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Webinar Series on Social Infrastrure and PPP

Background Note on | Managing Risk in SDG related PPPs

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Background Note

Managing Risk in SDG related PPPs

Public-private partnership (PPP) has emerged as one of the preferred mechanisms for developing infrastructure projects globally. Developed countries have immensely benefited from PPP infrastructure project delivery across a variety of sectors including the social sectors. However, the developing countries have had limited experience of PPP, that too only for economic projects such as roads, ports, aviation, and the electricity sector. They are yet to see any substantial progress on full-scale development of social infrastructure projects barring some examples of pilot interventions in the social sector such as health, education, and water and sanitation. Bench-marked service delivery has also been absent in the current public sector driven system. Public sector have little or no incentive to continuously improve performance. Therefore a unique blend of public sector socially accountable system with private sector efficiencies is possible through PPP, that is flexible and focussed on delivering impactful services, provided risks are identified and mitigated up front.

Risk elements and their impact on project delivery:

The projects concluded as PPP have specific characteristics, like fixed duration, fixed cost, and diverse stakeholders that make the arrangement complex. The crucial element is allocation of risk between the stakeholders. The risks involved in the PPP projects come mainly from the complexity of the contract, technical and financial specifications, performance guarantees, economic cycles over long concession periods etc. Whereas, theoretically it is possible to clearly identify risks and allocate it to the party best suited to bear it, in real life it is difficult because risks are difficult to clearly delineate and over the long concession periods risks often shift from one party to the other because of changes in the circumstances. Therefore, there is not only a requirement to have a proper qualitative and quantitative estimation of all the risks before the start of the project to the extent possible, but more importantly create formats to continuously evaluate the external environment and build in flexibilities to move risks from one bucket to the other, when warranted.

Some of the major risks that a PPP project carries can be listed as follows:

1. Technical risks: Risks associated with engineering design at the conceptual stage.
2. Social: Public opposition to the project at any point of the project cycle.
3. Construction risks: Cost overruns and delays in the construction phase of the project.

4. Economic risks: Risks associated with economic cycles, which include inflation and interest rate variations, exchange rate fluctuations, black swan events etc.
5. Legal risks: Change in law or contract default by either partner.
6. Regulatory risks: Change in policies and regulations.
7. Revenue risks: Collection risk on account of drop in traffic, fall in paying capacity etc.
8. Political risks: Change in government or leadership resulting in contract cancellation or unreasonable changes in contractual obligations.

Whereas these risks are present in all projects, social sector projects the risk gets heightened due to the inclusion of equity principle in the project design. Exclusion based on paying capacity can be part of the structuring of an airport or an expressway, for instance, is acceptable as part of financial structuring but this cannot be so in a drinking water project. Pricing would be based on the lowest common denominator for paying capacity as no one can be excluded, although it is possible to build in graded user charges for different classes. But such differential price structures are subject to pulls and pressures by interest groups for reduction in pricing, enhancing uncertainty and therefore, increases commercial risk. In traditional procurement regime, most projects are developed through the Engineering Procurement Contracts (EPC) route. The risk component for the private sector is manageable as the payment is linked to the construction milestones. O&M contract for service delivery is a separate contract and mostly executed by some local contractors, who are able to manage the external environment effectively. Even though some of recent O&M contracts also include certain number years of maintenance of the asset, there is no revenue risk for the contractor. Therefore, private investors are generally shy of entering into PPP with government for delivering social sector projects.

For social sector PPP projects in countries such as India, infrastructure asset are bundled with services linked to contracted service level standards which must be adhered to throughout the concession period. The payment to the service provider is linked to the quality of service delivery (predicated on the maintenance of the asset) and defaults attracts penalties. Unlike EPC contracts where payment is linked to construction milestones, social infrastructure PPP projects make the private party accountable for both the construction and operations for the entire life cycle of the project. While very high expectations of the “consumer” or ultimate beneficiaries of the project, are very often beyond the scope of the project deliverables, political risk and/or capacity or willingness to pay fully or even partially for the services, increases the commercial risk for the private partner. Mitigating the risk by increasing the risk premium in the pricing is also dysfunctional as the possibility of realizing the price (payment) is further reduced. Therefore, most social sector projects attract private investment only if revenue risk is transferred to the sponsoring authority. In such a case, the sponsoring authority pays “annuities” based on satisfactory provision of service to the ultimate beneficiaries. However, protracted disputes about quality of service could hold back annuity payments for long periods. This increases the working capital cost for the private party and has an adverse impact on project financials. On the other hand, failure to deliver the requisite service of quality results in public unrest and political cost for the government and even though there are penalties for non-performance, the time and cost of curing the default is very high. These risks need mitigation for the sponsoring authority.

Several factors, including the following, have impeded the progress in expanding PPP in social sector projects:

1. Social infrastructure projects often translate into moving a huge number of people in government systems, who deliver services, to a non-government private system. The former assures job security and is less demanding on performance; the latter does not - and is more demanding of performance. This induces political opposition, which creates policy uncertainty.
2. Private players are reluctant to invest long term in such projects due to high-risk perception.
3. Regulators and sponsors of PPP projects in the government sector have failed to develop consistency and predictability in dealing with PPP issues during the concession period resulting in adversarial relationship with the private sector.
4. Strong political and administrative will is missing in driving PPPs and expanding these in sectors other than core infrastructure, including the social sector infrastructure.
5. With increasing stress in the banking sector in specific and the financial sector in general, access to long term project finance is not easily forthcoming making it difficult for the private sector to invest.
6. Demand volatility and increasingly shorter economic cycles make long term forecasting and establishing commercial viability very difficult.

With the economic slowdown on account of COVID, private investment has declined sharply in all sectors. Infrastructure sector is also adversely impacted even though projects on offer are long term and immediacy of economic downturn should not have been a major deterrent. Therefore, it is important to understand what are the risks which the private sector is not in a position to mitigate through risk premium and would require policy intervention for redressal. Identifying the risks, especially in social sector projects which require infusion of substantial investment, both public and private to meet the Sustainable Development Goals (SDG) commitments, understanding which “partner” is better suited to bear the risk, understanding the phenomenon of “shifting risks” due to unpredictable and shorter economic cycles, creating new legal framework for swift dispute resolution and payment of dues, deepening of capital market financing of projects etc. are critical to relaunch PPPs in emerging market economies and other developing countries.

Risk management throughout the life of the concession is the key to the success of PPPs. If appropriate risk framework can be developed which is predicated on continuous review of risk and includes mechanism to transfer risk as and when the capacity to manage the risk stands transferred due to unforeseen developments can be established, flow of private investment in PPPs, including foreign direct investment (FDI) would increase significantly.

Way Forward:

With a few successful PPP projects on the social infrastructure side, it is difficult to establish a strong support to PPP intervention in this sector. More so, the grey areas in risk handling have never been addressed adequately. On the other hand, core infrastructure projects have a solid

base with a proven user-fees based system, reliable returns, and more aligned to the interest of the private sector.

SDG 2030 calls for a mechanism to measure infrastructure projects with people-centric SDG compliance. There is a gradual shift from "value for money" to "value for people" in the delivery of the project. This calls for designing social infrastructure projects that are less risky and more affordable to local community. The governments have to play a major role in lessening the risk component by treating the private party as a true partner and not just as another vendor in PPP projects.

The risk allocation is an evident hindrance for the PPP implementation in social infrastructure projects. There is no clear methodology for the risk allocation in the absence of adequate knowledge and training for public officials and private partners although there has been some discussion regarding designing a robust risk management framework, especially for social infrastructure projects.

Given all these inherent risks, private players are reluctant to invest in the social infrastructure segment.

In this context, CIRC is organizing a webinar where experts will present their views on

1. Potential risk elements in social infrastructure projects
2. Risk perception and reality from various stakeholders' perspective
3. How to design and develop a risk matrix management system for social infrastructure projects
4. Can the risk assessment framework be standardized?
5. Ring-fencing private developers from some of the risk element completely before the start of the project
6. Balancing the risk and project development in the current scenario of COVID 19