Sustainable Water Integrated Management (SWIM)

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TRAINING ON EVALUATING AND STRUCTURING PPPs IN THE WATER SECTOR

Day 3 – Session 2: Insurance & Dispute Resolution

by

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Insurance in Water PPPs

Insuring Risk: a Definition

The sharing of risk where the losses of the few are met by the resources of the many, i.e. a mechanism to transfer risk

What Is Insurance?

Insurance is a primarily a form of contingent **risk transfer** to another party in exchange for a payment or premium

The investment insurance market: purpose and structure

Why get insurance?

- Balance sheet protection/ Prudential rules and regulations
- Impact on the value of the company on the stock market if major political risk not insured. Can be critical for SMEs
- Facilitate access to finance: increase in loan tenor and lower financing costs
- Management of counterparty limitations by banks
- Competitiveness of the insured

What do we try to evaluate?

- Probability of occurrence of an event (risk) of a political nature over the medium term (3 to 5 years) which will change the viability perspectives of an investment project
- Possibilities to recover amounts paid to insured if such event takes place

Risk Quantity and Quality

Quantity of a risk represents the total monetary value which can be lost should the risk occurs.

The key concern for an insurer is to cover a risk which demonstrates "good quality". Good quality has some of the following meanings:

- There is a solid risk control framework behind that risk.
- The Insured is keen in reducing the overall risk exposure (likelihood & consequence).
- The Insured acts like non-insured. (does not rely on the fact that there is insurance)

Risk & Insurance

- To maximise the benefit of insurance the risk must be identified and understood
- Public entities often self insure
- A gap arises where the risk exceeds the ability of the party to which it is allocated to carry, absorb or manage the particular risk
- A gap also occurs when other stakeholders require protection beyond the ability of the allocated party to provide
- Insurance is often used to close the gap
- If it is too expensive or un-insurable a reallocation of the risk to the public entity is often considered (with an adjustment in the fee structure)

Typical pitfalls of PPPs

- Under-estimation of risk
- Over-estimation of risk
- Inappropriate transfer of risk
- Inappropriate PPP projects
- Lack of partnership approach: win-win
- Public sector inflexibility to change/new ideas

Key Bankability Issues

- Project delays
- Structure and security of payments
- Standardization of documents
- Changes in law
- Allocation of risk
- Termination
- No open ends

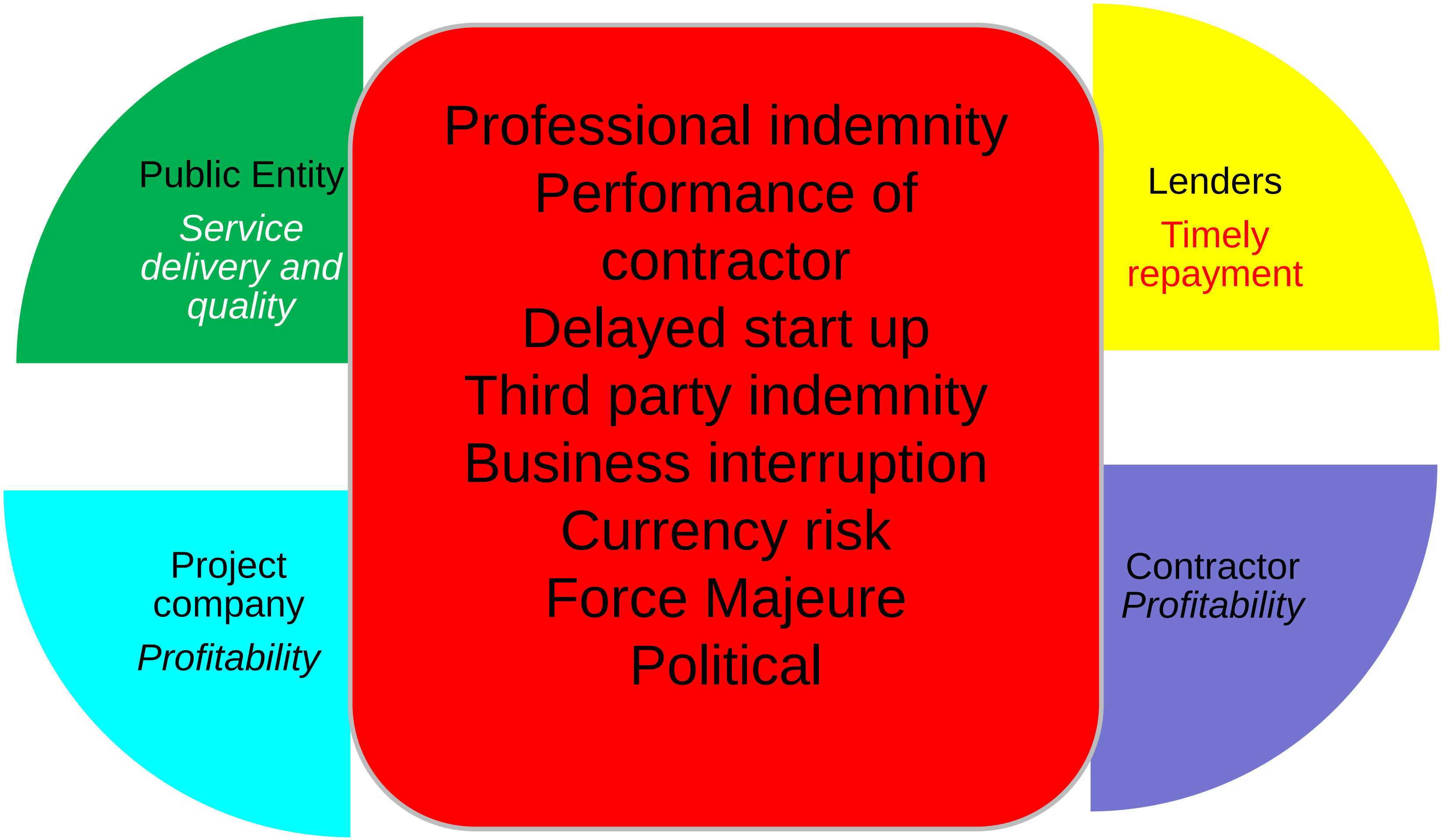
Characteristics of PPP Orientated Insurance

- In PPP’s, it is client specific, unique and has a specific objective.
- It is wide with comprehensive cover and low deductibles with minimum risk retained in the SPV.
- It normally has most stakeholders listed as co-insured.

Why Insurance in PPP's?

- Changes a potential **BIG** loss into a known **small** "loss" ensuring the survival of the business entity by preventing catastrophic loss
- Important component of prudent risk management
- Without insurance the financial consequences would not acceptable to any of the stakeholders
- Serves to protect the Grantor, the SPV and other parties from
  - Physical loss or damage to Project property/assets
  - Earnings and additional costs of the SPV in respect of the above
  - SPV balance sheet/cash flow protection
  - incurred Third Party Legal Liabilities (bodily injury and property damage)
  - Banks' comfort and protection of their loan
  - Government's comfort that SPV can continue to operate in event of losses

Common Gap Items Covered By Insurance



Sources of Commercial Insurance

- Commercial insurance covering the preceding is generally freely available in most countries and also internationally.

- There are also a substantial number of insurance brokers that will prepare a full package and handle claims in the case of an event.

Risks in the Water Sector that are seldomly covered by Insurance and, Some Suggestions

- ✓ Tariff regime **Attempt to include in political risk**
- ✓ Willingness to pay **Community awareness programs**
- ✓ Increase in insurance premiums over the life of the project **Include in adjustment or pass on to public entity**
- ✓ General business environment i.e. collapse of infrastructure / increase in corruption and consequential bribes **No mitigation**
- ✓ Interest rate increase **Hedging products**
- ✓ Currency exchange risks **Hedging products**

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Operating Company Insurance Requirements

Construction Period

- Performance bond
- Contractors all risk inclusive
- Force Majeure
- Third Party Liability
- Delay in Start Up
- Political Insurance
- Professional indemnity

Operating period

- All risks
- Force Majeure
- Third Party Liability
- Business interruption
- Contingent customer extension
- Political insurance

Definitions (1)

- A ***performance bond*** is a surety *bond* issued by an insurance company or a bank to guarantee satisfactory completion of a project by a contractor
- ***Contractors all risk*** is an insurance policy normally on a replacement cost basis covering physical damage to works ,materials and equipment It can include *Force Majeure* events like war and natural disasters.

Definitions (2)

- **Third-party liability** is an insurance policy purchased for protection against the actions of another (a third) party and can relate to claims and the defence against the claim
- **Delay in start-up** compensates the project company for loss of profit or additional costs from a delay caused by an event insured under the all risks policy

Definitions (3)

- **Professional indemnity** covers issues arising out of faulty design and design specifications
- **Business interruption** is the equivalent of the Start-up insurance and covers costs and losses by the period of interruption caused by breakdowns and replacement delays
- **Contingent customer extension** is the equivalent of force majeure in the construction phase and covers the insured against force majeure events affecting a third party ie non delivery of chemicals

Dispute resolution mechanisms

Dispute resolution mechanisms in PPPs are essential means of enforcing the allocation of risks among the project participants, including Government parties.

It is important that the applicable mechanism be flexible, reliable, final and enforceable

Means of dispute settlement in (international) infrastructure PPP transactions

- Domestic courts
- **Arbitration**
  (domestic and international)
- **Mediation** and conciliation
- Other

Alternative means of dispute settlement

The term Alternative Dispute Resolution (ADR) is often used to describe a wide variety of dispute resolution mechanisms that are alternative to full-scale court process. The term can refer to everything from facilitated settlement negotiations, to arbitration systems, mini trial, mediation, and other processes.

Arbitration

Arbitration is a proceeding in which a dispute is resolved by (an) impartial individual(s) chosen by the parties to the dispute on the basis of his/their expertise («arbitrator(s)»), whose decision (" the award"), the parties have agreed, or legislation or an international treaty has decreed, will be final and binding.

International arbitration is arbitration taking place in an international context: parties with different nationalities…

Main Types of Arbitration

- ***Standard commercial arbitration, national and international:*** *Disputes involving standard commercial risks*
- ***Investment arbitration*****:** Arbitration between investors and States (with a political risk dimension): special features, most common in international PPP projects

What is ICSID and what does it do?

ICSID (International Centre for Settlement of Investment Disputes) is one of the 5 organizations of the World Bank Group, which also includes:

- International Bank for Reconstruction & Developpent (IBRD)
- International Development Association (IDA)
- International Finance Corporation (IFC)
- Multilateral Investment Guarantee Agency (MIGA)

ICSID provides facilities for conciliation and **arbitration of investment disputes** between a State and a national of another State.

ICSID promotes international investment for development by providing an independent forum for dispute settlement.

Mediation

Mediation is a process in which a neutral third party – the mediator – assists parties in an effort to reach a mutually acceptable solution to a dispute.

The mediator uses a variety of skills and techniques to help the parties reach an agreement.

The mediator has no power to make a decision, because the parties take the decision themselves.

Concluding Remarks

Issues in the Water Sector (1)

- It is advisable that the project company undertakes to arrange the insurance even if there are separate operator and contractors as the policies are often intertwined like the delay in start up and all risks.
- The quantum of insurance covering physical damage: not all the components of the works are vulnerable, e.g. pipes underground are very unlikely to be damaged by fire, and even war, and even if they are damaged it is likely to be a small percentage of the overall line.

Issues in the Water Sector (2)

- If the project is vulnerable to bulk supply from a third party the contingent customer extension policy (also sometimes referred to as contingent business interruption) should be worded to cover interrupted supply and potential penalties.
- The political risk insurance is important and every effort should be made to include the formula for price adjustments and regular reviews in the contract with government and to ensure that it is covered by the political risk insurance.

Issues in the Water Sector (3)

- Address affordability and costs with selected caps and collars on premiums
- Quality of data
- What happens if risk becomes “uninsurable” ?
- Lack of understanding of the sector impacting on insurance availibility market

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Closing Thoughts

- Private sector insurers are unlikely to enter the emerging markets and the WSS sector, until products and coverages, particularly for contractual/regulatory and forex instruments, are better defined and tested.
- IFIs have the ability to help shape and develop projects to the point where guarantees can make a difference in private sector participation.
- IFIs have the leverage to enforce guarantees and serve as honest brokers between government and the private sector.
- But guarantees alone won't solve the WSS financing need
  - They are part of the solution to bringing private capital, management and know-how to the sector
  - Considerable effort is still needed at the water sector level to bring projects to the point of potential private sector interest

Conclusion

- There are many risk mitigation facilities available, some tied to origin and some untied, that cover both commercial risk and political risk to varying degrees
- There is a need to create more awareness of these facilities among private sector investors and potential investors inthe water sector

'You are now insured against fire, flood, theft liability, sickness, accident, death and any attempts on my part to sell you any more insurance.'

Thank you