Managing Political Risks in Private Infrastructure Projects

June 2017

Risks in infrastructure investments

Many investors simply treat political factors as background noise; surely, they argue, investment decisions should be based on concrete factors like cash flows of the projects and companies under consideration. But to conclude that politics does not matter for private investment would not only be wrong, but also set up projects for failure and expose investors to significant losses. Nowhere is this more true than in infrastructure projects – be it in transportation, communication, water and sewage, or electricity. As governments around the world have courted private investors in a bid to make up for public sector funding shortfalls and establish more robust national infrastructure, many investors have been unprepared to deal with political factors that determine whether the project is a success or a failure.

Imagine a project that requires considerable upfront investment in illiquid assets. The assets are expected to produce stable, predictable future cash-flows that require minimal subsequent technological or managerial intervention. Typical investors use net present value calculations to determine whether and how the firm should invest in such a project. So far, so good. Then, consider that for the project to get underway and continue operating, permits, contracts, and other government approvals are necessary. More aware and well-informed investors account for these set-up costs. But, when the projects provide basic social services that are vital to a country's economic development and prosperity, cash flows are closely monitored and depend on government set prices, tariffs, agreements, and regulation. Only a few astute and sophisticated investors acknowledge that these aspects of the project can vary considerably with political dynamics, and consider political factors in valuation, investment decisions, and ongoing management of the project.

Managing risks

1. Identify and quantify risk – Top management's attention to political risk is greater when it can be presented in terms familiar to them. Modeling and quantifying the risk could involve several assumptions based on historical trends of the host country/sector or recent events.

2. Identify lower risk value chain activities – In the electricity market, for example, electricity generation is less visible to consumers than distribution. Thus, investors are less likely to face a backlash against price hikes or capacity shortages.[1]

3. Choosing the right geographic location – Are there important differences between the regional and federal governments to the project?[1]

4. Diversify risk by investing in multiple projects – Jointly invest in large projects with multiple partners. This spreads the firm's limited resources over a large number of projects. While the risk of some loss increases, the risk of a really large loss declines.[1]

5. Monetize other parts of the value chain – Can the related operations provide an additional, and substantial, revenue stream? For example, maintenance services to the project provides an additional revenue stream.[1]

6. Ask for price increases and tariff adjustment before investment – Favor projects where consumer and industrial prices before investment are not below those required for profitability.[1,2]

7. Seek regulatory changes prior to investing – Investors have little idea of the regulatory framework they will be subject to if regulatory procedures are not established prior to investment. Ideally, regulatory framework will have remained in place over several business cycles.[1,2]

8. Identify experienced partners to anticipate political stresses – Multilateral agencies, such as the IFC, have significant global experience in infrastructure investments. Partnering with them can help in structuring operations to avoid typical political stresses.[2]

9. Seek transparency in entry – Contracts obtained through competitive bidding are less likely to be challenged by subsequent governments. Negotiating and bargaining in closed settings, in contrast, leaves investors open to charges of corruption.[1, 3]

10. Establish 'national treatment' standards – Tax and input/output prices should ideally be no different to foreign investors than those available to domestic investors at large. Exclude those issues from the contract where general legislation is adequate.[3]

11. Build flexibility into contracts – Infrastructure projects often last 15-30 years, and a lot can change over such an extended period. If contracts are designed to accommodate scheduled renegotiations, governments would be less tempted to undertake ad-hoc changes.[1, 4]

12. Identify dispute resolution mechanisms – Most contracts refer to arbitration or other legal channels to settle irreconcilable differences. But a sliding scale establishing alternate methods of dispute settlement (mediators, expert panels, regulators, etc.) reflecting the seriousness of the issue addresses relatively minor differences between parties without escalating them.[4]

13. Be proactive about addressing project spillovers into social issues – would the construction of a new road require land acquisition through eminent domain? Are there sufficient provisions for safe waste disposal? Such factors have to be addressed prior to the investment to prevent a social backlash against the investor.[2]

14. Include prominent international interests – If a project's the output is committed for export to international partners, and lending is facilitated by prominent banks, any cause for interruption in production would bring the entire coalition – including potentially home governments of the international partners – to put pressure on the host government.[4]

15. Use appropriate financial instruments – Some protection can be obtained through risk guarantees and political risk insurance. Hedging instruments can help to transfer risks, eg: foreign exchange swaps lower exchange rate risk exposure, credit default swaps hedge public default risk.[4]

The way forward

Some investors, citing the many political and regulatory risks, avoid investing in infrastructure projects. However, steps can be taken to minimize, if not entirely eliminate, those risks and gain significant returns.

Notes

1. Wells, L. T. 1998. "God and Fair Competition: Does the Foreign Investor Face Still Other Risks in Emerging Markets?" In Managing International Political Risk. Ed: Theodore Moran. Malden, MA: Blackwell Publishers.

2. Jandhyala, S. 2017. "International Organizations and Political Risk – The case of multilateral development banks in infrastructure projects" ESSEC Business School Working Paper.

3. Moran, T. 1998 Managing International Political Risk. Malden, MA: Blackwell Publishers.

4. World Economic Forum. 2015. "Strategic Infrastructure: Mitigation of Political & Regulatory Risk in Infrastructure Projects". Prepared in collaboration with The Boston Consulting Group.

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