Summary of key points, past significant questions and solutions

(Very useful for final exam)

Risk and mitigation:

Question 1

The key to project finance is the allocation of risks to those best able to manage them. By doing this the value of the project is enhanced.

a) Explain why a project is enhanced by allocation of risks?
b) Explain and give 4 examples of project risk and how they can be allocated.
c) Tinsley suggests a caveat "ensure the 3rd party is good for it". Explain.
d) Explain with examples why guarantees is one means to manage the risks

Answer:

a) Reason of allocating risks

Allocation of risk means allocate a particular risk to project participants such as contractor, government, insurance company and etc.

Risks within the project could bring uncertainties of, either reducing the revenue generated or increasing cost of project. By allocation of risks could minimize and even eliminate the uncertainty of losses (for example, market off-takers guarantee long run fixed sales quantity and price; government authorities and insurance company insure country risk such as expropriation could be avoided; contractor assures no delay on construction or engineering design flaws and etc). Thus, cash flows are less volatile and project value is enhanced.

Therefore, in such way, project risks are diversified to different parties rather than centralized. This is critical because uncontrolled risks within the project could bring uncertainty on cash flow and even project failure.

b) Four examples of project risks and allocation strategies

- ✓ *Political risk* in the form of expropriation and blocked fund could be fatal for an international project. By purchasing political risk insurance with insurance company, concession agreement and currency in-convertibility agreement with local government, this risk could be allocated to associate third parties.
- ✓ *Force majeure risk* such as strikes, natural disaster that could lead to project suspension or failure could be allocated to insurance company by purchasing relevant insurance.
- ✓ *Reserve risk* or shortage of reserves has significant impact on for resources projects. This risk could be allocated to independent consultant by requiring independent reserve report and to the insurance company via purchasing