Risk Allocation – Overcoming barriers for a well designed PPP

The Indian infrastructure sector is in a transitory phase. While the growth rate of India's economy averaged 8% in the Eleventh Five Year Plan, it did not meet the target of 9% due to a global economic slowdown. The Twelfth Five Year Plan by the Planning Commission has identified revival of investments as the immediate policy challenge for the Government of India to reverse the deceleration in growth. The Twelfth Five Year Plan has further predicted that the infrastructure sector will need investments of over one trillion US dollars. Given the fact that the majority of these investments have to be sourced from the private sector, the Government has encouraged private sector participation in sectors that traditionally used public procurement. One such initiative by the Government is called a public-private partnerships (PPP) arrangement. The motivation for using a PPP arrangement rather than a conservative public procurement regime is that through such PPP arrangement, the Government can allocate risks to the private sector and accomplish an optimal balance between commercial risks and returns.

The entity that can take the risk, should assume the risk

The Planning Commission envisages an investment of Rs. 26,83,840 crore by the private sector for PPP and other infrastructure projects during the Twelfth Five Year Plan. The bulk of funding for PPP projects is through debt financing, which on an average varies from 70% to 80% of the entire funding requirement, depending on the perceived risks of the project and its allocation.

The risks in PPP projects can be divided roughly into commercial, legal and political risks. Commercial risks can be further split into demand and supply risks. Supply risks can be further divided into construction and operation risks, based on the type of the PPP project. Demand risks are associated with the usage volumes compared to base case postulations. Commercial risks also carry a financial and market risk, for instance, alteration in the cost of the PPP project due to rise in cost of capital, raw materials, inflation, and other payment risks. Legal and political risks relate to amendments in the legal and regulatory framework including taxation policies, political uncertainty including expropriation. In India, the Government generally tends to pass all the risks to the private sector. This approach, however, could spell doom for the private sector as it affects the bankability of such projects. Risk should be allocated between the private sector and the public sector i.e. the party best placed to manage the risk. It should not be allocated to the private party that has agreed to take the risk and has, therefore, priced and negotiated accordingly – thereby burdening the tax payer. Inappropriate risk being transferred to the private sector results in higher risk premium being charged to the public sector.

A thorough understanding of these risks leads to a well conceived PPP project. It is this lacunae in understanding that has led to islands of progress in the country. Only a few states have leaned heavily towards using PPP for developing infrastructure projects. Even within the infrastructure sector, the country has seen significant PPP activity in roads, ports and airport sectors than in others.

Measures

The recipe for successful completion of a project life cycle is ascertaining the risks linked with the project and how they should be balanced so that the public private partnership profits and the consumers benefits.

PPPs are not a panacea and the process from project identification to implementation needs to be understood and assessed. In this transition to new methods of providing public services, the Government needs to adapt both its skills and its processes to ensure that PPP projects deliver what is expected of them. Some states and government agencies are driven by strong fundamentals and political commitment that have encouraged the private sector to invest in their PPP projects. To bring about similar success stories in rest of the country, government agencies have to be identified and educated so that they can competently and appropriately identify, procure and manage PPP projects. A well designed and efficient PPP procurement process leads to reduced costs and increased value for money for tax payers.

It is important for a Government agency to be aware that the risk allocation should be balanced between the public and the private sector. Risks such as site availability, change in law, and other matters within control of the Government should be borne by the public sector. Risks arising from the construction, operation and maintenance of the project, i.e. those matters for which the public sector has approached the private sector for its skills and expertise, will be borne by the private sector. Generally commercial risk should be passed on to the private sector and legal and political risk should be retained by the public sector.

To conclude, the Government should at the outset involve technical and legal consultants for every stage of the PPP project lifecycle, i.e. from the project identification stage to the project implementation stage. The consultants play a large role in assisting the Government with skill sets that are unavailable with the public sector including structuring of PPP, identifying risks, preparation of documentation and development of clear processes and guidelines.

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