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The Basics of Political Risk

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Many situations encountered by cost professionals involve uncertainty. These situations may be as probabilistic as they are deterministic.[1] In other words, the cost professional may be called upon to determine the expected capital cost of a new, international venture, but also determine the probability that the cost will be more or less than the determined baseline value of the venture. This is a type of risk assessment that is familiar to many cost professionals. However, the diligent assessment of risk can extend beyond base capital cost. In many cases, it should include an assessment of economic, financial, and political factors that may influence the business climate where a substantial project may be undertaken. In this article, political risk assessment is meant to include country risk factors.

Generally, there is a distinction between political risk and country risk. Political risk refers to the possibility that political decisions or events in a country will affect the business environment negatively. Country risk assessment incorporates financial and economic factors along with political factors.[2]

The concept of political risk assessment has been around since the beginning of trade and merchant activity. It can be described as an awareness of the likelihood that specific rules or circumstances may change in a way that adversely affects a financial endeavor. Therefore, financial institutions contemplating financial backing for an international project, for example, would conduct a political risk assessment of the project in the course of due diligence.

In the realm of global business, dealing with political risk is not an obscure issue.

The Overseas Private Investment Corporation (OPIC) of the U.S. federal government and the Multilateral Investment Guarantee Agency (MIGA) of the World Bank are prominent in political risk coverage.[2] The major types of losses covered by MIGA and OPIC are typical for the environments in which they operate.

MIGA provides the following non-commercial guarantees (insurance) for investments made in developing countries[3]:

- Risk of Transfer Restriction
- Expropriation
- War and Civil Disturbance
- Breach of Contract

OPIC insurance can cover the following three political risks[4]:

- Currency Inconvertibility
- Expropriation
- Political Violence

These two organizations offer similar categories of coverage. Risk of transfer restriction is essentially defined as currency inconvertibility. This is action taken by a government that prevents the investor from changing local currency into U.S currency. This type of coverage could apply to profits, debt service, and other financial returns. Expropriation, sometimes referred to as nationalization, is an action taken by a government to seize property or assets of the foreign investor without full compensation. Political violence includes war and civil disturbance. This category could also include terrorism and sabotage. MIGA offers coverage for breach of contract. This is also referred to as non-honoring of sovereign guarantees.

Traditionally, political risk assessment involves international emerging markets. However, it can also be required prior to committing financial backing for projects in the U.S. Consider the emerging issues surrounding a coal fired power plant project. Analysts in the energy industry anticipate legislation imposing carbon production restrictions on companies in the next several years.[5] The cost of these regulations is difficult to predict, but due diligence on a project of this type would certainly address the issue of CO_2 restrictions in the political risk assessment.

In another example, consider a resort development project that is under authority of multiple state agencies and local jurisdictions. Project designs and estimates in the conceptual development phase rely, in part, on a set of assumptions that are easily affected by these agencies and political jurisdictions. When assumptions are affected, cost can change substantially. Often, attorneys are called upon to make judgments about political and economic risks in circumstances that are so complex as to be outside of their scope of expertise. As with other subject matter, attorneys can utilize experts in these risk areas to better serve their clients.

Political risk assessment is much more than an assessment based on experience. It is a set of factors and their probabilities that are relevant to the project or venture at issue. For the resort project mentioned above, whether the authoritative political jurisdictions are pro-growth or anti-growth is a critical question. Furthermore, the longevity of this assumption depends upon the election cycle and the prospects for a change in governmental policies.

For any of the examples mentioned, a political assessment and analysis is a forecast intended to enable better risk management by project owners and financiers. Political risk insurance alone is not actual risk management. Although it can be a risk management tool, it is generally part of the crisis management and recovery plan. Whether this type of risk is found in legislative activity, project political environments, or international projects, undiscovered political risk can blindside owners and investors. Fortunately, there is expertise available to assess and analyze macro-economic, financial, and political risk factors.

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1 Kenneth K. Humphries, ed., *Jelen's Cost and Optimization Engineering*, Third Edition (McGraw-Hill, 1991), 168
2 Llewellyn S. Howell, Ph.D. ed., *The Handbook of Country and Political Risk Analysis*, Fourth Edition (The PRS Group, 2007), 7-8
3 http://www.miga.org/quickref/index_sv.cfm?stid=1587 (Accessed April, 01, 2008)
4 http://www.opic.gov/pdf/05_ProgramHandbook.pdf (Accessed March 31, 2008)
5 John Goff, "Carbon Trading", CFO, January, 2008, 40-47

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International Projects

Legis Consultancy recently expanded its international practice, sending vice president, Patrick S. Ray, JD, CCC, PMP, to Scotland. Mr. Ray presented a four-day seminar on topics covering the elements of project management and cost engineering. The seminar, held at the Dounreay Nuclear Facility in Thurso, Caithness, Scotland, included members of the facility's project control team and was introduced in order to educate the members on the most up-to-date, innovative practices in project management and cost engineering.

The United Kingdom Atomic Energy Authority (UKAEA) is currently undergoing changes to its business structure and is executing a major privatization effort at its Dounreay facility. The management at UKAEA's Dounreay facility desired to enhance the team's knowledge with a thorough understanding of the processes that serve as the key components to project management and cost engineering at the facility. The purpose of the seminar was to provide the team with the foundational knowledge necessary to be successful in their efforts. Legis continues to advance its practice in education for government and private sector clients.

Jonathan Ma Joins Legis

Legis Consultancy is pleased to announce that Jonathan Ma has joined our team as an associate. Mr. Ma graduated from the University of Georgia with a Bachelor's in Business Administration. He is a Certified Associate in Project Management and is currently pursuing a Cost Technician Certification. Mr. Ma is currently engaged on several cost estimating and scheduling projects.

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