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PORTFOLIO RISK & EXPECTATIONS RISK
More serious than you may think

Cash strapped governments are looking to the private sector to solve the problem of how to provide more with less. But private funding introduces extra risk. Here are two of the lesser discussed risks that are important at the PROGRAM or STRATEGIC level.

- **Portfolio risk** is the risk that the wrong projects will be done, or the right projects but at the wrong time, or in the wrong sequence, and
- **Expectations risk** is the risk that unrealistic expectations will cause decision makers to perceive a failure where there isn't any – and to withdraw support before the real benefits are achieved.

Portfolio and Expectations Risk are common to all sources of funding but, as we shall see in a moment, they are greater with private sector funding.

Curiously, you generally won't find these risks discussed in Risk Management Guidelines or in conference addresses by lawyers. There are reasons for this, of course; both the guidelines and the presentations concentrate on the risks attached to individual projects rather than the risks attached to the entire program. Portfolio and Expectations risks relate to the Program, not to individual projects.

How serious are these risks? Very! How should they be managed? First, recognise them. Second, ensure that decision makers are aware of the consequences.

See over page.

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Strategic Asset Management

Portfolio and Expectations Risks are subsets of PROGRAM Risk. Most textbooks deal with PROJECT Risk.

PROJECT AND PROGRAM RISK
What's the Difference?

Project Risk

Project risk is the risk that, in some way, the project will fail to

- Come in on time
- Come in on budget, or
- Provide the expected benefits

Most risk discussion is on project risk, dissecting the various elements and managing them.

Program Risk

Program risk is the risk that, regardless of the performance of individual projects in the program, the *overall program may fail* to achieve its objectives.

It includes the risk that political support—and therefore funding—could be withdrawn from the program before it is completed; a very real risk that is seldom, but should be, managed.

A program is an integrated set of projects where the full recognition of the benefits can only come from completion of all of the elements. As an example, some health authorities have a major program of change in their processes of service delivery – services that have traditionally been provided in the major teaching hospitals in the capital cities are being 'moved back into the community', into regional hospitals. And services that were provided in the regional hospitals are being moved out in very local day clinics and surgeries, often in shopping centres where people can easily reach them.

Where program benefits depend on both

- New capital works and
- Renewal and/or modification of existing assets

(as in the example given here of the hospital shift), there is a danger that the new capital works will be given more emphasis because of their ability to attract private funding and the renewal works may be overlooked—to the detriment of the overall objectives.

Such a program entails the need for a very carefully managed asset strategy since the regional hospitals are freeing up space by moving services out into the local day clinics but this space will generally need to be modified to make it suitable for the services that they are receiving from the teaching hospitals.

Selection of projects

Projects need to be chosen to meet overall objectives, not simply the individual project objectives. The logistics of such a major service delivery shift means that changes need to be made in a certain sequence and there are timing constraints. A major risk is that the requirements of private funding may disrupt the sequence or delay it.

Consequences of portfolio risk are

Portfolio imbalance – wrong projects chosen or wrong timing
Portfolio waste – assets that would be fully functional with renewal or modification are overlooked – causing an excessive drain on maintenance and operations budgets but providing a lower quality of service.

(this is often seen as poorer service from publicly owned assets and can exacerbate the desire to acquire private funding – so fuelling the overall problem!)

MANAGING EXPECTATIONS

Community fuzzy thinking about private funding can be a serious hazard to achieving your asset management objectives.

Listening to the speeches and conversation of your decision makers will show you whether you have a problem. As an indication of what they may be thinking, we present below, three 'urban myths' - ideas that have currency in certain decision making quarters that have the capability of destroying your program benefits unless addressed.

Urban Myth 1:
Public capital otherwise spent on Privately Funded Assets can now be spent elsewhere.
Wrong!

This looks ok, but it is still wrong.

Private sector funding is basically a lending mechanism. The private sector pays the capital investment up front and the public sector 'repays the loan' by making annual service payments over a contract period.

Only if the private funding mechanism results in lower overall costs will any capital be available for spending elsewhere – and then *only the savings element is available*. (the rest needs to be invested in order to pay the annual service charges)

The danger is that all of the capital freed up in the initial instance will be directed to non-income earning areas with no provision for the higher annual charges involved. This results in the Government overcommitting itself, it becomes more 'cash strapped' and other projects have to go – and that's where your program starts to go off the rails.

Another danger is that even if the Government is aware that only the "savings" element is available for re-direction, it *may overstate the size of the savings. (see sidebar)*

Where the savings were negative

In the case of the Commonwealth Government's recent notorious property deals, the argument was that the Government could achieve a higher 'social return' by spending monies invested in property on non-income earning social expenditure instead. However, the property deals did not result in any savings, but quite the reverse. So the impact of the decision is that LESS will now be available to be spent on social expenditure over the life of the property contracts (unless more taxes are raised!)

Questions are now being raised over the responsibility of the Government Departments in this debacle – even though it was 'government policy'. The implication is that it is still incumbent on managers to make the consequences of their actions clear to policy makers – if only to protect their own backs!

Private funding will generally result in a <u>higher</u> budget cost— even where total costs are lower!

When a project is funded via private sector investment in the provision of public services, depreciation, opportunity cost and general financial risk, are brought to account in the annual service payments. So even if there are real cost savings from the private funding deal, the actual budget will be higher! (And when these budget costs are passed on in user charges, the charges will be higher!)

Warning: One method of ensuring that proposed project savings are not overstated and are actually achieved is to factor the savings into budget allocations— but only those savings that are currently in the budget are fair game. Anything more and the budget cuts will have a detrimental effect on efficiencies.

Urban Myth 2
Cost savings mean Budget Savings
They don't!

This is true only if all costs are in the budget in the first place! - but they are not.

Costs that are generally not in the budget include

- depreciation,
- opportunity cost, and
- General financial risk.

Opportunity cost, that is the cost to the community of having money tied up in physical assets, is not currently budgeted for. (Under a proposed capital charging regime it would be in the budget if fully funded, but most treasuries have shied away from full funding of the capital charge)

Depreciation is also not currently funded in most budgets. While details of how the new accrual or output budgeting will be applied with respect to depreciation are still in the development phase, it would appear from Treasury discussion papers that full funding is not intended. *The argument for opportunity costs therefore also applies.*

General risk on government funded projects is usually carried by the Treasury and is not funded through the budget (in fact, not funded at all.) Rather Treasury stands ready to wear the cost if and when the adverse event occurs. This includes crown risk, demand risk, etc.

The dangers of this urban myth are not in the higher budgets, but in not recognising that the budgets need to be higher to allow for previously not recognised costs.

One danger is that Governments will, through ignorance or delusion, <u>claim that budgets and prices have been reduced.</u> Experience in the privatisation of electricity and the major water outsourcing contracts show the reverse. It is not so much that the COSTS have gone up (although that may also be the case), *but rather that <u>all the costs are now</u> being counted!*

Another danger is that the accommodation that agencies have to make to their reduced cash availability from the budget after all of the costs are now accounted for *by them,* may result in non private funded services being cut to make budget room for those that are.

And it is not only governments that can be misled. Head Offices can too! (see sidebar)

Urban Myth 3 –
Enhanced performance can be enforced in private sector contracts without extra cost
It can't!

All three of these 'urban myths' can de-rail your program by

- Creating artificial funding shortages for the elements of the program that need to be government funded
- Distorting the balance of the portfolio
- Leading to increased prices when the government has promised lower prices (or poorer services when the government has promised better services)

It has become commonplace for government departments to manage budget stress by reducing the level of maintenance. Thus 'efficiencies' have frequently been gained at the expense of reduced performance and earlier-than-otherwise renewal.

When private provision contracts are written, maintenance is built in and cannot be cut by the government because it is part of the ongoing contracted payments. This reduces the government's flexibility to cut maintenance. This might be argued to be a 'good thing' from the point of view of performance, but it does have the impact of increasing the average maintenance cost over the contract period - and if this is not allowed for in the budget (and it won't be if this myth is allowed to continue), then you know which other projects are going to suffer!

In practice, higher performance in private management contracts is only made possible by higher capital investment by the government.

Then, when the results are not as expected, the decision makers do one, or both, of the following:

- Blame you
- Cut your funding

What can you do? See below

Managing Expectations

1. Be active in identifying the presence of these myths—and others.
2. Ensure that all of your staff understand the nature of these myths, and the real state of play. Especially be aware that the total costs may have fallen even though the budget costs have increased.
3. Explicit recognition of the benefits of private sector involvement will help when you come to 'sell' your messages to decision makers
4. When 'educating' colleagues or decision makers, ensure that you take as your example, a case where private sector funding is definitely favourable for the organisation—and yet still the risks and the budget funding issues remain.
5. Remember that expectations from your project or program may be seen differently by your colleagues. Their subsequent disappointment may harm you—so manage sideways, too.

WHAT SHOULD TAKE PRECEDENCE – ASSET CONDITION OR SERVICE DELIVERY?

(AND NO, THEY ARE NOT THE SAME!)

Changing mindsets from preserving asset condition to providing service is perhaps the most difficult thing that asset managers have to do and even the best can easily slip into the asset preservation mindset while they actually believe themselves to be addressing service delivery.

Take the following action recommendation:

> "If we increase the percentage of paved footpaths, service levels will increase. So we should define the condition of all of our footpaths and give them a rating from "A" to "D" with "A" being the highest quality. We should then work at increasing the proportion of "A" paths and eliminating all of the "D" paths. We should set ourselves performance targets, such as 90% of all paths to have an "A" rating in the next two years. We can cost this out and put a maintenance program in place to achieve this goal."

What's wrong with this as a prescription?

(1) It ASSUMES that higher asset condition is equal to a higher service level. But if a "C" condition is adequate for purpose then anything more is waste, not higher service. (see sidebar)
(2) It rates footpaths on the basis of asset condition only and not according to the needed condition, or what is fit for purpose.
(3) The target set is arbitrary – bearing no stated relationship to resources
(4) It acts as if decisions on footpaths can be made in isolation from other needs.

A tale of two cities.

An asset manager from a neighbouring council observed that the side street by my property had no footpaths. This was no great problem I told him, there is very little pedestrian traffic and the quiet rural look suited us all well. "If I could get away with this', he said, 'we would save many tens of thousands of dollars every year!" In his council, footpaths are routinely provided on both sides of every street – and the council even irrigates many of the nature strips. This raises a real question of when is extra service real 'value for money'.

Index May 4 – Sep 7 (Issues 61-70)

Note: Index will now be bound in on every 10th issue.
The last index was issued as a separate sheet in May to cover Issues 51-60

Categories:
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Readers Inquiries and Feedback

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