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Political risk in light rail transit PPP projects

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Since 2003 public-private partnerships (PPPs) have represented between 10 and 13.5% of the total investment in public services in the UK. The macro-economic and political benefits of PPPs were among the key drivers for central government's decision to promote this form of procurement to improve UK public services. Political support for a PPP project is critical and is frequently cited as the most important critical success factor. This paper investigates the significance of political support and reviews the treatment of political risk in a business case by the public sector project sponsor for major UK-based light rail transit PPP projects during their development stage. The investigation demonstrates that in the early project stages it is not traditional quantitative Monte Carlo risk analysis that is important; rather it is the identification and representation of political support within a business case together with an understanding of how this information is then used to inform critical project decisions.

1. INTRODUCTION

The main driver to the evolution of the current UK public-private partnerships (PPP) was the Conservative government's privatisation programme, which was intensified by the 1981 Ryrie rules and the 1992 private finance initiative (PFI); this background is well known and reported in many texts,¹⁻⁴ and hence will not be repeated here. Between April 1987 and December 2006, £55 billion of private capital equating to 794 projects was invested under PPP across 20 public sector departments within local and central government, representing from 2003 onwards, between 10 and 13.5% of total investment in public services. Since 1987, £22 billion of private capital has been invested in the UK PPP transport sector of which 85% has been invested in 16 rail projects.

PPPs have been successfully used by central government in the UK to deliver improvements in public services, including light rail transit (LRT) projects such as in Croydon which is shown in Fig. 1. There have, however, been failures and PPPs are not universally beneficial to all sectors and/or all projects as demonstrated by the collapse of the consortium Metronet⁵ and underperforming LRTs.⁶ This is particularly noticeable because the private sector's ability to borrow money and the rate of interest that is charged are directly dependent upon the perception of political support for the project. Empirically, this issue was highlighted in July 2004 when three LRTs (Manchester phase 3, Leeds SuperTram and South Hampshire Rapid Transit)

were revoked by the secretary of state for transport for 'modestly' exceeding affordability targets in comparison with London Underground Limited's (LUL's) PPP that 'significantly' exceeded intended affordability targets.⁷ With each of the LRT projects, sponsors promoted the project believing they had full political support with their business case and project; however, this evidence suggests some projects are politically more supported than others.

Political risk, its analysis and management in an international business context has been the focus of significant attention in literature for over two decades and still remains a significant business and project issue. This early work was focused on the private sector investor rather than the public sector sponsor and on international rather than domestic business. However, importantly two conclusions can be drawn

- (a) researchers have been unable to reach a consensus on a clear definition for political risk due to diversity of risks and its sources⁸
- (b) political risk is not easily quantified and included in an objective manner in a decision-making framework.⁹

Political support and the evaluation and communication of the political risk associated with the degree of support for a public sector PPP project is fundamental to achieving a successful PPP project outcome. This is more so during the development stage of a project through to contract signature. This paper concentrates on the political information required within a business case to assess the level of political support and associated risk with this support. This topic was a single, critical aspect of a larger research project that involved developing and testing an ideal business case to facilitate successful decision making for PPP LRT projects.¹

2. ISSUES WITH DEFINING AND EVALUATING POLITICAL RISK

According to Kettis¹⁰ political risk is difficult to clarify due to the fact that it is a phenomenon present in the interface between an organisation and a political environment and involves the concepts of risk and uncertainty, political sources and political environments. At a general level political risk is 'an implicitly unwanted political activity'¹¹ and has been classified under two categories; risks arising from government action and risks arising from government and societal events.¹² Political risk is frequently referred to in an operational business context or in relation to foreign direct investment (FDI).^{13,14}

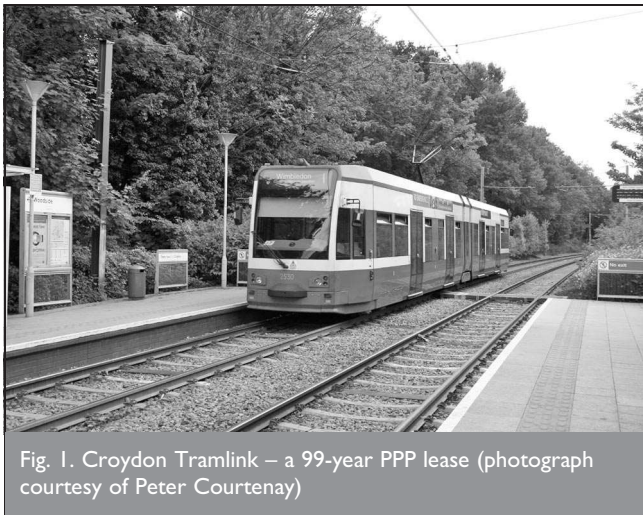


Fig. 1. Croydon Tramlink – a 99-year PPP lease (photograph courtesy of Peter Courtenay)

Furthermore, political risk has been broadly defined as the risk arising from adverse interference of central government on an organisation’s business operations (i.e. forced divestment, confiscation of assets or expropriation) or as a result of political decisions (i.e. changes in taxation or policy) or societal events (i.e. strikes, terrorism, protests or kidnapping) impacting on an investment already made in that country that results in reduced returns, major losses or managerial control.

Sethi and Luther¹⁴ strongly advocate the problem with identifying and evaluating political risks that arises from the lack of attention to political concepts and the weak definitions that do not capture the breadth of the problem. In literature political risk has been used to group political events that affect business decisions, and all too often are associated with political instability rather than other forms of political risk. They strongly argue it is the lack of clarity with the political risk definition that leads to inappropriate analysis and interpretation of findings.

Political risk analysis is often conducted using a combination of qualitative and quantitative techniques.^{10,15} Qualitative methods include grand tours, expert opinions (or old hands), checklists, influence diagrams, scenarios or Delphi technique. Quantitative methods include statistical analyses such as multivariate analysis, and stochastic methods including Monte Carlo simulation^{11,16,17} or multi-criteria analysis such as analytical hierarchical process¹⁸ or predicting using artificial neural networks.¹⁹ According to Pahud de Mortanges and Allers¹¹ who investigated political risk assessment techniques in Dutch firms, industry tended towards qualitative unstructured methods for evaluation that include intuition, judgement and expert opinion rather than more traditional quantitative techniques. Sethi and Luther¹⁴ argue that political risk analysis is frequently hampered by biased data due to interviewees responding guardedly to sensitive questions, censorship of published reports, and frequent ‘bad’ information being hidden. Sethi and Luther¹⁴ then raise problems with analysis and interpretation that include: limited applicability of the past being projected into the future; a lack of consensus over representation of variables; and treatment of risk models as ‘black boxes’ being a substitute for reality. Inappropriate methods of identifying, evaluating and perceiving political risk could cause the project to become unbankable.

3. THE BUSINESS CASE, POLITICAL INFORMATION AND DECISION MAKING IN CONTEXT

One of the key components of a business case is the risk associated with the investment. With PPP projects risks are frequently classified into two categories: project risks and general risks.²⁰ Project risks are those specific to the project’s micro-environment and include such risks arising from the technical, contractual, management and site conditions. General risks are those arising from the project’s macro-environment. General risks have a significant impact on the outcome of the project and include legal, political, economic, social or technological risks. It is recognised by PPP project sponsors that the most significant general risk to a project is political risk. Whereas project risk is identified, quantified and assessed to form part of the business cases (value for money) for decision making, it is the general risks such as political risk that are not.²¹⁻²³ Some project sponsors have experienced problems in identifying and representing political information that is political support for a project, within a project’s business case and using this information to make decisions on the political risk associated with a project. In many instances there is a tendency for project sponsors to focus on the quantifiable aspects for the business case for decision making and keep the qualitative political information for decision making outside of the business case. Fundamentally, a project’s business case is used as a tool to support project decision making and planning.

The ideal PPP business case structure, developed by Gannon,¹ is comprised of strategic- and tactical-level information and a critical success factor (CSF) reporting structure. Strategic-level CSFs are factors that originate from the organisation’s internal and external environment and are utilised for corporate decision making. Tactical-level CSFs are project-related factors that comprise forecast business case components developed by the project team and characteristics of the project team and their methods/systems of working. Information defining the degree of political ‘support’ for the project is a critical component of the strategic-level information category, and the risk associated with this support is the project’s political risk (Fig. 2). This is a strategic-level risk that can have a significant impact on the public sector organisation and its objective to develop and

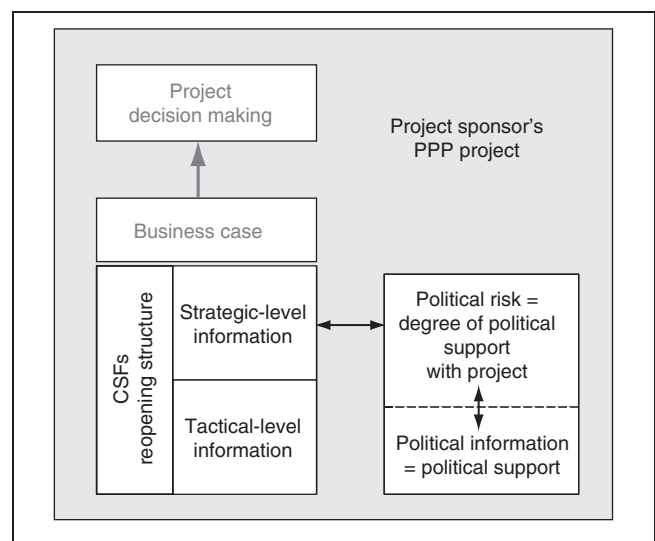


Fig. 2. The business case, political information and decision-making in context¹

deliver the PPP project. Strategic risks are different from traditional project risks in that they are a series of connected dynamic processes rather than events, strongly linked to people and culture and consequently need to be identified, predicted and managed differently from traditional risk analysis techniques.²⁴

Clearly, it is essential for good and transparent decision making that a robust and credible business case containing the best possible project information is prepared otherwise poor decisions will be made resulting in significant wasted time and cost for the public and private sector. Therefore, it follows that the content and structure of a business case needs to provide sufficient critical project information, including political information, as necessary, to facilitate a successful project decision.

4. RESEARCH METHODOLOGY

As part of the larger study,¹ 'unsanitised' project data, information and documentation were extracted from two detailed LRT PPP case studies and four partial LRT PPP case studies but these have to remain confidential. Critical success factors (CSFs) were identified using a case study methodology. A two-phased analytical hierarchical process (AHP) was then used to assess the effectiveness of business case CSFs in decision making with the project affordability decision. The business case was then re-engineered using business process re-engineering. Verification and validation of the ideal business case were subsequently undertaken using the Delphi technique.

For AHP phase one, 12 PPP experts (four each from a group of project sponsors, consultants and advisors, and corporate

decision makers) were interviewed and for phase two nine PPP experts (three from each of phase one's group). During the Delphi exercise nine PPP experts were identified using purposive and snowball sampling, comprising six from industry (four public sector and two private sector) and three from academia. The experts were invited to provide their opinions to verify and validate the ideal PPP business case, a key component of this being the CSF reporting structure. Each expert for the AHP phase one and two and Delphi study had between five and 12 years' PPP experience gained from developing, advising or researching PPP projects – seven experts in rail-based projects and two experts in education and health based PPP projects. The findings from this study that are relevant to political risk are discussed below.

5. ASSESSING THE EFFECTIVENESS OF POLITICAL INFORMATION IN DECISION MAKING

Twenty-three CSFs (with 106 sub-factors) were identified from the case studies as being necessary for realistic and successful decision making. Political information was represented by a 'political perspective' CSF which contained two sub-factors: one providing information on the 'political support and commitment' for the project explicitly communicated by central government to the project sponsor; and the other the 'DfT priority' to demonstrate the significance of the project from the viewpoint of the Department for Transport (DfT). Both these sub-factors are critical to the business case when seeking approval by the sponsors for funding or progression of the project to the next stage by the secretary of state for transport.

After identifying CSFs the AHP was utilised in conjunction with Kendall's coefficient of concordance to assess association

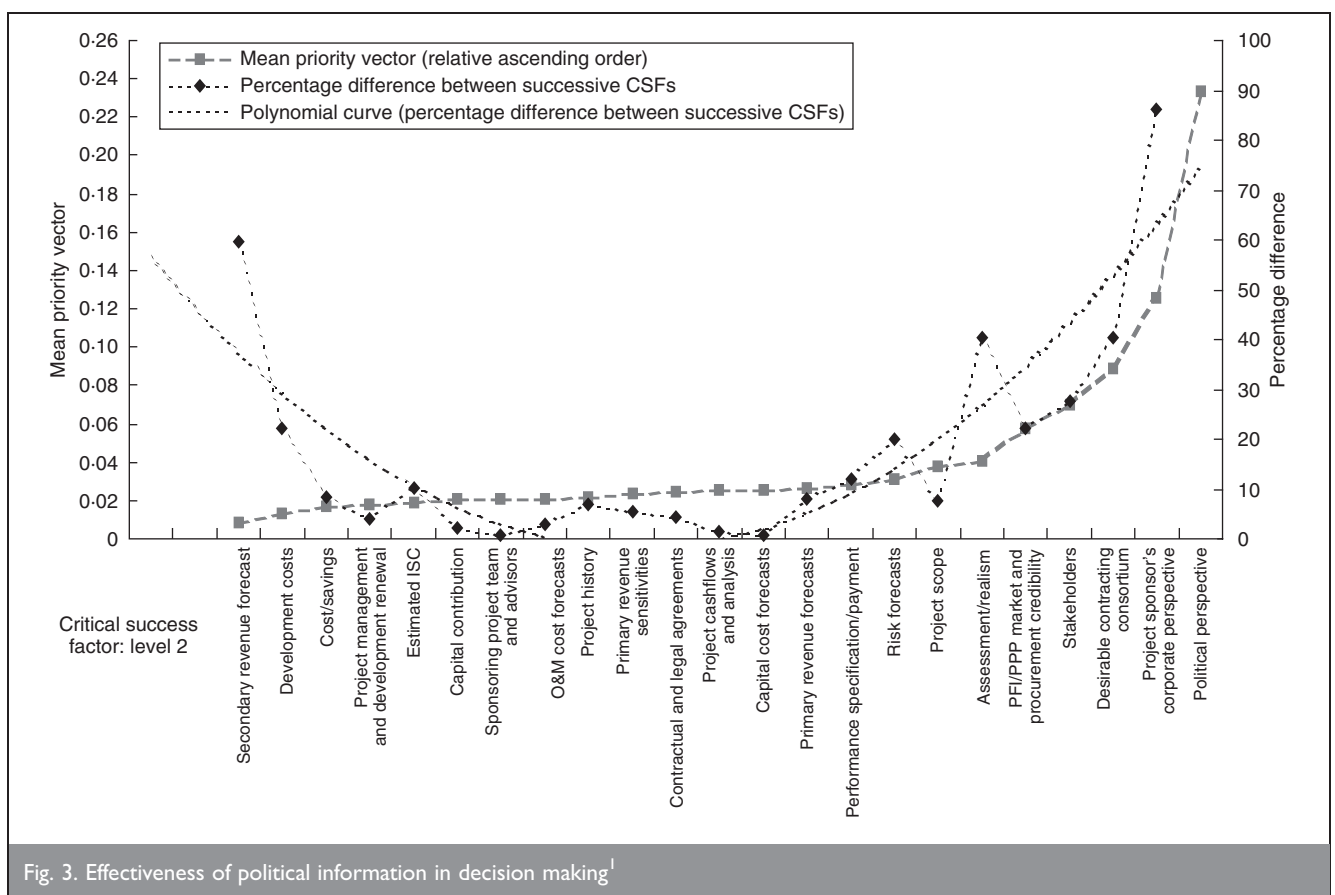


Fig. 3. Effectiveness of political information in decision making¹

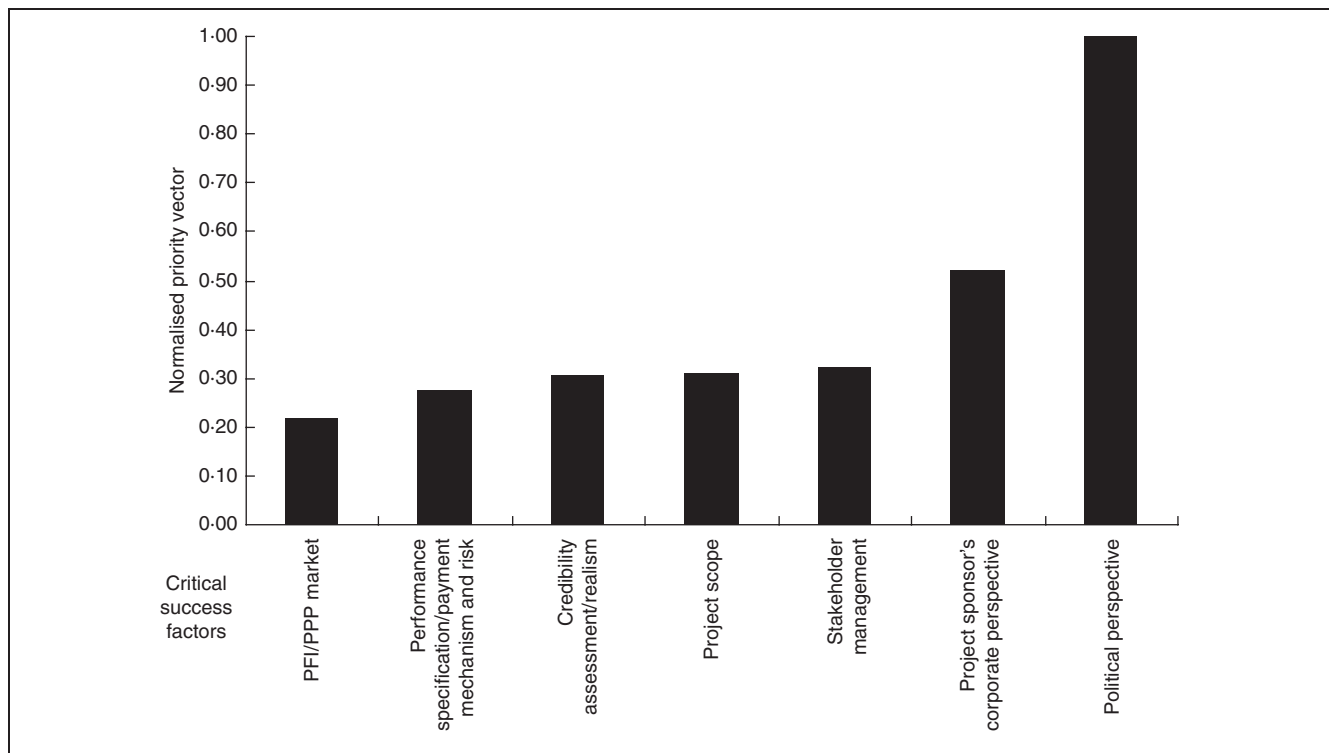


Fig. 4. Effectiveness of political information in decision making¹

between findings.²⁵ During the first AHP phase, 11 out of 12 respondents ranked political perspective within their three top-ranked factors (Fig. 3). Eight of these respondents had ranked this factor as the most critical factor in the decision-making process. There was a more than 40% increase in the weighting of the political perspective mean priority vector (weighting by AHP) compared with the nearest CSF. Most respondents stressed the importance of political support with the project and how this can change and impact on a project over time, a force driven by the government's transport policy and priorities.

Although it was stated by one respondent that 'lots of cities want LRT but it really depends on the government's view at the time, they blow hot and cold; 1 year pro tram and the next pro guided bus-way', respondents stressed the importance of political support needed to 'get the project off the ground'. However, to achieve this political backing it was necessary for sponsors to have a robust and credible business case to present to political stakeholders in the first instance.

After a detailed review and analysis of transcribed documents resulting from AHP phase one, the political perspective CSF was developed further to distinguish between central and local government sub-factors that were critical to PPP projects and business case decision making. The central government information included: project fit with policy and priorities, financial commitment to project, political support (original CSF in phase one) link with major projects politically supported/committed. Local government information included: project fit with policy and priorities, financial commitment and political support with project. A second AHP phase with nine respondents was undertaken with the nine most critical CSFs from AHP phase one; the leading result unsurprisingly was political perspective CSF as shown in Fig. 4.

All respondents, bar one, ranked political perspective as their top priority, the exception ranking it equal first to sponsors perspective, on the basis that the sponsoring organisation needs to understand the business case and project internally unless a strong political policy dictat is being given with the project, as was the case with LUL's PPP.

All respondents ranked central government as their top priority followed by local government. This was on the basis that local government was dependent on central government for its finance and policies. Within central government, 'financial commitment with project' was followed by 'link with major projects already supported/committed by central government', 'political support with project', 'project fit with policies and priorities' (Fig. 5). Respondents' priority vectors and rankings for CSFs, as shown in Fig. 5 and Kendall's coefficient of concordance (W) were calculated; a positive association existed for CSFs with $W = 0.52$.¹

Within local government the overall rankings by respondents were 'financial commitment to a project', 'political support with a project' and 'project fit with policies and priorities' (Fig. 5). Generally respondents ranked 'political support over project fit' with 'policy and priorities' as projects that seemed to 'press all the policy buttons' but do not have political support and are left to languish. However, with London-based projects it was evident that a link with a major project already politically committed was more significant than having support with a project by central government. 'Political support' was the most important factor followed by 'affordability' and the fit with the 'corporate strategy' and 'policies and priorities'. Respondents viewed policies and project priorities as changeable within their organisation so ranked these the lowest CSF in decision making. A respondent from one local authority ranked capital investment programmes according to each project's fit with

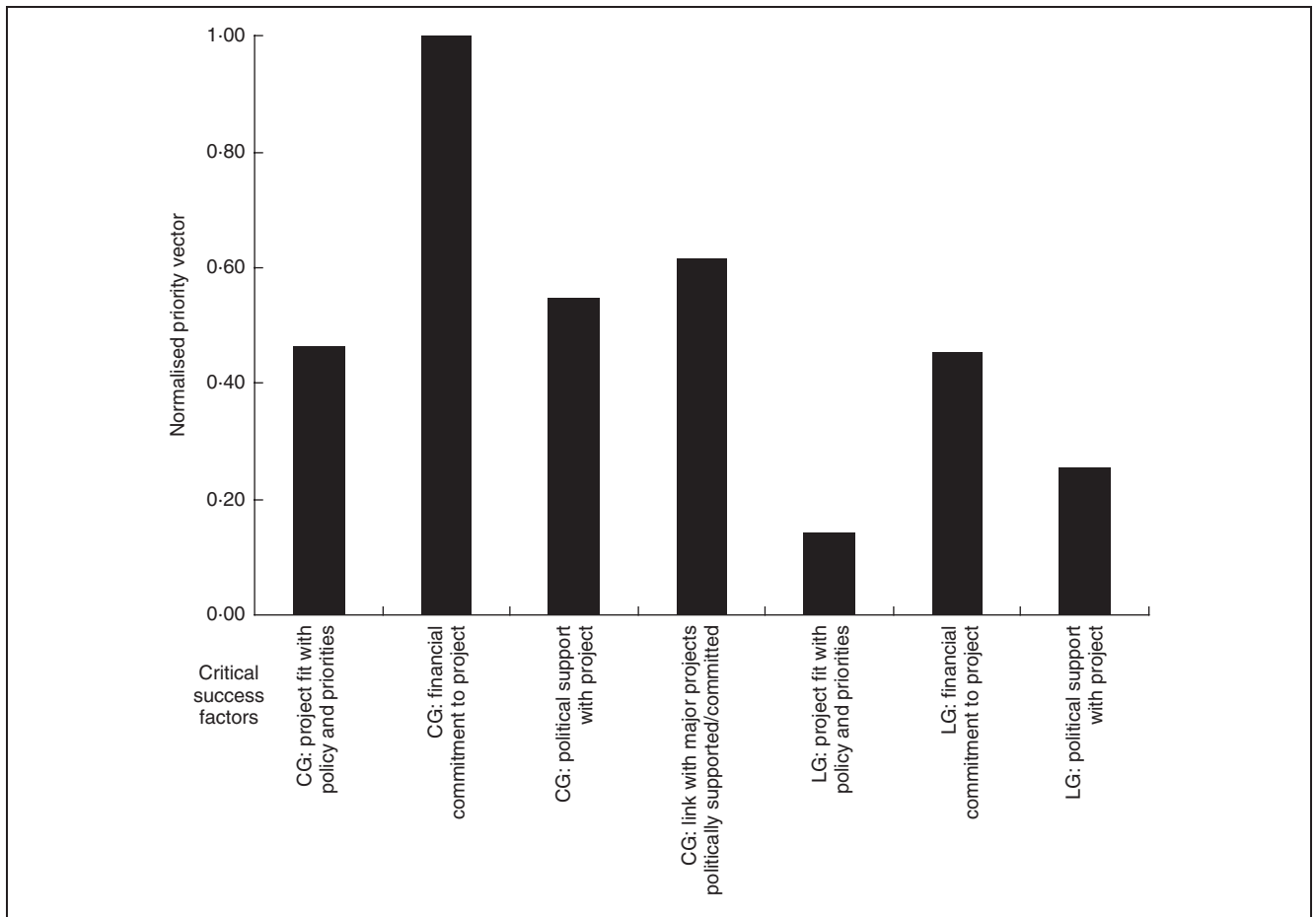


Fig. 5. Effectiveness of central (CG) and local government (LG) information in decision making¹

local government’s policies and priorities; projects with low rankings are fast-tracked to the top of the investment programme due to political reasons. Although political support can be quite strong for projects, one respondent indicated that ‘at the end of the day it is all about politicians, councillors essentially, and if necessary they will rewrite all the policies to give the answer they want’.¹

6. DISCUSSION OF POLITICAL SUPPORT AND THE BUSINESS CASE

As a result of verifying and validating the ideal business case using the Delphi technique, experts expressed their opinions that were strongly focused on the political support for projects assessing political risk and the value and limitation of representing political information within the business case for decision making.

Political support and the risk associated with this support from central government was a critical issue for sponsors during development. Political support was evident at two levels: local government support and central government support through members of parliament (MPs). At the early development stage of a PPP project significant emphasis was input by the project sponsor into gaining central and local government political support with the project, as without this support there was no project despite a technically sound business case. Once these two levels of political support had been gained, the project sponsor would then focus on the PPP transaction and the marketplace and update politicians on progress.

Despite project sponsors and advisors developing credible and robust business cases conforming to DfT’s and Her Majesty’s Treasury’s (HMT) PPP business case best practices, they were still prone to political uncertainty even though, in some cases, the DfT informed sponsors they had political support and financial commitment to their project. One PPP expert stressed transport projects in the UK were nearly always politically driven; technical people invent them but projects never really happen unless they have political support at the right level. It was noted that political support was often swayed by forthcoming elections and other sector priorities. Two kinds of political support were identified by experts. Some PPP rail projects in the UK had political ‘ticking over’ support by HMT, whereby development funds were available to projects, albeit in a steady stream. This often seemed to be the case when elections were on the horizon. However, these projects never appeared to progress on to the next stage and/or reach contract signature. Whereas projects that had ‘genuine’ political support from HMT, despite consuming significant development funds and changing the original funding objectives, managed to reach contract signature.¹ One expert stressed that genuine political support is evident by HMT’s appetite for risk and funding PPP projects and is often demonstrated by rapid decision making, throwing money at projects or taking risks away from the project to ensure the contract is signed.

Issues raised by many of the experts included how to assess and express HMT’s ‘genuine’ political appetite for a project. Being unable to include fully ‘committed’ political information

Political support	Central government information	Local government information
Project fit with policy and priority Financial commitment Link with other projects	White papers, strategic plans, National Audit Office Public terms and conditions for support payments Factual public record	Local transport plan Authority 5-year plans Expert assessment/commentary

Table 1. Prototype systematic political risk profile

for a project weakens strategic decision making, leaving corporate decision makers having to make a decision on the status of an unknown critical factor that is outside their control. However, this is a risk frequently accepted by corporate decision makers and sponsors believing they have, 'genuine' political support when in reality they do not. In these instances an exit strategy is essential to mitigate the risk of significant wasted funds and time in project development. PPP experts agreed that it would be impossible to write this explicitly in a business case or elsewhere, as it is as politically unacceptable to commit support to a project which is not viable. It was suggested by one expert that perhaps HMT commitment to a project could perhaps be detected through 'tell-tale' signs such as: a link to a major project of national economic importance already supported (i.e. Heathrow Terminal 5, Olympics), positive messages to the private sector, reimbursement of bid costs, response to decision making or attending meetings by HMT and DfT officials.

Despite the lack of confidence sponsors had in being able to include 'real' political information in a business case, it was clear that information for central government ('project fit with policy and priorities', 'financial commitment to the project', 'political support with the project' and 'link with major projects politically supported or committed') and the same for local government could be identified and incorporated, as shown in Table 1. The local government level information should demonstrate the project fit with local government policies and priorities typically sourced from the authority's local transport plan (LTP), the five-year investment plan or other strategic documents published by the local authority. The level of financial commitment provided to the project by the local authority covering development and/or implementation costs (annual profile, total and present value) with a



Fig. 6. LUL PPP one of the UK's largest PPPs (© Transport for London 2005)

supporting commentary is also beneficial. To communicate the position as clearly as possible, any conditions on the project funding levels also need to be provided in a supporting commentary.

7. CONCLUSIONS

This paper has investigated the inherent riskiness associated with the significance of political support and hence for project decision making for PPP LRT projects. Although traditional Monte Carlo techniques are frequently used by sponsors to evaluate project risk, they tend to be based on an input of hard project risks, which are relatively easy to identify and quantify but produce outputs that are insufficient for realistic decision making. The paper shows that for LRT infrastructure investment projects, including the exemplar of LUL Tubelines PPP shown in Fig. 6, it is the soft risks affecting the investment that are critical to the project's overall success or failure. The paper clearly demonstrates the critical significance of the soft risks in general and of political support in particular, which is another way of expressing political risk. Any misperception of risk can cause lending rates to rise, creditworthiness to fall and adverse conditions for the project to prevail.

Despite problems of confidentiality and the pressures of public accountability, the paper shows that financial information on central government's financial commitment required for a business case includes development and/or implementation costs (annual, total and PV) to the project (typically capital grant) with a supporting commentary; a summary of the political support for the project across the three major UK political parties is also required; details of major project(s) (dates, dependency) which the sponsor's project is integral to and already supported or committed to by government are required. It is therefore significant if political risks can be identified and expressed more transparently; and this seems to be undertaken most appropriately in the business case and used for decision-making purposes. This process will reduce time and cost in wasted project development. Critically this information will allow project sponsors to formulate an exit strategy from the project to mitigate political risks.

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