The impact of political risks on public-private partnership (PPP) opportunities in Asia

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Abstract

Political risks have strong impact on opportunities in public-private partnerships (PPP). This paper presents the results of a survey conducted among PPP practitioners from multiple backgrounds and countries on the impact of political risks on PPP opportunities in Asian countries and sectors.

The level of perceived political risks determines the costs in PPP projects. The survey shows that political risks differ significantly across the 14 Asian countries and 14 PPP sectors surveyed.

The survey shows that with increasing political risks, PPP opportunities become less and the costs of PPPs increase as well. The political risk profiles between matured and developing countries in Asia do not correlate significantly, thereby allowing for the suggestion that with increasing economic development, PPP opportunities may also increase.

Introduction

In Asian countries, the number of public-private partnership (PPPs) opportunities is increasing. Under PPPs, private sector entities provide public sector goods and services such as utilities, infrastructure, social services, and public real estate. The success of PPPs depends on the successful identification, allocation, mitigation, and management of risks. Political risks are key risks in the public-private relationship.

Some political risks are insurable (A to D) by public and private insurers while others aren’t (E and F):

- A: Currency inconvertibility and transfer restriction (CI/TR)
- B: Expropriation
- C: Breach of contract
- D: Political violence
- E: Legal, regulatory, and bureaucratic risks
- F: Non-governmental action risks

Impact of political risks on public-private partnerships (PPPs)

Figure 1: Influence diagram of political risks

The survey covers PPP opportunities in Bangladesh, Cambodia, China, India, Indonesia, Japan, Korea, Malaysia, Pakistan, Philippines, Singapore, Taiwan, Thailand, and Vietnam.
PPPs are possible in a number of sectors. In the different countries, not all sectors are equally developed for PPPs. The survey covers following PPP sectors:

- Utilities: power, water and waste water, and waste treatment and management
- Infrastructure: toll road, rail, sea port, and airport
- Social infrastructure and public real estate: mail, IT and telecommunications, education, health, leisure and sports, administration, and security

The respondents were asked to indicate their perception by using a seven grade scale from “extremely low” to “extremely high”.

The survey consists of three parts: one is on political risk assessment in PPP opportunities in Asian countries and sectors, the other one asks for perceptions on the likelihood and impact of the six political risk factors on financial decision criteria in specific projects, and the third asks for absolute values of these parameters.

Asian countries

Ranking of political risks within countries

The survey shows that within the Asian countries, the political risk factors vary in their perception. In Bangladesh for instance, currency inconvertibility and transfer restrictions are perceived as having the highest negative impact on possible PPP opportunities.

For all Asian countries, except Korea, Japan, and Singapore, legal, regulatory, and bureaucratic risks are perceived as having the strongest negative impact on PPP opportunities. These are followed by currency inconvertibility and transfer restrictions, breach of contract, then non-governmental action or outside risks, and expropriation. The least risky factor is political violence.

The picture differs significantly for the matured economies of Korea, Japan, and Singapore. They seem to bear little internal political risks and the worst political risk that may impact PPP opportunities in these matured economies is induced by actions outside the span of control of the host governments. However, the perceived second riskiest factor is legal, regulatory and bureaucratic risks followed by breach of contract, political violence, and expropriation. The least critical factor in these comparatively strong economies is currency inconvertibility and transfer restrictions.

This comparison of survey results indicates that PPPs in developing countries need to mitigate different risk profiles than in matured economies. While developing and matured Asian economies have in common that breach of contract risk is higher than expropriation risk, it is the opposite for currency inconvertibility, political violence, legal and regulators risks, and non-governmental action risks. In fact, there is only a weak positive correlation between the two country sets of $r = 0.143$ and the level of significance of this correlation is less than 75%.

Future PPP opportunities in Asian countries

The survey responses indicate that in the near future, there will be less PPP opportunities than from 2010 to 2025. While in the developing Asian countries there will continuously be increasing opportunities in 2016 to 2025, the peak for PPP opportunities in the matured economies of Japan, Korea, and Singapore will be between 2010 and 2015.
Comparing the survey results on the future PPP opportunities by country provides a more accurate picture.

While India is the single champion, Cambodia, Bangladesh, and Pakistan show least opportunities in PPPs throughout the years. Singapore ranks second best in 2007, but is drastically declining in the following years. Vietnam and Indonesia in contrary are most exceptional and consistently pick up in promising PPP opportunities. Malaysia is first picking up and then declining while Philippines is the reverse. Japan remains unchanged at rank seven. South Korea, China, and Thailand vary at a high rank level but show neither drastic up nor down developments. Taiwan starts from the third highest level and will at first pick up momentum but then decline and remain at a lower level.

PPP sectors

Ranking of PPP sectors with respect to political risks

In general, PPP opportunities in utilities are perceived riskiest, followed by infrastructure PPP opportunities. The survey suggests that social infrastructure and public real estate are least exposed to political risks.

Ranking of political risks within sectors

Except for rail, legal, regulatory, and bureaucratic risks are the single worst risk category across all sectors.

The risk profiles across the aggregated sectors correlate positively with each other. Legal, regulatory, and bureaucratic risks and non-governmental action risks are perceived the most critical ones. Currency inconvertibility and expropriation are perceived least risky. Political violence and breach of contract are ranked medium across the aggregated sectors.

Future PPP opportunities in sectors

In general, the peak for PPP opportunities will be between 2010 and 2015 while in the near future, there are fewer opportunities than after 2016.

Following figure illustrates the ranking from the least to the most attractive sectors

Mail, security, administration and education promise the least PPP opportunities in the future. PPPs in power, water and waste water, and leisure and sports promise the greatest opportunities. Opportunities in rail and waste management and treatment are continuously increasing over the years, while IT/telecommunications, airports, and toll roads vary in the middle range. Health remains relatively unchanged and PPP opportunities in sea ports decline.

In aggregation, from 2007 to 2025, social infrastructure and public real estate promise the least PPP opportunities, while infrastructure is second and the most PPP opportunities are with the utilities.

Project specific political risk quantification

With increasing political risks, investment appetite decreases. Also with increasing political risks, the expected minimum internal rate of return (IRR), minimum required debt-service-coverage-ratio (DSCR), the risk margin on loans, and the insurance premiums increase. Investment
appetite, loan spread, and insurance premium are chosen to best show the effect of political risks on the PPP project participants’ objectives. The survey shows that there are also positive correlations between loan risk margins and minimum required DSCR, and positive correlations between investment appetite and minimum expected IRR.

The survey respondents were asked to provide their perception on the likelihood of occurrence and possible consequence of the six single political risk factors on these five financial decision criteria in specific projects. Also, respondents were asked to provide absolute values on project specific financial criteria as reference. The doctoral research on quantifying qualitative information on risks (QQIR) has been applied to quantify these perceptions. The project specific risk perceptions correlate with the general country and sector perceptions discussed before.

<table>
<thead>
<tr>
<th>Direct survey response</th>
<th>QQIR validation</th>
</tr>
</thead>
<tbody>
<tr>
<td>No. of responses</td>
<td>true [%]</td>
</tr>
<tr>
<td>1. If the perceived political risks increase, the amount of investment decreases</td>
<td>21</td>
</tr>
<tr>
<td>2. If the perceived political risks increase, the expected IRR will increase</td>
<td>22</td>
</tr>
<tr>
<td>3. If the perceived political risks increase, the minimum annual DSCR will increase</td>
<td>23</td>
</tr>
<tr>
<td>4. If the perceived political risks increase, the risk margin on a project loan will increase</td>
<td>21</td>
</tr>
<tr>
<td>5. If the perceived political risks increase, the insurance premium will increase</td>
<td>20</td>
</tr>
<tr>
<td>6. There is zero or a negative correlation between risk margin on loans and insurance premium</td>
<td>21</td>
</tr>
<tr>
<td>7. With decreasing equity commitment, the risk margin on a project loan increases</td>
<td>22</td>
</tr>
<tr>
<td>8. With decreasing equity commitment, the insurance premium increases</td>
<td>21</td>
</tr>
<tr>
<td>9. With decreasing investment appetite, the minimum required DSCR increases</td>
<td>n.a.</td>
</tr>
<tr>
<td>10. There is a positive correlation between increasing investment appetite and expected IRR</td>
<td>n.a.</td>
</tr>
<tr>
<td>11. There is a positive correlation between increasing minimum required DSCR and risk margin on loans</td>
<td>n.a.</td>
</tr>
</tbody>
</table>

Table 1: Risk and return

The numerical results fall within the actual market data, presented by HSBC.

<table>
<thead>
<tr>
<th>HSBC market data presentation</th>
<th>&quot;Asia&quot; PPP</th>
<th>Impact of political risks on PPPs in Asia</th>
</tr>
</thead>
<tbody>
<tr>
<td>Leverage</td>
<td>&gt; 90%</td>
<td>60% – 80 %</td>
</tr>
<tr>
<td>Bank Risk Margins</td>
<td>&lt; 100bp</td>
<td>&gt; 100bp</td>
</tr>
<tr>
<td>Base case equity risk premiums</td>
<td>12% - 30%</td>
<td>10% - 20%</td>
</tr>
<tr>
<td>ADSCR</td>
<td>Min. 1.18 – 1.2</td>
<td>1.2 – 1.4</td>
</tr>
<tr>
<td>Tenor</td>
<td>&gt; 30 years</td>
<td>12 – 15 years – subject to market</td>
</tr>
<tr>
<td>Maturity</td>
<td>1 – 2 years</td>
<td>2 – 5 years</td>
</tr>
<tr>
<td>Insurance premium</td>
<td>n.a.</td>
<td>n.a.</td>
</tr>
</tbody>
</table>


Conclusion

The three data sets of survey findings are consistent and also correspond with current PPP market data. This survey has clearly shown that political risks have a significant impact on a country’s development. The higher the perceived political risks, the lower are chances for PPP opportunities in these countries and the costs for PPPs in such countries increase as well. While for example Bangladesh, Cambodia, and Pakistan are perceived riskiest, they also are perceived promising the least PPP opportunities. A reason may be quoted from a survey respondent: “PPPs
require stable legal and regulatory frameworks. In contrary, the survey also yields the result that in sectors, the risk-return perception may be different. While for instance “power” is perceived being among the riskiest project types, “power” also promises some of the highest future opportunities. In general, utility projects are perceived riskier than infrastructure projects or social infrastructure and public real estate projects. These also are perceived promising more opportunities.

However, one may not jump to the conclusion that in political risky countries such as Indonesia, only investments in risky projects such as power projects are the most promising opportunities, nor that in countries with little political risks such as Singapore educational projects offer least PPP opportunities. For project appraisal, opportunities and risks must be assessed country and sector specific and may contradict the here described general trends.

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