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APPROACHES FOR PPP RISK SHARING AND RISK MANAGEMENT: INDIA

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Presentation Structure

- Risk allocation
- Risk management approach
- Financial incentives as risk management tools

Risk Allocation



Standard Guidelines

- There are no explicit risk allocation policies and guidelines
 - Though the standard "model" concession agreements for various sectors prepared by the Planning Commission, have a wealth of detail on how risks are allocated
 - However, these documents cover certain sectors only. No allocation policies/ guidelines are available for other sectors
- At the State level, there are generally no guidelines
 - Generally, a 'negotiated' approach

Risk Allocation Principle

- Clichéd, but:
 - Each risk is allocated to the party best positioned to manage it
- Land, R&R, environmental ‘consent to establish’, clearance from key departments such as railways & defense – **Government Agency**
- Design, Finance, Build, Operate, Maintain and obtain all other clearances & approvals – **Private sector**

Risk Measurement

- Risk matrices and risk registers are rarely used
- Quantification methods are generally:
 - Sensitivity analysis based on point estimates of key variables (basically costs and revenues)
 - Most common, by far
 - Probabilistic methods based on base-high-low assignments for key variables
 - Rare
 - Probabilistic simulation methods
 - Not used at all
 - Also unclear that all the real options available in a contract can be modeled, anyway

Allocation vs. Measurement

- The focus of most agreements is on allocation of risk, rather than measurement
- Even the private sector spends more time and effort on the allocation and not on quantification
 - Rudimentary ‘sensitivity’ methods are normally used:
- However, the model documents have some covenants that place an indirect value on some variables:
 - For instance, if the traffic on a road reduces below the anticipated design traffic, there is an increase in the concession period (and vice-versa too)
 - But a large part of the risks are not modeled...

Demand Risk: Variations

- Demand risk is normally allocated to the private sector
 - However, there are some constructs where demand risk is taken over by the Government Agency, either in whole or in part:
 - Annuity/ Deferred Performance-based Payment Scheme
 - Take-or-pay
 - Though there is some debate whether PPP still remains PPP with the demand risk removed!

(Private Sector) Sponsor Risk

- Since projects are structured on a non-recourse basis, sponsor risk is important to address
 - The members of the consortium are ‘locked into’ the SPV equity, at a certain percentage, for a certain period
 - Performance Securities (about 5% of project cost)
 - Financially this is not a severe penalty, but then the ‘good name’ of the consortium members is also at risk...

Financing, Refinancing Risk, & Windfall

- Financing is at the risk of the private sector
- Refinancing is not addressed in the agreements at all
 - Loan agreements have covenants about refinancing, including prepayment penalties
- Windfall clauses are not built in
 - Except the provisions in the model agreements that have mechanisms for adjustment of concession period in the event of traffic changes
 - The absence of these provisions is causing disputes in many projects

Risk Management Approach



Conditions Precedent

- While the agreement is signed on a certain date, it becomes 'effective' only when Conditions Precedent described in the agreement are satisfied
- The CPs ensure that some of the key risks are addressed prior to the agreement becoming effective, and neither party loses significantly if these are not fulfilled
 - Government
 - Land clear of encumbrances
 - Clearances from key agencies
 - Private sector
 - Obtaining certain key clearances
 - Financial closure

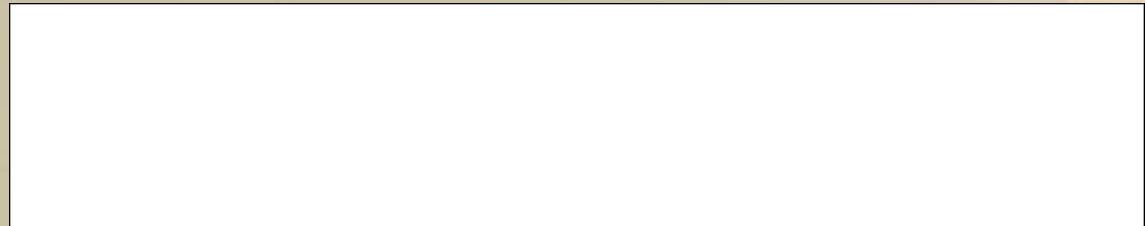
Other Measures for Risk Management

- Change of Scope is explicitly addressed
- Termination is explicitly addressed
- Model concession agreements have some clauses that address risk management
 - For instance, increase in concession period if traffic volumes drop
 - However, for the most part, management of risks is not directly addressed, except very indirectly through certain dispute resolution mechanisms
- In most State agreements, management is by allocation of risks through a negotiation process with potential bidders when the project is under bid
 - Such as an annuity structure if there are issues in demand or collection

Dispute Resolution & Termination

- Dispute resolution
 - Intermediation of Independent Engineer
 - Amicable Settlement
 - Arbitration under the Arbitration & Conciliation Act 1996
- Termination
 - Normally no 'buy out' or 'terminate at will' clauses
 - The principles of early termination are as follows:
 - Termination due to concessionaire event of default: the equity investment is forfeited by the concessionaire;
 - Termination due to Government default: the Government pays a premium (of upto 50%) on equity investment.
 - Lenders are protected by ensuring payments of debt due: (90-100%, depending on reason and agreement)

Financial Incentives as Risk Management Tools



Incentives & Penalties

- Performance Security
- Some agreements have incentives for early completion
 - Most have liquidated damages for delayed completion
 - Plus, of course, the revenue streams will also be correspondingly delayed
- Lenders covenants in loan agreements
 - However, the State may not be aware of what the covenants are, and these can also be changed...
- Penalties for not maintaining service levels

Incentives & Penalties... (2)

- Force Majeure provisions that handle direct and indirect political events
 - Equity and debt are protected
- Severe penalties on default
 - Essentially, the entire equity is forfeited

Thank You!

