Lagos State Public Private Partnership Law (2011).

[56] The Director General of the Lagos State Public–Private Partnership Office, Mr. Ayo Gbeleyi, said that the suspension was to enable the State government to engage with the Concessionaire and other stakeholders.

[57] Stake Holder Forum (comprising indigenes, businesses and residents of the Lekki Ajah axis of Lagos State and the Etiosa Heritage Group.

legal proceedings against the government and the concessionaire.[58] Some of the stakeholder groups have even asked the government to terminate the contract and pay off the concessionaire.

On 18 December 2011, the state government reverted to the collection of tolls on the road. The government had been placed under a considerable fiscal burden by having to pay shadow tolls to the concessionaire for a year. It was suggested by Governor Raji Fashola that the state had spent over NGN 4 billion on shadow tolls,[59] being money which could have been used in other developmental projects. The decision to resume with the tolling of road led to a massive protest by the residents of the area,[60] who were allegedly dispelled by thugs and policemen loyal to the state government.[61] At the end of the protest, a number of people were severely injured and 23 people were arrested, including a governorship candidate of the opposition party.[62] This has led one of the opposition parties in the state, the Peoples Democratic Party (PDP), to call for the impeachment of the governor if he continues with the collection of tolls on the road.[63]

On 27 August 2013, the Lagos state government finally announced the cancellation of the Lekki toll road concession.[64] The government

[58] For example, a Lagos based lawyer and resident of the area, Ebun Olu Adegboruwa, went to court alleging fraud and challenging the government's right to toll the road, as he considered the toll an infringement of his constitutional right to free movement. He also insisted that the government should make available the provisions of the contract for everyone to see and read. See D. Benson (2011) "Lekki/Epe Expressway Toll Plaza: Lagos Govt Violated our Fundamental Right to Protest—Adegboruwa", *Vanguard* newspaper, 22 December, p. 8.

[59] This assertion was made by the Governor while presenting the 2012 budget. See *This Day* newspaper, 11 December 2012.

[60] Tagged "Occupy Lekki". See *Sahara Reporters*, "Occupy Lekki: Lagos Protests Against Lekki Toll Gate", available at http//www.saharareporters.com/news-page/occupy-lekki-lagos-protests-against-lekki-toll-gate (last accessed 13 October 2015).

[61] E. Pedro (2012) "Nigerian Stars Support Lekki Protest", *Daily Times* newspaper, 18 December: p. 15; C. Iremeka (2012) "Anxiety Mounts Over Second Toll Gate" *The Guardian* newspaper, 17 December: 2.

[62] S. Okoruwa and O. Olabulo (2011) "1 Killed, Many injured in Lekki Tollgate Protests", *Nigerian Tribune* Newspaper, 18 December: 4.

[63] "PDP Calls for Fashola's Impeachment Over Lekki Toll Plaza", *Nigerian Compass* newspaper, 16 December 2011, p. 12.

[64] Akinpeli Dada and Rasheed Bisiriyu, "Lagos Cancels Lekki–Epe Expressway Concession", *Punch* newspaper, 28 August 2013; G. Akinsanmi. "Lekki-Epe Road: Lagos to Raise NGN 87.5 bn to Acquire Concession Rights", *This Day* newspaper, 29 August 2013.

proposed to buy out the unexpired term of the concession from the concessionaire. The Governor of Lagos State explained that the move is designed to "leave the State with wider policy options" regarding the infrastructure. However, it is widely believed that this move by the government is in reaction to the continued public opposition to the project.[65]

The problem with the collapse of PPP projects is that it is usually expensive and the biggest losers are usually the citizens. For instance, the Lagos state government has proposed to buy back the concession from the concessionaires through an additional NGN 7.5 billion budgetary allocation[66] and by raising NGN 87.5 billion through the issuance of bonds.[67] In this case, both sources of funds are going to be provided by taxpayers in one way or the other. In contrast, the private sector concessionaire walks away with a profit. This is because the concessionaire would have factored transaction costs, estimated income and a very liberal return on investment into the agreed buy-out amount. All these add up to make the project more expensive than it would have been if it had been completed through traditional procurement. Also, cancellation of projects of this nature lends the perception of the existence of a high degree of political risk within the country, adversely affecting the viability of future projects.

In carrying out a case study of the reasons for the stalling of the project, a number of affected parties were spoken with, and newspaper articles and interviews were also relied on. In summary, the reasons given by the stakeholders for the imbroglio are that:

- the road sought to be tolled had always been in existence and was, in fact, constructed in 1982 by a previous government; that the whole process of upgrading and then collecting toll on an existing road was fraudulent. The opposing public argued that the state government and the concessionaire ought to have constructed and tolled an entirely new road and not the existing one.

[65] See, for example, *Defender* newspaper (2013) "Lekki-Epe Expressway Cancellation: I won't withdraw suit against Lagos, lawyer says", 28 August, available at http://www.osundefender.org/?p=118622 (last accessed on 13 October 2015).

[66] Akinpeli Dada and Rasheed Bisiriyu (2013).

[67] G. Akinsanmi (2013).

- the toll rate—ranging from NGN 120 to NGN 350 depending on the type of vehicle—was exorbitant and led to concomitant increase in bus fares.
- the publicised reason given by the government for the upgrading of the road, which was to improve traffic congestion, has not been achieved. The concessionaire had increased the number of roundabouts to 10 and tolled the 49 km road at three different locations. The stakeholders argued that the numerous roundabouts and the multiple toll plazas mean that the traffic congestion will not abate and that the situation will only ensure the worsening of the present traffic situation.
- as argued by the stakeholders, the government ought to have provided an alternative route before tolling the existing road. The concessionaire argued that there is, indeed, an alternative route, along the Oniru Market Road. The stakeholder groups readily dismissed this position. They contended that any alternative route must run parallel with the existing road and that they must not be made to travel a complicated route to get to their homes and businesses.
- the decision to fence off the highway by the concessionaire was inconsiderate. The concessionaire, however, argued that the decision to fence off the highway was for safety reasons; the stakeholder group alleges that the sole reason was to raise money through advertising on the erected walls.
- the erection of the toll plazas will artificially disconnect communities that have been socially and historically connected for a long time.
- the decision to start collection of tolls on a proposed 49 km road, where only 4 km of the total network was completed, was unacceptable. They felt that, if any collection should take place at all, it should commence after the completion of the entire network of roads. The concessionaire, however, says that it was allowed, under the terms of the PPP contract, to set up its toll plazas and begin collection at this point.

Also, the financial arrangement is shrouded in a great deal of secrecy and, therefore, the people suspect foul play by the government and the concessionaire. People question how much capital was employed in the project,

the level of debt-to-equity ratio, and the exact nature of the relationship between the concessionaire and certain individuals within the government. Finally, it was also alleged that the construction on the road constituted a health hazard by contributing to flooding of houses around the area.[68]

The reasons given by concerned stakeholders for their resistance to the project, while not completely accurate and objective, are indicative of the ease with which improper stakeholder consultation may adversely affect a project. The lack of consultation and transparency in the project has left details of the project open, sometimes, to inaccurate conjecture. Indeed, sometimes it has been easier to get details of the project from people opposed to the project than from the government or the private sector partner, and this has not helped the credibility of the project.

First, it is argued that, if the Lagos state government had engaged the public early enough before embarking on this project, it would have been able to feel the pulse of the public. It would have decided early on whether the public actually wanted the project or not, and on what terms, if any, they were willing to accept the project. Merely dumping or forcing a project onto the public and then requiring them to pay toll fees is not a very wise decision. The issue of the availability of alternative routes could have been resolved prior to the commencement of the project. The fact that the state government had to suspend collection of the toll in the first instance, pending completion of the alternative route, reinforces the argument that the project was commenced hastily without due consideration and consultation with stakeholders.

Second, it is obvious that the stakeholders had no input in the design of the project or the user charge they would pay for the use of the road. If they had, the issues of the multiple roundabouts and toll plazas would have been flagged very early in the initial stages of design and compromise arrangements reached. There could have also been a robust debate about the merits, or otherwise, of erecting fences on the highway and a compromise decision reached, rather than the residents now dreading

[68] On 5 July 2011, there was a protest staged by residents of the area where some contractors working for the concessionaires were beaten up by an angry mob. Flooding experienced in the homes of a number of residents caused the protests. The residents alleged that the flooding was as a result of the ongoing construction work. The concessionaire later issued a statement to the effect that it was not responsible for any of the flooding in the area.

that the fence will alienate them from their kith and kin on the other side. There should also have been consultation on user charges. The decision unilaterally to fix a user charge without input from the public also affected the project.

Third, the stakeholders were not involved in the procurement or tender stage in any shape or manner. This had led to a high level of distrust and allegations of fraud and corruption, which is of no help to anyone. There are reports, though, that there was actually a tender process in which only three companies participated. Opposition claims differently and alleges that the procurement was conducted in secret, so that the government would concession the road to its cronies.

There is dispute regarding when the concessionaire should start collecting tolls on the road. While the stakeholders argue that it should be after the entire 49 km of road is fully completed, the concessionaire argues that, under the Concession Agreement, they were allowed to start toll collection even though only less than 10 % of the road had been completed. It does not help the government and the concessionaire that the public is trying to second-guess the content of an agreement made for their benefit. While conceding that the concessionaire might have some confidential issues which it might not want in the public domain, surely the essential portions of this contract could have been made available to members of the public. This will not only reduce the level of public mistrust, but will also give the public better parameters within which to evaluate and monitor the concessionaire.

From the case study, it is discernible that this project failed because of the lack of stakeholder engagement and management. Stakeholder opposition risk in the project was not identified and dealt with properly at the beginning of the project. Neither was the risk properly allocated to any of the parties to the project and, therefore, not properly mitigated. The private sector party, however, claimed to have undertaken some form of stakeholder consultation but there is no evidence of this. The consequences of not dealing with this risk has manifested in chaos and discontent. The consequence of this is failure of an otherwise good project.

Indeed, even at this stage, where government has taken over the operation of tolling on the road, there is still the need for serious engagement with stakeholders to buy into the project. Some of the genuine

concerns by the stakeholders should be addressed and compromise solutions found; it might not be the same as doing so very early in the life of the project but it will help, especially when government decides to adjust tolls in line with inflation, or for other reasons. The alternative will be for the government to resort to the use of force to continue to compel the public to accept the project, as it presently is, and it is doubtful whether the public will accept any further increases or upwards adjustments in tolls.

## 9.5 Prerequisites for Adequate Stakeholder Risk Management

PPPs are multifaceted and complicated long-term investment projects which involve the ceding of risks, rights and responsibilities that hitherto resided with the public and were held in trust on their behalf by their governments. On the basis of stakeholder accountability theory, it is the position of this book that governments therefore do not have the moral, or even constitutional, right to cede these powers to the private sector without any recourse to the public who actually own these rights and conferred the responsibilities. It is on this basis that it is argued that stakeholder consultation and involvement is not merely desired good governance or moral practice, but is even a constitutional right of the citizens. By its nature, PPPs entail a partnership. It is argued that this partnership is, in real terms, between the citizens (represented by their governments) and the private sector, not between the government, who are merely agents of the people, and the private sector.[69] It is for this reason that the government must therefore ensure that it actively engages the citizens and keep them informed.

There is no uniform, formal systematic stakeholder management approach discernible from the available literature;[70] what we have is a random

[69] See also Mark R. Hayller (2010) "Public-Private Partnerships in Hong Kong: Good Governance—The Essential Missing Ingredient", *Australian Journal of Public Administration*, 69, March: 99–119.

[70] Jan T. Karlsen (2002).

affair,[71] characterised by spontaneity and causal action, which usually leads to unpredictable outcomes.[72] Several authors[73] have, however, proposed various models for managing stakeholders during projects: the suggested options range from identification of stakeholders, analysis of the characteristics and influence of stakeholders on a project, development of an engagement strategy, communicating and sharing information with shareholders to monitor and evaluate the effectiveness of the engagement strategy. These models have been criticised for being based on superficial rather than deep knowledge.[74] Therefore, it has been advocated that these guidelines should be considered as conceptual frameworks, rather than instructions on how to undertake real world stakeholder analysis.[75] There is therefore no single-most effective approach to stakeholder management[76] and the selection of a particular method or strategy should be based on the particular context.[77]

In a similar vein, there has been robust study of the critical success factors for stakeholder management. For example, Jergeas,[78] after carrying out an empirical study, found that communication with stakeholders and setting common goals, objectives and project priorities can improve the performance of project stakeholder management. Olander

[71] Ezekiel A. Chinyio and Akintola Akintoye (2008) "Practical Approaches for Engaging Stakeholders: Findings from the UK", *Construction Management and Economics*, 26 (6): 591–599.

[72] Jan T. Karlesen (2002).

[73] Jan T. Karlesen (2002); Arun A. Elias and Robert Y. Cavana and Laurie S. Jackson (2002) "Stakeholder Analysis for R&D Project Management",*R&D Management*, 34(2): 301–310; Trevor L. Young (2006) *Successful Project Management*, 2nd edn., London and Philadelphia: Kogan Page; Lydia Bourne and Derek H.T. Walker (2006) "Visualizing Stakeholder Influence—Two Australian Examples",, *Project Management Journal*, 37(1): 5–22; Derek H.T. Walker, Lynda Bourne and Steve Rowlinson (2008) "Stakeholder and the Supply Chain", in Derek H.T. Walker and Steve Rowlinson (eds.), *Procurement Systems: A Cross-industry Project Management Perspective*, Abingdon, UK: Taylor & Francis, pp. 70–100.

[74] Anna L. Jepsen and Pernille Eskerod (2009) "Stakeholder Analysis in Projects: Challenges in Using Current Guidelines in the Real World", *International Journal of Project Management*, 27: 335–343.

[75] Ibid.

[76] Jing Yang, Geoffery Q. Shen, Derek S. Drew, Manfong Ho and Xiaolong Xue (2011) "Stakeholder Management in Construction: An Empirical Study to address Research Gaps in Previous Studies", *International Journal of Project Management*, 29: 900–910.

[77] Jing Yang, Geoffery Q. Shen, Derek S. Drew, Manfong Ho and Xiaolong Xue (2011); Lydia Bourne and Derek H.T. Walker (2006).

[78] G.F. Jergeas, G.F. Jergeas, P. Eng, E. Williamson, G.J. Skulmoski and J.L. Thomas (2000).

and Landin[79] compared the project stakeholder management of two railway development projects in Sweden and identified five crucial factors for implementing stakeholder management. These include the analysis of stakeholder concerns and needs, communication of the benefits and negative impacts, evaluations of alternative solutions, project organisation and media relations. Jepsen and Eskerod[80] were of the opinion that identification of sufficiently important stakeholders and warranting information gathering concerning expectations is critical to meeting the challenge of project stakeholder management. Yang et al.[81] were most comprehensive and prioritised 15 critical success factors for project stakeholder management. According to them, the most critical were "managing stakeholders with social responsibilities", "assessing the stakeholder needs and constraints to the project" and "communicating with stakeholders properly and frequently".

If there is any coherent model discernible from these authors, it is that stakeholder engagement or involvement means adopting a stakeholder participatory approach, which entails engaging and involving stakeholders meaningfully at every stage of the project as early as from the project inception stage up to post-project monitoring stage. Initiating early and constant communication with various stakeholders is key to the success of infrastructure projects.[82] Also, capturing the inputs obtained from stakeholders as a result of that communication process into the execution of the project is a crucial aspect of the project development process and must be taken seriously. It is important to note and integrate the concerns of stakeholders into the execution of the project to better facilitate the development of a project that will meet the needs of the stakeholders and not just execute what the

[79] Stefan Olander and Anne Landin (2008) "A Comparative Study of Factors affecting the External Stakeholder Management Process", *Construction Management and Economics*, 26(6): 553–561.

[80] Anna L. Jepsen and Pernille Eskerod (2009).

[81] Jing Yang, Geoffrey Q. Shen, Derek S. Drew and Manfong Ho (2010) "Critical Success Factors for Stakeholder Management: Construction Practitioners' Perspectives",*Journal of Construction. Engineering Management*, 136(7): 778–786; Jing Yang, Geoffrey Q. Shen, Manfong Ho, Derek S. Drew and Albert P.C. Chan (2009)"Exploring Critical Success Factors for Stakeholder Management in Construction Projects", *Journal of Civil. Engineering Management*, 15(4): 337–348; Jing Yang, Geoffrey Q. Shen, Manfong Ho, Derek S. Drew, Xiaolong Xue (2011).

[82] Wim Bakens, Greg Foliente and Mansi Jasuja (2005) "Engaging Stakeholders in Performance-based Building: Lessons from the Performance-Based Building (PeBBu) Network", *Building Research & Information*, 33(2), 149–158; G.F. Jergeas, P. Eng, E. Williamson, G.J. Skulmoski and J.L. Thomas (2000); Stefan Olander and Anne Landin (2008).

government or the private sector entity think is what the public desire. Also, it is important that the public is assured that their concerns are taken seriously. Participatory decision making has been found to generate better buy-ins, thereby limiting delays, mistakes and eventual lawsuits that protract the whole project.[83] It helps create trust, and there is evidence that stakeholders are more likely to accept a decision reached in a participatory manner, even when it is not the individually preferred outcome, because they believe it was reached in an equitable and impartial manner.[84] Finally, it is evident that the particular method used to engage stakeholders depends on several factors, including the nature of the project, the resources available for the project, and the objectives to be attained from the engagement.[85]

From a project risk management perspective, stakeholder opposition risk should be clearly identified very early in the project through the use of risk matrixes. The risk should also be shared appropriately between the parties and not just allocated to the private sector, as was observed in the case study of the Lekki toll road concession.

When PPP projects fail because of stakeholder opposition, this is usually because:

1. the public is unaware, fail to understand the reasons behind the project or have no understanding of the project whatsoever;
2. event (1) has occurred because the public were not properly informed about the project;
3. event (2) would most likely happen because the public are denied access to detailed information relating to the project.[86]

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[83] Donald P. Moynihan (2003) "Normative and Instrumental Perspectives on Public Participation: Citizen Summits in Washington, D.C.", *American Review of Public Administration*, 33: 164–188; Mary G. Kweit and Robert W. Kweit (2007) "Participation, Perception of Participation, and Citizen Support", *American Politics Research*, 35: 407–25.

[84] Robert J. Bies and Debra L. Shapiro (1988) "Voice and Justification: Their Influence on Procedural Fairness Judgments", *Academy of Management Journal*, 31(3): 676–685; Tom R. Tyler and Peter Degoey (1995) "Collective Restraint in Social Dilemmas: Procedural Justice and Social Identification Effects on Support for Authorities", *Journal of Personality and Social Psychology*, 69(3): 482–97. Patrick D. Smith and Maureen H. McDonough (2001) "Beyond Public Participation: Fairness in Natural Resource Decision Making", *Society & Natural Resources*, 14(3): 239–249.

[85] Jing Yang, Geoffery Q. Shen, Derek S. Drew, Manfong Ho and Xiaolong Xue (2011) "Stakeholder Management in Construction: An Empirical Study to address Research Gaps in Previous Studies", *International Journal of Project Management*, 29: 900–910.

[86] Ibid.

Stakeholders have concerns that cut across every stage of the project and therefore must be actively engaged and encouraged during every stage of the project: at project tender, project design, construction and post-project monitoring.

### 9.5.1 Project Tender

At this stage, stakeholders have concerns about the nature, objectives and rationale for the project, the relative costs and identification of those on whom the cost might fall.[87] Value for money and loss of jobs considerations are also of concern to stakeholders at this stage. Lack of consultation or inadequate consultation at this stage may lead to accusations against the government of collusion, fraud, corruption and favouritism, as was the case in the Lekki toll road project. Accordingly, failure to involve potential stakeholders sufficiently and consult with them can lead to distrust from the public, conflict of interests and, ultimately, project failure.[88] Sometimes, enthusiasm for PPPs can give rise to hastily crafted partnerships that are likely to trigger public opposition.[89]

### 9.5.2 Project Design

At this stage, stakeholders are concerned about design efficiency and whether, for instance, the designs are going to affect the culture, values, traditions, religion and heritage of the people. One of the complaints raised by stakeholders against the Lekki concession was that the toll plazas artificially disconnected communities that have been socially and historically connected for a long time. Another example could be a situation where, for instance, innocently designing a national monument to look like a mosque might offend the sensibilities of a section of the Christian communities in Nigeria and this may derail an otherwise good project.

[87] Mark R. Hayllar (2010).

[88] OECD (Organisation for Economic Cooperation and Development) (2007) *OECD Principles for Private Sector Participation in Infrastructure*.

[89] John Forrer, James Edwin Kee, Kathryn E. Newcomer and Eric Boyer (2010).

Such concerns can be flagged early and necessary adjustments made to address the issues. The private sector is advised to adopt a high degree of transparency and provide as much information as possible regarding technological options, costs, and so on.[90]

### 9.5.3 Construction

At this stage, the stakeholders are concerned with how construction activities by the private sector impact on their daily routine and lifestyle. For instance, there may be concerns about issues such as environmental degradation, public nuisance and traffic congestion. These were all issues that affected the Lekki toll road project. Also, there might be concerns relating to whether projects are going to be delivered within the stipulated and agreed time frames.

### 9.5.4 Post-Project Monitoring

Issues of service efficiency, adequate regulation, contract violation and variation may cause concerns for stakeholders. It is vital at this stage that targets and key performance indicators are set out. This will lead to better accountability and will enable the stakeholders to better monitor and evaluate the project.[91]

Stakeholders should actively be encouraged to participate in every step of the project, especially from project conception, and throughout implementation and monitoring. The members of the public should have a say on whether a particular project is initiated or not. If they decide to go along with the project, their input in the PPP decision making process and any suggested alternative course of action advised by them ought to

[90] OECD (2007) "OECD Principles for Private Sector Participation in Infrastructure", available at: http//www.oecd/investment/investmentpolicy/38309896.pdf (last accessed on 13 October 2015).

[91] This is limited by the fact that PPP contracts are usually very complex and difficult to understand, and that the private sector might insist that certain aspects of the contract remain confidential, which therefore limits the amount of information that may be available in the public domain.

be taken onboard and be seen to have been incorporated in the final decisions taken with respect to the project.

It also makes sense on the part of government to bring end-users and the private sector involved in providing the service together as early as possible. That way, both parties reach consensus early and their objectives, needs and concerns can be identified and addressed fully in the execution of the project.[92] Due to differences in the project objectives of the private sector and the public sector, and also members of the public, there are bound to be disagreements. It is therefore essential to provide avenues for the resolution of differences in the PPP decision making process, to resolve the disputes which are, ultimately, bound to occur between the private sector and the public before these develop into full-blown conflict.

An important resource for stakeholder engagement in PPPs is the OECD Principles for Private Sector Participation in Infrastructure,[93] which also recommends most of these doctrines discussed above. Countries like Nigeria that aspire to the use of PPPs as a method of financing infrastructure should look towards adopting several of them. On 20 March 2007, the Council of the OECD approved the Principles for Private Sector Participation in Infrastructure to help governments work with private sector partners to finance and bring infrastructure projects to fruition in areas such as transport, water, power supply and telecommunications.[94]

The Principles were developed through a process of consultation with broad groups of public and private sector experts from OECD and non-OECD countries, as well as from nongovernmental organisations.[95] These principles provide a template for the improvement of governance in private sector participation in infrastructure, as well as a tool for government assessment, action plans and reporting international cooperation and public private partnerships. Of particular interest to this work are Principles 3, 9, 13, 23 and 24.

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[92] The Guidebook on Promoting Good Governance in Public Private Partnerships, supra.

[93] OECD principles for Private Sector Participation in Infrastructure, supra.

[94] Preamble to the OECD principles for Private Sector Participation in Infrastructure, supra.

[95] Ibid.

> Principle 3: *The allocation of risk between private parties and public sector will be largely determined by the chosen model of private sector involvement, including the allocation of responsibilities. The selection of a particular model and an associated allocation of risk should be based upon an assessment of the public interest.*

This principle summarises the principal theme of this section of the book, which is that risk allocation should not be based only on commercial principles; the interests of the public should also be taken into consideration.

> Principle 9: *Public Authorities should ensure adequate consultation with end-users and other stakeholders including prior to the initiation of an infrastructure project.*

PPPs are likely to fail unless public authorities have assured themselves beforehand that the projects are in the public's interests and are acceptable to consumers and other stakeholders.[96] This involves consultation with all affected parties, especially if the transfer of infrastructure services to the private domain is linked with a cessation of subsidies, as consumers may see this as a denial of well-earned rights.[97]

> Principle 13: *To optimize the involvement of the private sector, Public Authorities should communicate clearly the objectives of their infrastructure policies and they should put in place mechanisms for consultations between the public and private sectors regarding these objectives as well as individual projects.*
>
> Principle 23: *Private sector participants should contribute to strategies for communicating and consulting with the general public, including vis-à-vis consumers, affected communities and corporate stakeholders with a view to developing mutual acceptance and understanding of the objectives of the parties involved.*

Corporate approaches to communication and consultation with the public and other affected persons generally work better when applied in concert with, rather than in lieu of, public sector communication strategies. It is interesting to note that, in the Lekki toll road concession, communication with

[96] OECD 92007) "OECD Principles for Private Sector Participation in Infrastructure" available at http//www.oecd/investment/investmentpolicy/38309896.pdf [Last accessed on 13 October, 2015].
[97] Ibid. This explains some of the reasons for public revolt to the Lekki toll road concession.

the user public was left solely to the private sector. End-users should have appropriate access to information about the financial and technical aspects of the project, and be given the opportunity to make their priorities heard. If this is not done, the public might respond with hostility to tariff adjustments and any other shortfall in services relative to expectations, potentially leading to a backlash against both the government and the private sector partners.[98]

> Principle 24: *Private sector participants in the provision of vital services to the communities need to be mindful of the consequences of their actions for those communities and work together with public authorities to avoid and mitigate socially unacceptable outcomes*.

Issues such as the affordability of services, and the promotion and upholding of human rights are some of the issues to which the private sector should pay attention.[99] Private parties, while not directly responsible for these issues, must show willingness to take into account these concerns while engaging with the public sector in PPP transactions.

These principles provide a broad outline and create responsibilities for both the public and private sectors in the stakeholder engagement process. It is recommended that Nigeria, despite not being a member country of the OECD, should use these broad guidelines in developing a comprehensive framework for stakeholder engagement.

## 9.6 Stakeholder Engagement Principles for PPPs in Nigeria

The National Policy on PPPs recognises the need for public interest consideration in PPPs. It provides as follows:

1. Public authorities should ensure adequate consultation with end-users and other stakeholders prior to the initiation of an infrastructure project;

[98] Ibid.

[99] Ibid.

2. Private sector participants in a PPP project will contribute to strategies for communicating and consulting with the general public, customers, affected communities and corporate stakeholders, with a view of developing mutual acceptance and understanding of the objectives of the public and private parties;
3. Private sector contractors in the provision of vital services to the communities need to be mindful of the consequences of their actions for those communities and work together with the public authorities, to avoid and mitigate socially unacceptable outcomes.[100]

In practice, despite these express provisions, scant attention has been paid to this very important aspect of the National Policy. The reasons for this may be traced to the very foundations of PPP in Nigeria. The government has always seen the use of PPPs primarily as a means of raising the much needed off-budgetary finance for infrastructure projects. In the haste to complete projects quickly, insufficient attention has been paid to a stakeholder engagement process and there has definitely been no connection drawn between proper stakeholder management and concepts like value for money and better service delivery. The management of stakeholders has only focused on internal stakeholders, where project steering committees and delivery teams have been formed and have focused on managing relations between the different MDAs that make up these steering committees or project delivery teams. Hitherto, the idea had been basically to 'dump' the project, risks and other stakeholder management responsibilities on the private sector. There is perhaps now a need to codify the requirement for public consultation in a legal instrument, taking cognisance of the stakeholder accountability theory articulated in this book.

When a government decides to enter into long-term PPP contracts, it inevitably cedes to the private sector some of the rights constitutionally granted by its citizens through the electoral process and constitutionally guaranteed obligations it owes its citizens. Unlike elected governments, the private sector owes no duty to the people beyond those which have been documented in a contract which, in any case, is most often hidden

[100] National Policy on Public Private Partnership, 2009.

away from the people in the guise of protecting private sector confidentiality. This can lead to the public feeling completely alienated from the whole PPP process.

Again, most long-term contracts usually contain clauses that are designed to protect the income of the private sector, like stabilisation clauses[101] and non-compete clauses.[102] These clauses have the effect of, for instance, preventing the passage of new laws that will adversely affect the revenue of the private sector investor. Neither the executive nor the legislature has the power to cede this constitutional right to make or execute legislation. It is argued that if, indeed, there is a need to enter into such a contract where these rights or obligations are going to be curtailed, then only the citizens to whom those obligations are owed or who bestowed such rights on the government in the first place should be allowed to make the decision. This further emphasises the constitutional right of the public to be properly engaged and consulted throughout the private sector engagement process.

This problem enumerated in the case study is not unique to the Lekki Road Concession Project; it is prevalent in nearly all the PPP projects in Nigeria. In fact, the problem dates back to the privatisation era under the BPE. However, the limited consultation in that case may be excused because of the complete transfer of the public asset that occurs under privatisation. The same conditions that dictate the limited method of stakeholder engagement during privatisation is non-existent in PPPs. PPPs require a higher degree of stakeholder involvement and the government should build in a mechanism for early, useful and real stakeholder engagement into its PPP procedures and rule books. The present practice of merely paying lip service to the need for stakeholder engagement in the different PPP policies is not enough; there should be a detailed

[101] These clauses are risk management devises used to stabilise the expectations of investors for instance preventing changes in the laws from adversely affecting the investment contract during the term of the investment. Depending on which side you are, stabilisation clauses are either an absolute necessity or out rightly dubious.

[102] Some PPP contracts prevent the building or improvement of competing infrastructure in order to leave no alternative but using the private sector's infrastructure and thus guaranteeing its revenues. See generally Ellen Dannin, (2009) "Infrastructure Privatization Contracts and Their Effect on Governance", *The Pennsylvania State University*, *The Dickson School of Law*, *Legal Studies Research Paper* No. 19–2009 @, p. 9.

exposition of how the engagement of stakeholders would take place in practice, and the consequences of not following them.

Partnership Victoria in Australia has a best practice procedure that is recommended by the Guidebook on Promoting Good Governance in Public-Private Partnerships.[103] Under this practice, the decision on whether or not a PPP should go forward or not depends on three questions:

1. Which if any part or parts of the proposed service is a service that the government itself should deliver to its citizens? (The core service question).
2. For all other aspects of the service and supporting physical infrastructure, what is the project model that delivers the best value for money? (The value for money question).
3. Do the outcomes of the value for money question satisfy the public interest criteria articulated in the policy? If not, can the public interest criteria be satisfied by either building safeguards into the contract or through regulatory measures (and at what cost), or should the project be reconceived to "reserve" further areas of service for provision directly by the government? (The public interest question).

The PPP process must put people first. Government and the private sector must communicate with affected stakeholders to develop mutual understanding of the project objectives. This is crucial for the private sector, as well as its public sector partners. For the private sector, stakeholders play a very important role in their success. Stakeholders pay the user charges that ensure that the private sector recovers its investments and makes a profit for its shareholders. Opposition to the project might limit its ability to do this.

For the government, the stakeholders qua citizens are responsible for putting them into power, and the success of most governments depends on what the citizens perceive as the government's achievements. Where the public have doubts about government policies, it may mark the end

[103] United Nations Economic Commission for Europe (2008) Guidebook on Promoting Good Governance in Public-Private Partnerships, New York and Geneva: UNECE.

of the particular government. From a project governance perspective, the public can play an active role in improving project accountability and service quality. The people not only play the role of service receivers, but can also be active service partners;[104] this can happen only when they are properly engaged.

PPPs are usually complex and difficult to understand. This problem is even more pronounced in a country like Nigeria where PPP is a novel concept, and there is greater suspicion and lack of trust because of previous government antecedents. Perhaps the government and the private sector need to invest a little more in educating the people about the nature and merits of PPPs, so that they are equipped to play a more participatory role in the process which affects their lives more than that of the government officials who make these decisions on their behalf.

## 9.7 Conclusion

This chapter examined stakeholder opposition risk. First, it compared the use of the term "public opposition risk" and "stakeholder opposition risk" in different literature, opting for the use of the term "stakeholder opposition risk" because of its wider scope and theoretical foundations.

The chapter emphasised the correlation between the success of projects and proper stakeholder management. This is even more relevant under PPPs because PPPs are very political and controversial, primarily because they pursue the divesting of public control and the operation of public assets to a private sector operator. There is therefore a need to properly gauge the acceptance of the public for a project and find ways of mitigating any apprehension before its commencement, otherwise there is a risk that the public will oppose the project.

The chapter further advocated the extension of stakeholder theory into stakeholder accountability theory as the theoretical basis for analysing stakeholder opposition risk in PPPs, as both the private sector and the government ought to pursue stakeholder accountability because it

[104] Shafiul A. Ahmed and Syed M. Ali (2006) "People as Partners: Facilitating People's Participation in Public Private Partnerships for Solid Waste Management", *Habitat International*, 30: 781–796.

is morally desirable, necessary for successful project delivery, and also legally, or even constitutionally, obligatory on the part of government.

Finally, the case study of the Lekki toll road concession reveals that stakeholder opposition risk is not being properly handled in Nigeria. The project almost collapsed for this reason and continues to suffer credibility issues arising from this lack of consultation. This further emphasises the need for proper risk allocation and mitigation as a sine qua non to the emergence of good projects in Nigeria.

# 10

# PPPs in the Future in Nigeria

## 10.1 Towards a New Regulatory and Institutional Framework for PPPs

Prospective investors in Nigeria's PPP projects would like to be assured of a predictable, enabling and well-defined legislative and regulatory environment to convince them that their investment will be safe. Currently, Nigeria lacks this sort of legislative and regulatory framework, and this has heightened the perception of the country as being susceptible to political risk.

It was pointed out in previous chapters that the legal and institutional framework for PPPs in Nigeria comprises a tangled and confusing web of regulations and policies. There are just too many conflicting laws and institutions regulating PPP projects and most of them contradict each other, while others do not take cognisance of other existing legislation. This situation leads to project delays, manifest uncertainties, a drain on the public purse and conflict between government agencies. It is obvious, therefore, that there is a need for a review of the entire legal framework for PPPs in Nigeria.



G. Nwangwu, *Public Private Partnerships in Nigeria*,
DOI 10.1057/978-1-137-54242-7_10

The major legislation for PPPs, the ICRC Act, is deficient in so many respects; the decision to use a policy document to expand and to fill gaps in the ICRC Act further exacerbates the problems. Conventional wisdom is that the law should follow the policy instrument and not the policy instrument superseding and contradicting the law. The ICRC Act created the ICRC as the regulator for PPPs in Nigeria. The use of the word "regulatory" in the title of the ICRC Act is a misnomer in itself, as the ICRC is neither an economic nor technical regulator. In fact, the organisation hardly performs any regulatory function. This explains why the institution is still grappling with an identity crisis despite now having been in existence for 11 years. It continues to find it difficult properly to define or position itself within the PPP project cycle, oscillating from performing the role of a project developer to being a transaction adviser, and then to assuming the role of a regulator over the years. The position of this book is that Nigeria does not really require a "regulator" for PPPs in the true sense of the word. What the country needs is a "facilitator" for PPPs. Most sectors of the economy now have economic and technical regulators; any additional regulator overseeing the same sector is bound to create confusion and increase the cost of compliance for the private sector.

The other major legislation, the Privatisation Act, on the other hand, was enacted principally for superintending the federal privatisation programme, which is slowly winding down. While one would argue that there is a difference between PPPs and privatisation, these lines are, however, quite slim in practice as the boundaries of PPPs are elastic. This is why the Privatisation Act was relied on to complete a number of concessions in consonance with the provisions of that law but in conflict with the ICRC Act. The Privatisation Act also creates a very robust and well-staffed institution, the BPE, which continues to be funded through budgetary allocations. However, it is doubtful whether the country still requires an elaborate privatisation institution as it winds down its privatisation programme. The position of this book, therefore, is that both the BPE and ICRC laws should be repealed; they should be replaced with a single piece of legislation that will create one institution that will serve under the limited operational framework of a PPP resource as an advisory base for public authorities and as a facilitator for PPPs in the country.

## 10.2 Rethinking the Management of Risk

First, after an evaluation of the theoretical and empirical analysis of risk allocation and mitigation methods around the world, it was concluded that, even though there were several factors that enable the success of PPP transactions, proper risk allocation and mitigation was key and the most critical. The book went on to measure the performance of PPP projects that have been concluded in Nigeria within a risk management framework. It was confirmed that these projects suffered major shortcomings, principally because risks were not managed properly.

Second, it was discovered that most of the literature and empirical studies analysed in this book tended to view risk as a static construct. However, in reality, risks continue to change during the lifetime of a project and the different categories of risk are interrelated. Also, the attempt at the mitigation of one type of risk may increase the likelihood of another type of risk occurring, shift the burden of the risk to another party, or increase the profile of another category of risk not even contemplated by the parties. This is evident from the MMA2 case study, where the use of non-compete clauses in the Concession Agreement, in order to protect the private sector investor from demand risk, led to the increase in political risk, as it was discovered that government was more likely to breach the concession contract rather than suffer the consequences arising from enforcement of that clause. It is proposed that there is a need to look at risk mitigation more holistically, rather than dealing with each risk category separately.

It is evident from the history of PPPs in Nigeria, and even its precursor privatisation programme, that the issues of risk transfer, risk balancing and risk mitigation have never been properly handled. There has always been some tendency to dump all the project risks on the private sector partner without properly evaluating whether it is capable of managing them adequately. This was less damaging in privatisations, which involved absolute transfer of title; however, the negative consequences are more obvious with concessions. Where the comparative capacity of parties to handle risks is not properly analysed, the allocation of risk is unbalanced and the tendency for the project to run into difficulties, and

even fail, increases. Yet, the practice to dump the risks on the private sector appears to be favoured in Nigeria. This is principally because it fits into the overriding policy reason for PPPs in Nigeria, which is to raise money off government balance sheet. Lesser consideration is often given to the other benefits that arise from implementing PPPs, as they are not a more direct and convincing selling point than saving government funds.

Third, it was also discovered that the predisposition to shift all the risks to the private sector has led to an increase in the use of secondary risk mitigating techniques by the private sector. These techniques—including "non-compete clauses", "guarantee clauses", "equilibrium clauses" and "stabilisation clauses", among others—are not sustainable in the long term. The use of these clauses contributes to denying citizens access to infrastructure services and stifles economic and infrastructure development in the long run. For instance, non-compete clauses could bar the government from building additional competing infrastructure close to that built by the private sector partner, irrespective of inadequacies that may arise in future. The likely consequence of this is that government ultimately breaches its contractual obligations following its likely inability to absorb the socio-economic consequences of contracts that include such secondary risk mitigating techniques.

Finally, in the area of risk, three different case studies were carried out, with each case study dealing with a single case or project. Each of the cases was used to illustrate or discuss how a particular type of risk was handled in PPP projects in Nigeria. The three cases were: the concession of the 26 ports (political risk), the MMA 2 local airport terminal in Lagos (demand risk) and the Lekki toll road concession (stakeholder opposition risk). The three cases were selected basically because they are three of the biggest transactions that have been concluded and are currently in their operational phase in Nigeria. Below is a summary of the findings and recommendations on the three different risks derived from the three projects that were evaluated.

### 10.2.1 Political Risk Recommendations

1. Strong political support is imperative for the success of PPPs in Nigeria and all over sub-Saharan Africa, as no long-term project can proceed successfully without the continued support of successive governments

or administrations. Parties to the PPP contract, especially government, must also have a realistic and honest awareness of what they are able to bring to the transaction, instead of making reckless and spurious undertakings, either in the form of representations or warranties. This will ensure that their undertakings under the contracts are in tune with the abilities and resources available to them. This will reduce the incidences of contractual breaches.

2. The lack of coordination between the different arms of government and the different agencies of government in issuing guarantees, warranties and other commitments to the private sector increases the contingent liabilities of government. However, it is conceded that there must be a means of ensuring that transactions which deserve such guarantees benefit from them. The government has now created a central risk management unit within the Ministry of Finance to have an overview of and track the contingent liabilities that may arise from these guarantees, warranties or other commitments; this is a productive development.
3. There is a need to have independent regulators in place in the different infrastructure sectors. The situation where the government is both a party in and regulator of certain contracts, especially in the transport sector, leads to conflict of interest. Invariably, this affects contractual equity and fair play. The passage into law of the various infrastructure-wide bills currently before the Nigerian parliament will be a step in the right direction.
4. Corruption is pervasive in the Nigerian public service and this increases the cost of doing business in the country. This takes its toll not only on the transactions, which suffer from lack of credibility, but also private sector profits and, ultimately, the sustainability of the business. There is therefore need for this malaise to be tackled effectively for the sustainability of PPP projects. Conversely, PPPs actually help in reducing corruption, as PPP transactions take away the opportunity for government officials to participate in commercial transactions on a day-to-day basis, since the management of the projects resides with the private sector.
5. Lack of human and institutional capacity in the public sector is a major problem. This obvious deficiency usually results in government

assuming risks and obligations during contractual negotiations to which it would not ordinarily have acceded if the public officers negotiating on its behalf were better aware at the time. The short-term solution for the government is to engage competent transaction advisers and, in the long run, to build the capacity of its workforce. The private sector parties should also ensure the fairness of contracts, instead of taking undue advantage of the naivety of the government, because one-sided contracts have a high tendency to backfire as government tries to assert its authority, to the detriment of both parties.

6. The inadequacy and multiplicity of the federal legislation on PPPs is also a major problem. The best method for mitigating political risk is through the enactment of an appropriate enabling legal framework that supports PPP and eliminates loopholes for the manipulation of the system. As has been mentioned, it is advised that Nigeria re-engineers its legal and regulatory framework so that it will give necessary comfort to the private sector.

### 10.2.2 Recommendations for Demand Risk

1. In allocating demand risk in infrastructure projects, parties to PPP contracts, particularly the public authorities, must not be slaves to the use of concession contracts to the exclusion of availability contracts. The decision to use either of the two options must be predicated on sound project evaluations. Several studies have shown that it is erroneous to assume that either of the two contract types is better than the other.[1] The key is to understand when to use one option in favour of the other.

[1] J. Brux Gregor and C. Desrieux (2012) "Public Private Partnerships and the Allocation of Demand Risk: An Incomplete Contract Theory Approach", (online), available at http://extrant.isnie.org/uploads/isnie2012/de-brux_desrieux.pdf (last accessed 13 August 2012); L. Athias (2007) "Political Accountability, Incentives, and Contractual Design of Public Private Partnerships" MPRA Paper No. 17,089, online, available at http://mpra.ub.uni-muenchen.de/17089/ (last accessed 5 May 2012); L. Athias and R. Soubeyran (2012) "Less Risk, More Effort: Demand Risk Allocation in Incomplete Contracts", (online), available at www.lameta.univ-montp1.fr/Documents/DR2012-20.pdf (last accessed 11 August 2013).

2. There is generally nothing wrong with the public sector passing demand risk to the private sector. However, to pass this risk appropriately the public sector must realise that the private sector partner will demand certain incentives. The public authority must also assess whether it is able to bear the consequences. This requires a conscious evaluation and pricing of the risk by the public sector, including non-commercial factors such as the satisfaction of citizens, both in the short and long term.
3. In situations where the government decides that it wishes to transfer demand risk to the private sector, there are other less onerous methods of achieving this than have been used in some of the concession contracts in Nigeria. If the use of availability contracts is preferred to concession contracts, then the public sector must ensure that payments are only made according to predefined and measurable outputs in the contract. These outputs must act as targets which the private sector must fulfil. To compel adherence to the standards of the specified output and encourage efficiency from the private sector, the contract should also provide for penalties and bonuses. This will encourage the private sector partner to continue to innovate.

### 10.2.3 Stakeholder Opposition Risk

1. It is argued that stakeholder consultation and involvement is not merely desired good governance or moral practice, but even a constitutional right of the citizens. It is also opined that the real partnership in PPPs is actually between the citizens (represented by their governments) and the private sector, not between the government (who are merely agents of the people) and the private sector.[2]
2. Stakeholder engagement or involvement means adopting a stakeholder participatory approach, which entails engaging and involving stakeholders meaningfully at every stage of the project, as early as from the project inception stage up to the post-project monitoring stage. Initiating early and constant communication with various stakeholders

[2] See also Mark R. Hayller (2010) "Public-Private Partnerships in Hong Kong: Good Governance—The Essential Missing Ingredient", *The Australian Journal of Public Administration*, 69: S99–S119.

is key to the success of infrastructure projects.[3] Also, the particular method used to engage stakeholders should depend on several factors, including the nature of the project, the resources available for the project and the objectives to be attained from the engagement.

3. From a project risk management perspective, stakeholder opposition risk should be clearly identified very early in the project through the use of risk matrixes. The risk should also be shared appropriately between the parties and not just allocated to the private sector, as is the case currently in Nigeria. Stakeholders should actively be encouraged to participate in every step of the project, especially from project conception and throughout to implementation and monitoring. Public opinion should always be taken into serious consideration when decisions are taken on whether particular projects should be initiated or otherwise.
4. Despite the express provisions of Nigeria's National PPP Policy on the need for stakeholder engagement, the public has hardly been engaged in practice. There is therefore a need for a mandatory requirement for public consultation to be taken more seriously by codifying the provision in a legal instrument. The consultation process advocated by the Environmental Impact Assessment legislation is inadequate to meet this constitutional necessity.
5. From a project governance perspective, the public can also play an active role in improving project accountability and service quality. The people may not just play the role of service receivers, but can also be active service partners; this can happen only when they are properly engaged.
6. PPPs are usually complex and difficult to understand. This problem is even more pronounced in a country like Nigeria, where PPP is a novel concept and there is greater suspicion and lack of trust between the citizens and the government because of previous government

[3] Wim Bakens, Greg Foliente and Mansi Jasuja (2005) "Engaging Stakeholders in Performance-based Building: Lessons from the Performance-Based Building (PeBBu) Network", *Building Research & Information*, 33(2): 149–158.; G.E. Jergeas, P. Eng, E. Williamson, G.J. Skulmoski and J.L. Thomas (2000)"Stakeholder Management on Construction Projects", *AACE International Transactions*, 12, 1–5.; S. Olander and A. Landin (2008) "A Comparative Study of Factors affecting the External Stakeholder Management Process",*Construction Management and Economics*, 26(6): 553.

antecedents. Perhaps the government and the private sector need to invest a little more in educating the people about the nature and merits of PPPs so that they are equipped to play a more participatory role in the process.

## 10.3 Rethinking Value for Money in PPPs

This book identified that, in deciding whether to finance a project through PPP rather than through traditional public sector procurement, the major consideration for most governments is usually whether the PPP alternative presents better VFM to traditional public procurement. VFM is often computed in most jurisdictions by using a benchmark called the PSC. The issue on the suitability of the PSC for PPP benchmarking is not yet topical in Nigeria because the focus for the government now is primarily to raise much needed private sector finance for PPP projects and not to engage in comparative evaluations between non-existent alternatives.

Indeed, PPP is one of the most frequently used sources of infrastructure development globally and, as the country continues to mature in PPP project delivery, VFM—and, by extension, the use of the PSC—will become more important considerations. Despite its limited relevance to current Nigerian circumstances, the PSC remains a useful tool, as it performs other functions apart from determining VFM. First, it promotes full costing of alternatives at an early stage in project development; second, it provides a key management tool during the procurement process by focusing attention on the output specification, risk allocation and comprehensive costing. Third, it provides a consistent benchmark and evaluation tool that can be used to assess the project. Finally, it encourages competition by generating confidence in the market that financial rigour and probity principles have been applied to the project.[4]

Currently, the National Policy on PPPs does not provide any discernible basis for PSC computation, conceding that there is no simple

[4] Darrin Grimsey and Mervyn K. Lewis (2005) "Are Public Private Partnerships Value For Money: Evaluating Alternative Approaches and Comparing Academic and Practitioner Views", *Accounting Forum*, 29: 345–378.

rule that can be used to satisfy a VFM test because of the difficulty in measuring the quality and cost of a service, as well as the unavailability of relevant data.[5] While admitting that Nigeria must not necessarily use the PSC as the basis for determining VFM in projects, it remains a fact that the country urgently needs a decision making framework, which could be either a refined PSC framework that takes into consideration the social and economic realities of the country, or a credible alternative.

[5] National Policy on Public-Private Partnerships, p. 35.

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G. Nwangwu, *Public Private Partnerships in Nigeria*,
DOI 10.1057/978-1-137-54242-7