The Soro Dondar Project

A Case Study in Project Deal Terms and Political Risk Evaluation

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Abstract

Assessing and measuring political risk is important to both project economics and the question of how to finance a project. Private project sponsors often face the question of whether project financing is worth the extra costs and effort that it entails. To answer this question, they must quantitatively assess the political risks associated with the project and determine whether employing project financing will reduce those risks to a degree that justifies its added costs.

This case presents a project in a country where political risks have taken a turn for the worse. Simultaneous with these adverse developments, the original project sponsor, Mission Oil, has merged with Flagler Petroleum. Management in the merged company is now taking a fresh look at the Soro Dondar project. The conversation focuses on how to measure the increased risk in Simonivar and reflect that in project economics.

This discussion will set the stage for the financing decision to follow. If management decides to proceed with the project, it will want to analyze whether the risk adjusted return appears better with or without the use of project financing. To the maximum extent possible, this determination should be evaluated quantitatively. That begins by determining how much incremental risk premium should be added to the discount rate used for de-levered project economics. Then, when project financing is introduced, sponsors can reflect the added financing costs directly in the cash flows while determining what reduction in the discount rate is justified by using project financing. The resulting Net Present Value should indicate whether project financing improves upon a corporate financing approach or actually worsens the base case economics.

The case concentrates on the first part of this process, the assessment of an appropriate risk premium for de-levered project economics. Special attention should be paid to the sets of "Project Planning Bases," the key production, price, and market assumptions from which cash flows are developed. These change over the years that Soro Dondar is "under development". Some of the more important changes come in response to the emergence of Armand Benitar as Simonivar's new president and his ensuing economic policies. Others reflect changes in the global economic outlook and the merger of Mission and Flagler.

Students are asked to examine all of these changes and determine a composite risk premium to use for project economics. Although the case doesn't specifically pose this question, students should also consider to what degree the use of project financing will

reduce this premium.