Infrastructure Finance
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Lecture - 34
Risk Management - Country / Political Risks III

Welcome back to this course on Infrastructure Finance, this is a lecture 34. We will continue our discussion on Risk Management, specifically with the focus on Country and Political Risks in this lecture as well.

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And before we actually going more detail about the country and political risks. In fact, if you remember we had a initiation to this topic in the previous lecture, and we will try and continue the discussion in this lecture as well. But before we do that, let us try and spend some time to talk about this thought question, that we actually had at the end of the previous lecture. We had two questions; the first question is political risk a concern only in the case of a foreign investment, before we actually try and discuss this question, I want to give you an example of about, what is political risk.

Because political risk is a very, very broad converse and then there are so many things which can actually be club runner political risk. So, to help you to understand what can be actually called as political risk, let me give you this example; in about, in early 1990's

when India actually went on path of a liberalization and reform and so on. Many of the infrastructure sectors, which were once reserved for public sector investment were thrown open for private sector.

So, one of the first sector that was thrown open was the private sector, and specifically power generation. And the first larger a private sector investment that happened India was for a power generation project, which was situated in state of Maharashtra. So, this project was being promoted by company called indrawn, which at that time was one of the world largest energy company. Today, the company it does not exist in a significant way, but indrawn was a leader in power generation at that point in time.

And they actually got a mandate to setup a large power project, more than 2000 Megawatt power project, in the costal part of Maharashtra. And the total investment at that time was worth about 2.8 billion dollar, and close to about 3000 people were suppose to be employed in the project, doing the construction, and subsequently when project has been operate as well. And the project was suppose to be in two phases, the first phase about 600 Megawatt generation capacity; and in the second the remaining about 1400 Megawatt capacity.

And in 1995, when the state government actually changed, so initially it was the congress government. And then subsequently in second half of 1995, a new government took over of his after the election. So, when the new government came into the picture, they actually cancel the contract indicating various reasons; the first reason that they decided was the project was been awarded without any competitivity. Remember at that point in time, when India was opening up it is country for private sector investment, the lot of concessions that were needed to provided.

So, over a period of time it became mandatory that, large investment would have to be awarded on the basis of competitive bidding, but the initial few projects were suppose to be it is objective of giving proof that, India is open for private sector investment. And they were not actually awarded on the basis of competitive bidding, so a discussion to it was more of a memorandum of understanding that was signed, between the government and the investors, and based on that the permission or the approval was granted, so this was side as reason for the cancelation of project contract by the state government.

So, they actually cancelation happened two things, one is the first phase investment of about 600 million which is already occurred, and in the second phase which was yet to happen. So, the state government canceled the second phase of the contract siding that the project has been awarded, without any competitive bidding. And the phase of the project for which a power purchase agreement had been signed as well with the Maharashtra state electricity board, was cancel siding the tariffs were very high.

So, all of this in terms of the higher tariff all this known, even at the time of singing the contract as well, but all of this became an issue, because of the change in the political government at the state level. So, this essentially was a precipitator, because of a political risk, because of the change in government it is not a because of a any of the other reasons that one could actually think of. So, this is a good example of how political risk can actually affect the infrastructure projects, and then in addition to cancelation of the project, because of higher tariff and so on.

They were questions about the environmental concern of the project, so there were lot of movements both of the local level as well as the state level, siding, civiler, environment impacts that could occur, because of the project. And that again is also an outcome of the political risk, and so the entire project at the end of the day becomes so mired a lot of a producers and legal problems. And ultimately it is very, very severe setback for the investors, so this is an example of a political risk.

So, the question is, in this case of indrawn we actually had investors from abroad, so we had indrawn, we had a general electric, these are all companies which are based in the west. And did the political risk come about, because of a foreign investment had we actually had complete investment from the domestic investors would be actually had political risk. So, political risk is immaterial of whether the investment is coming from foreign or whether the investment coming from the domestic. So, there are several instances, where even investors they are from the private sector, they actually had to suffer, because of the political risk.

One famous case is a toll road in Karur, which actually had to branch which was taken over by the government from the private sector, following a change in government. So, in this case there was no foreign investors involved, it was more a domestic investment, the road was actually developed by largest and too broad, which is in more than one

sense consider to be domestic company. But still because of the change in the government, the project was taken over by state government.

And then obviously, there was some compensation given, but the compensation might not be adequate to meet the expectation of the private investors. So, therefore, the risk is largely an issue against a private sector investment, on private sector profiting in the infrastructure segment. It is little bit higher in the case of foreign investment, but we cannot say that the political risk is completely absented, when you have only domestic investment.

Now, let us look at the second question, is political risk seen only in developing countries or do we actually also see some seeds of political risk in fairly developed countries as well. So, the answer to that question is, there are different types of political risk and one of the segments of political risk is actually called as a change of law risks, we will deal about some these in today's lecture as well. So, when you consider about change of law risks, change of law risks is essentially prevalent throughout the world, it is not only an aspect that concern only developing countries.

And particular Finotin is book mention that US probably actually has a highest amount of risk, because of changes in law. Changes in law affect the project in many ways, most cases environmental regulations or change with retrospective effect, that is even existing projects will actually have to comply with any changes in the environment regulations. So, this actually creates affects the project and it can actually be seen as one of the political risk, so there is one example that Finotin sites in his book, which is actually the Bonneville power authority, this is actually govern grown authority.

And it is actually sing a contract purchaser power with a power plant, and on the basis of this contract private investors are invested in the construction and development of the power plant. But, midway through the construction apparently the authority which is actually arm of the government, pull back out of the contract saying that it is customers have walked away from the power contract, because they have not been able to find cheaper sources of power.

And because it is customers are walked away, this not able to honor the power purchase contract that has signed with the a project company. So, this actually in some sense government authority not honoring the commitment on the obligations of the contract,

and this actually happened in the development country which is a US. So, there we cannot really see political risk as being prevalent only in developing countries, it may be relatively higher, but we can also see political risk even in developed countries.

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With this we will actually look at the today's lecture, which is to discuss little bit more about political risk. First question is can we actually classify political risk, yes we can actually look at political risk under various categories, broadly we define political risk as under three categories, one is the investment risk. So, investment risk basically is a unwillingness or the inability of the host government, to fulfill the obligations of the government support agreement.

In most infrastructure projects what you actually have is, there is government support agreement, where the government clearly indicates what this sign of support that this be able to give the project company. Now, generally in most circumstances, the government sings the agreement with the objective of attractive private sector investment. But, in the future if for some reason of the other, the government is unable, one is it is unable to actually honor the obligations of contract.

And the second is even though it is able, it would be able to honor, it is unwilling to honor the obligations of the contract, so in both this cases the investment risk is prevalent for the project company. So, next is your change of law risks, when there is a new law that is being instituted or there are changes to the regulations under the existing law, it

can actually affect the variability of the project, so this is this is basically change of law risks. Law making is essentially a political process, so therefore in this change of law risks can also be consider as a element of a political risk.

And then you have quasi political risks, basically these are issues that might either have a political or commercial background, but it is going to be very difficult to distinguish between these two. So, therefore, these are all probably problems that has a political connotation, it is probably has a political background, but makes it very, very difficult to distinguish whether it is really a commercial risk or it is a risk that is arising, because of political reasons. So, each of them has certain specific features, now we will look at each of this three categories one by one.

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First we will look at investment risk, a investment risk can be consider under any of the three categories, it can due to currency, convertibility and transfer. Let us look at a currency, convertibility and transfer, how will this affect the project, so normally if you look at the project, particular in the infrastructure project it needs a lot of investment. And the domestic capital markets are not in a position to finance, the entire capital requirements of the project, so this is something that we have looked at earlier.

So, therefore, the project look at attracting private sector investment, so when we actually attract private sector investment, the investors are based abroad and they will have to be given returns based on the revenues that the project company generates. So, in

most cases, the revenues are generate at the post currency, but it has to be converted to a foreign currency, before it can be repaid it to the investors abroad, so how does this work.

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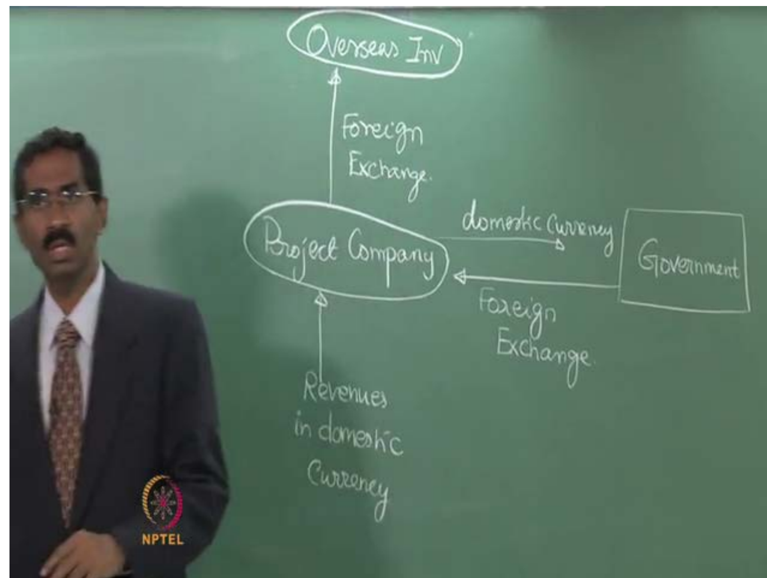

So, we have let say the project company and then, the project company gets, let us say revenues in domestic currency, and this domestic currency cannot be directly used to pay the investors. Because, investors are abroad, the investors need to be paid in foreign currency, so therefore the domestic currency needs to be first converted to foreign currency. So, how will the domestic currency be converted to the foreign currency, so for example, you will have to provide let say, a project company gives a domestic currency to the government or any particular arm of the government.

So, let say this is your government and then, the government intern gives what is called as your foreign exchange and then, the project company transfers a foreign exchange to the overseas investors, this is your overseas investors. Now, that can be a risk in two places, one is if the government is not in a position to convert the domestic currency to foreign exchange, so this is your currency convertibility. If are some reasons the government prevents, the government prevents control of domestic currency to foreign exchange. And then the second is your transfer, if the government prevents transfer of foreign exchange leaving the country.

So, if the government prevents either of this from happening, then the project company will find the difficult to serviced the investors, so this essentially is what is called as your currency convertibility and transfer risk. So, when can this actually happen, it can actually happened if the country gets into the economic difficulties. So, because of economic difficulties, the government is running short of foreign exchange and a foreign exchange is needed to an procure goods and services that are essential for running the country.

So, the economic difficulties, we know forces the government to use foreign exchange for much more urgent needs, rather than paying the project company. Second there is shortage of foreign exchange, foreign exchange reserve is not adequate for it to be pay, so in both this cases this problems can happen. Sometimes currency convertibility might be hampered when there is devaluation, so when the project was started the exchange ratio had a particular level. But, some somewhere during the project operations the exchange ratio was completely change, because of a catastrophic devaluation.

So, in this case also the domestic government find the very difficult to honor the currency convertibility and transfer. Let say for example, for particular level foreign exchange after the devaluation means, you need to have a lot of domestic currencies, so it is actually going to put pressure on the government, in terms of currency convertibility. So, how do we the investors mitigate this, there are various ways investors can look at mitigate it, one is the most often site of approach is basically called as enclave projects. So, when you actually create an enclave projects what essentially you are doing is, the revenues of the project do not come to the a host country.

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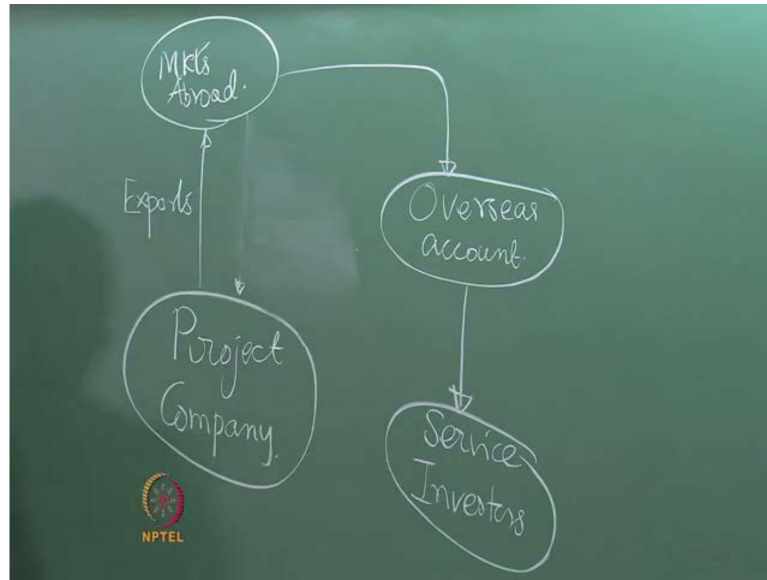

Let say for example, you have a project company, which exports it is products and services and we have markets abroad, now when it actually exporting, obviously the revenues are going to be coming from the foreign currency, so the revenues will come from the foreign currency. So, in a normal project the foreign exchange revenues, foreign revenues will come to the a project company. But, in the case of enclave project what is going to happen is instead of foreign revenues coming to the project company, it is actually directed to an overseas account.

It is actually directed to an overseas account and this overseas account is used to service investors, so we do not really have this link of foreign revenues coming to the project. So, this was created in a separate overseas account, and because of the fact that, it is an account that is abroad and it is an account that actually has foreign currency. The issue of convertibility and transfer out of the host country does not arise, because the account itself is outside the foreign country and the account is based in a foreign exchange, in a foreign currency.

Whatever remains after the investors being serviced can be broad back to the host country to the project company, so this is an enclave project. So, normally this strategy would be adequate, when we actually exporting the products or services, so that means, the commodity is actually in a position to generate export revenues. So, when can we

actually also create this kinds of enclave projects, when selling the commodity is becoming a very important for countries economy.

So, if there is any a disruptions in selling the commodity, the countries economy will suffer, so therefore there will always be political support to operate a project and then sale the commodity. Because, in the absence of it the economy might be affected, second is there is no alternate market for the commodity, particularly there is no market for commodity in the domestic markets, so therefore compulsorily the commodity will have to be exported. So, therefore, the opportunity for diversion of into the local market is gang to be a very minimum, so these are some opportunities to crate enclave projects.

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And other opportunity to mitigate the currency convertibility risk is to actually create offshore reserve accounts, so there are let say specified reserve account that needs to be created, to operate the project without any disruptions. If there are any sudden disruptions, the reserve accounts help the company to operate this project in a in a continuous basis; so once such reserve account is called as your debt service reserve account.

So, that means, we actually have a reserve account which is actually used to serviced the debtors, when there are some temporarily problems related to currency convertibility a transfers. So, if you assume that this is going to be temporarily problem, we can actually use the debt service reserve accounts, so tied over the problem of convertibility and

transfer. So, like we actually have an overseas accounts, we can actually create an overseas debt service reserve account.

So, it is only the reserve account that is created overseas, but not the entire revenues at actually is in a separate overseas account. So, reserve account, then can be used to pay the debtors whenever there is a problem of convertibility or transfer.

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But, what needs to reminded here is that, reserve account will only help to overcome a temporary problem. If the government is going to put a blanket ban on convertibility and transfer, then having a reserve account abroad might not be a solution. But then the logic here is that any such instance is going to only temporary, rather than of more of being a permanent nature.

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The second type of investment risk is known as expropriation, so what is expropriation, so normally what we actually have is a government can takeover private assets, under the principle of eminent domain. See for example, if road needs to be constructed for the greater public good, and part of the road is actually passing through a private farmland, then the government can actually acquire the farmland under the principle of eminent domain.

Because, the infrastructure that is actually going to come up there, it is actually going to benefit lager part of the public and it is good for the society as a whole. So, whenever the government takes over under the principle of eminent domain, they actually provide compensation for such actions. The compensation can be decide at it can be the market value or it can be based on some negotiation between, the person whose land is been acquired or whose assets are being acquired on the a government.

So, what is this expropriation, so expropriation is a seizure by the host government, without the payment of just compensation, whenever the government comes away and takes over the land, but it does not compensate just manner, then that action is called as expropriation. So, expropriation not only means that, we actually takeover the assets of the company, technically the government can also do several actions that can take control of the project company. Let say for example, the company is govern by the board of

directors, and if the government passes and action which will enabled to represent more members in the board of directors.

Then the government can actually control the operations of the project company, without actually taking over the assets of the company. So, we need to really remember that expropriation means, any actions that can actually affect the investors by taking out the assets or by taking over the control of the company.

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The third type of investment risk is your war and civil disturbance, so sometimes that can be several actions are can actually, disturb the operation of the plant. It could be like internal political instability, it could be civil unrest, that could be sabotage, terrorism, that could even be a war against the host country, which can damage the project. So, today specifically if you look at, there are several countries, which are having a lot of unrest in the midlist area like Egypt like, so many other countries in the Northern part of Africa.

So, whenever you actually have projects in this countries, then if you are investor and in any such action is going to actually impact you, because the project might not be able to operate, the project might be delayed, the project assets could be destroy and so on. Sometimes after the project has began that could be some actions against the host government, which can also affect the investors for example, there could be blockade or sanctions against the host government.

So, whenever we have this kinds of blockade or sanctions, it can actually affect the ability of the project company to actually import the equipment to the country and so on. Let say for example, if US has actually a made sanctions against the particular government, then a project company, if it is actually plan to import an equipment from the US manufacturer will be finding an difficult. Or even unable to that equipment simply because of this sanctions impose by the US government, so this is again because can be attributed to the some level of a political risk.

Some amount of physical damage and the consequence loss of revenues, because some these acts, act of war can be covered by insurance. But, then there are so many other aspects which may not be able to covered under the insurance, but nevertheless this is a significant investment risk for the project company.

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The second classification of a political risk is what can be attributed to the change of law, so normally if you look at investment risks, we do not see this in the case of developed countries. For example, currency convertibility and transfers risks are largely not seen in the developed countries, because there they actually operate in the open foreign exchanging market. And exchange rate risk is risk, but then there is no risk in terms of currency convertibility, then we talked about expropriation.

Expropriation again is an act that, we see very, very scarily in the developed country, then you have war and war like acts, this again is normally not seen in the case of

developed country. There are instances, there are exceptions, but by enlarge the investment risks are of concern only in the developing country, but it is not so in the case of a change of law. A change of law can occur both in developing countries, as well as the developed countries.

And the change of law as actually much wider application, and it can actually affect the project company in a variety of ways, law can be changed after the project has been constructed, law can change when the project is in the operation stage. So, whatever it is, when the change of law is on retrospective bases, then even the post project will have to make addition investments to be in confirmation with the new law. So, that means, incurring addition investment that means, that could be a stoppage of the operations leading to loss of revenues and so on, and so forth.

So, let us look at some examples of a change of law, let us say that is a new environmental requirements. The government can always come back and say that, the environmental laws are changed and we want to make at a stricter, so therefore the emissions norms are going to be change and so on. So, whenever such changes happened the project company will have to make additional investments, let us say for example, if the emission level has changed from, let us say x parts per million it is now become y parts per million which is a lot more stricter .

So, therefore, the government the project company will have to make additional investments, so this additional investments can actually impact on the project and the returns to the investors, so that is one example of a change of law. The second could be let us say imposition of price controls on project, companies products and revenues. So, earlier let us say, if the price is being decided on, let us say in opened market or based on some agreement between the a producer and the purchaser.

But, the government can always come back siding the interest rate of the society and siding, the ability of the people to pay to control the price. So, whenever the price is controlled it is not possible to charge beyond the certain limit, and this can actually affect the a profitability of abroad. So, let us say this can actually we also seen in the case of toll road, so a toll road will generally have clauses, under which prices can increase based on things like inflation and so on, and so forth.

But, then the government can always say that the price of the road cannot be increase beyond a certain limit, because the uses of the road will find the difficulty to pay. So, therefore, imposing certain kind of control on what price the company can charge, so that can affect the revenues and profitability of the project. And it could increases the in import duties, if a project will have to import a particular equipment, the government can actually go back and say, earlier the import duties was 20 percent and it can change the duties structure and make it 30 percent.

So, this can actually again affect the project costing, so these are all some a manifestation of change of law and how it can actually affect the project. So, sometime they can actually impose special taxes or levies, to the project company or the industry in which it operates. There are many instances where the government unknown to charge, certain kind of special taxes on a particular category of industry, and that can also again impact the project.

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Invalidation of project contracts, normally the project contracts will have to comply with the law of the land, and if some of the project contracts do not comply with the law of land. And if the law has changed, then all the project contracts can invalidated, so remember when you talking about the project finance structure, where the project contracts are basically the main form of security. Invalidating the project contracts can

tremendously have impact on the project, you can variable imaging, how severe this impact would be.

A difference between the investment risks and a change of law risks is that, a change of law risks generally affects the industry as a whole, but an investment risks can actually affect a particular project. In the case of change of law, it may not actually discriminate against a particular project, so again the change of law can be looked at two level. One is a change of law that actually impact a particular industry. Now, whenever the cost increase because of the change of law that impacts a particular industry, let us say for example, much stricter a emission norm in the case of a power plants, can actually affect only the power sectors.

So, whenever we have a norm that affects a particular sector, the additional costs that are incurred to comply with the change of law is largely borne by the users; the end users of that particular industry, it is generally not absurd by the a project company. Let us say a a change in the laws and regulations, leads to the change in design and obviously, this can lead to addition cost. And EPC contractor is not going to incur this additional cost, this additional cost is going to be passed on to the project company, and naturally the project company will not been a position to bear this addition cost.

So, project company will then pass it on to the project off taker and the off taker again will pass it on to the end consumer, so therefore any such change that affect the industry will naturally passed on to the end users. But then, there are changes that are more of the general nature let us say for example, the changes in import duties, changes in taxes structure as a whole which not portents to a particular industry, but portents to the overall economy or introduction of new tax.

So, whenever we have chances of a more general nature, it is considered as a normal risk of doing business and it is not suppose to be passed on to the a inducers. Ultimately there is a way in which part of it might actually get passed on to the inducers, but part of which also absorbed by the a project company, because this seen as a risk of doing business.

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The third category of political risk is called as a quasi political risks, so essentially it is very difficult in many instances to distinguish between a political risks and a commercial risks. So, why do we actually have to differentiate between the political risks and commercial risks, as we will see later; sometimes a political risks can actually be you know mitigated by the suitable structures. Or you can actually cover political risks through insurance or that can be some guarantees, or the government support agreement which will kind of help to mitigate the political risks.

But, it is not possible buy an insurance to mitigate the commercial risks, commercial risks is inherent risk of doing business. So, therefore, if you actually have a problem, if you actually have a risk, whether it is very difficult to distinguish, whether it is a political risks or commercial risks, it is also going to be difficult to claim insurance support should such a risk occur. So, therefore, it is very important for us to understand such quasi political risks, can actually going to be very difficult to handle with.

Quasi political risks can arise, because of under following issues, one is it could be because of breach of contract and court decisions. ((Refer Time: 36:17)). Or it could be because of sub sovereign risks or it could be under what is called as creeping expropriation. Let us look each of this in some detail, let us look at first the breach of contract and court decisions.

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So, breach of contract is one, so there is a contract that is being signed by let us say, a government or a government supporter entity. And if this off taker is not in a position to fulfill it is obligations under the project contracts, so the project company if it is being able to honored, it is terms of the contract. But, if the off taker is not able to fulfill it is obligations of the contract, this is called as your breach of contract; if the project company is not able to honor the terms of the contract.

And if the off taker is not obliges, then it is not consider to be a breach of contract, it is consider to be a commercial dispute. A commercial dispute occurs when one party to the contract essentially the project company, is not able to honor its obligations of the project contract. But, a breach of contract will occur when the project company is able to fulfill it is part of the contract, but the off taker is not in a position to honor its obligations, so that constitutes a breach of contract.

So, whenever there are such a breach of contract, what is the most logical recurs, the most logical recurs for pursue will be to take it to a court of law. In several developing countries the courts of law are not very well experienced, to actually handle such contracts and some cases courts can actually be also coming at political pressures. And under the circumstances it is very difficult to determine the correctness of legal decision making, or the legal judgment. So, therefore, the decisions or the judgment might also not be very objective, so that actually a risk.

So, to avoid this kind of risk, the common practice is to actually settle this disputes in a market or in a foreign that is outside the host country. So, it is very common to actually see agreements, where it is govern under the UK law, where arbitration is let us say for example, a country like Singapore. The common example is let us say the recent airport, agreement that happen between Maldives and Joemars, which is a company based in India; so the arbitration was done the court of Singapore, it is not done in Maldives.

So, having a arbitration forum, there is outside the host country is seen as one possible way to kind of make the decisions independent of the local courts. Because, the local courts can be actually subjective to the political pressure, and in order to be able to avoid the political risk we should be actually have this kind of mechanisms outside the host country.

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The next category of quasi political risk is what is called as sub sovereign risks, so political risk is always not should be consider as a risk on the central government. Ultimately infrastructure projects contract with a variety of public authorities, not all of them are the central government, in many cases such as water supply and so on, the main purview of the sector is this state government. So, therefore, if a project company signs a contract this state government and the state government does not honor the obligations, it is still consider as a political risk, but it is not a sovereign risk.

So, risks that are due to government organizations that are not a sovereign level, it could be state government, it could be municipalities or it could be public sector organizations that are setup by the government. So, risks arising due to this is called as your sub sovereign risks. So, though the government actually has a direct say in some of the organizations, let us say for example, in the case of state electricity board, this state electricity board is virtually consider to be arm of the government.

But, it is not essentially the government, it is essentially a public sector organization that is setup by the government, and the government does not have any liability for a company that happens to be owned by the state. So, therefore, though it is possible to actually have a state guarantee for country level risk, it is going to be very difficult to handle the sub sovereign risks, because it is actually by an organization that is not really the government, but something that is under the government.

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The third category is called as your creeping expropriation, what is creeping expropriation, creeping expropriation is usually denotes actions by the government, which essentially is way of taking action against the project company without specifically repudiating contractual obligations. So, it is a essentially making the life very difficult for the project company, the government can actually do a variety of things.

Let us say for example, the government can actually be very slow in issuing permits and for example, it can hold up exports or imports at the docks siding some procedures issue

or the other. Or it can actually make an enquiry for some tax offenses or it can lead to something that can be leading to lengthy investigations. So, these are all issues which can actually create a lot of discomfort, it can actually create lot of huddles for the project company. So, in essence it actually deprive the investors the real benefit of the project.

So, without individually, let us say for example, individually each of these actions cannot really have any major impact, all things being equal. If the government is being slow in issuing permits, the process can be accelerated through a negotiation process, but then if the government does a lot of things, let us as delays in issuing permits, holding up exports and imports and then starting of investigations and so on. Cumulatively all of this can actually lead to an impact on the a benefit of the project.

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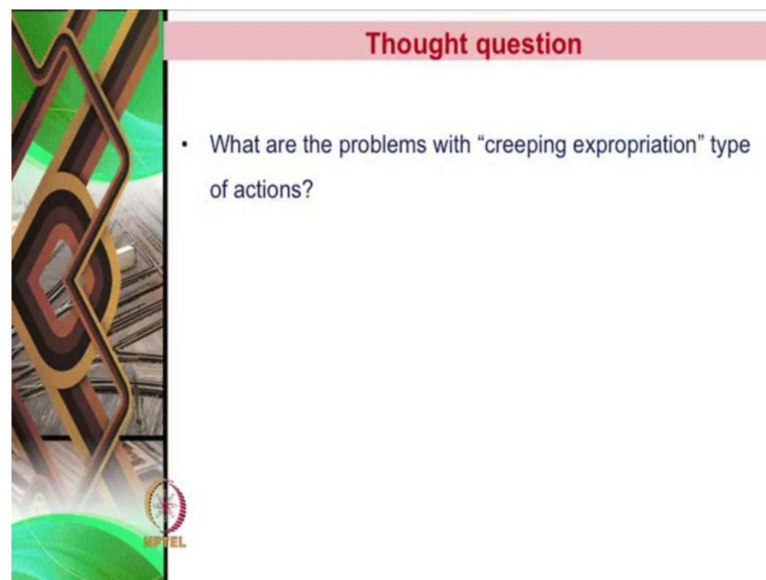

So, before we end this on the thought question is, what are the problems with actions that can be term as creeping expropriation. And why is this such a difficult thing to handle, so we will discuss about it in the next lecture.