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Risk: Managing it strategically

Playgrounds closed, builders unable to build and medical practitioners unable to practice!

When the management of risk entails the cessation of the service, people have a right to wonder if we are losing the plot!

How can we replace a short-term, tactical response to risk pressures with a more strategic response: one that puts the focus on achieving the goals and objectives of the agency, within the compass of its stated values?

This is the management task and, insofar as the risks facing asset intensive agencies are inevitably bound up in the way that assets are managed, it is also the asset management task.

In this issue

we take a number of risk issues and look at them through the lens of the Asset Management Strategy. This strategy consists of the agency's goals, objectives and values (derived from the agency's/community's corporate plan) together with knowledge of agency assets and community demand. It informs all decisions, all actions and is the underpinning of all asset management plans.

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Risk of What?

A council recently cut down a stand of old coconut palms because of fears that a falling coconut could maybe kill or injure someone. Had there been any reports of coconuts injuring or causing death? No! Did the action contravene the agency's strategic directions? Quite possibly! The palms were old and attractive and had been considered one of the tourist attractions of the town.

What were the council's values and objectives that drove this decision?

For example, did they have values that promoted preservation of the environment? Did they have objectives for promoting the tourist attraction of the town? If so, what role did these have in the decision? Or was the action driven by a knee-jerk reaction to a real (or imagined) potential legal liability claim?

Suppose that environmental protection and tourist promotion were part of the values and objectives, what other actions could the council have taken?

What other actions could have been taken?

For example, could the council have picked the coconuts before they dropped – a seasonal maintenance exercise?

(this comes at a cost, but provides a benefit in the protection of an old stand of attractive trees that provided an amenity in the area)

Extending this, could the council have made the annual coconut picking a tourist event in its own right, with trained tree climbers recovering the nuts in an annual exhibition? This could be of considerable interest as few people nowadays get to see professional tree climbing, let alone coconut picking.

(again, there would be a cost, but the tourist attraction would have not only been preserved, but enhanced.)

And no doubt other creative solutions could be found.

Message:

If the values and objectives are clear, they can drive effective actions. The way to make them clear is to embody them in the Asset Management Strategy.

Risk to Whom?

Scene in a local council: In the light of the High Court's recent decision to remove council's protection against liability for non-feasance, discussion revolves around whether the council should pay to have someone identify all risk elements relating to its assets. The Finance Officer argues that the costs are hardly worth it as they are a member of a pooled liability scheme and all members of the pool would share the costs of any case against them resulting in a minimal increase in their insurance costs. The Technical Officer, however, wants to ensure that in the event of any accident, the council can demonstrate that it is not to be held responsible.

What's the question here?

The finance officer is rightly concerned with the financial consequences of liability for council and the technical officer is also rightly concerned with putting up a compelling defence case. Both concerns are legitimate, but they are risks to council.

What about risks to the community - who is looking at the council's duty of care?

Prevention is better than cure (and both are better than *justification after the event*).

Just identifying risks is not sufficient to prevent accidents happening. For this purpose council also needs to have policies for addressing each of the identified risks – and it needs to teach all council staff what they are. An annual inspection of, say, dangerous tree limbs, even if they are dealt with on the spot, is not as effective as a policy for identifying and dealing with dangerous tree limbs taught to all on-road personnel to be applied throughout the year.

Safety as a 'business case'?

There is a much publicised case of the motor car company that knew of a defect in its product that could cause death and disability but did nothing because it (correctly) assessed that the costs of payouts to successful litigants would be less than the cost of correction. What it hadn't taken into account in this economic bottom line consideration was the impact on the social wellbeing of the community. In today's world of triple bottom line reporting and accountability, the asset management strategy needs to take into account not only the economic impact but the social and environmental impact.

Message

The Asset Management Strategy needs to contain the agency's social and environmental obligations as well as its economic goals and objectives. All three need to influence decisions and actions

Risks—

Can they really be transferred?

“The Greek government is increasingly turning to private-public co-operation in order to better exploit the state's real estate assets. Many public enterprises have hived off all or part of their real estate holdings into property management and/or development companies or entered into contracts with other private companies to exploit their properties.

Typically, professionals undertake the risk of renovating properties and putting them on the open market, against payment of fees to the institution. **The institutions hope to significantly increase their revenues while transferring the risk to the property companies.”**

Greek Public Real Estate Corporation (my emphasis)

Some risks can be transferred to the private sector – and some can't

This quote captures the essence of the risk transfer issue— the hope that the public sector can transfer the risks, yet still reap the benefits. Hope is perhaps the right word!

Risk of liability for death and disablement does not automatically pass from the client to the contractor. If your contractor does something to injure a member of the community, you can be liable because you chose the contractor. In one sense this could result in increased risk for the clients since their management of the risk is now at one remove.

Political risk may be mitigated but is not necessarily avoided by privatisation. The sale of the electricity industry to the private sector is a case in point.

But what about economic risk – the risk of profits being less than anticipated? Many would argue that this is the main risk that is transferred in contracts with the private sector, but does it really work?

Contracts are continually being renegotiated because the contractor cannot make a profit at the figure quoted. It doesn't matter that the contractor quoted too low in the first place in order to secure the contract; if you want the service continued you have the choice of paying up, forcing the contractor to the wall and then picking up the pieces when it fails, or engaging in expensive litigation. Frankly, if the contractor can't win on the contract – you can't either!

Some risks are just naturally with the client – demand risk (the risk that demand might change) and crown risk (ie risk that the government will change its mind on something) are just two of them. (For a much-publicised example of how this was tried and failed, see our case study on the Latrobe Hospital in the next issue.)

Message

Writing risk transfer into a contract doesn't mean that it has really happened! If you are responsible for the end service to the community, the risk of continuity of supply will remain yours. Any risk that relates to your goals, your objectives and your values, remain yours.

Risk Transfer

Why do we want to do it?

The problem of uneven cash flows

One of the inspirations for risk switching has already been referred to – the hope that revenues will increase (ie costs reduce). But observation suggests that even if the costs are likely to be considerably greater, there will still be an incentive to use the private sector. This is because the biggest risks that all public entities face are associated with managing lumpy cash flows.

Dick Scotton, one of the architects of the medicare scheme, puts it brilliantly, and simply, in the following passage, quoted in the Northern Toronto Star, March 25, 2000.

If a government pays \$50 million to build a hospital, the cost appears as a one-time item in the government's books. This, in turn, leaves it vulnerable to charges of wasting money.

If it borrows that \$50 million, the politics are even worse. It is accused then of incurring a debt on the backs of generations yet unborn.

But if a private firm borrows \$60 million to build the same hospital on behalf of government, these objections mysteriously disappear.

And even if the government, over 15 or 20 years, ends up paying the private firm double that amount in annual operating grants, the political perception is better. For in this case, the government pays just a few million dollars a year over a long period, rather than a big chunk of money all at once.

The desire to even out uneven demands for cash that result from the natural life cycle ebbs and flows of assets underlines many of the larger scale maintenance contracts that have been written recently, for example, the roads and schools maintenance contracts of the NSW government.

Do these contracts “work”?

Yes, they can. In the case of the schools maintenance contracts, the contractors were required to bring the school buildings up to some specified performance level and then keep them there throughout the life of the 5-year contract. This required a lump sum investment on the part of the contractors for which they received an even annual payout over the contract.

Message:

The risks of managing uneven cash flows can be contracted out, but recognise that it is a service being rendered by the contractor, over and above the maintenance or construction task that may be the prime focus of the contract. And all services have to be paid for.

(Only the deluded expect something for nothing)

Risk Transfer

Does transfer reduce costs overall?

To reap the gains of someone else's actions we need to be very good negotiators!

Much of the failure of privatisation contracts, particularly in the health area, has resulted from an assertion that the private sector is more efficient than the public sector – without identifying the source of these efficiencies. It is this assertion that fuels the 'hope' for revenue gains and cost reductions.

Everyone knows that the way to minimise the cost of risk is to assign responsibility for managing to the party most able to do it efficiently. But, by itself, this tells us nothing about the distribution of the efficiency gains.

If a contractor accepts greater risk, he expects to benefit from managing it. If we transfer risk but also expect to reap the benefits, it is essential that we be very good negotiators!

In practice, we may be very poor negotiators because we do not understand the real costs involved. Consider the following in the case of the schools maintenance contracts referred to on the previous page.

Where are the gains to be found? Generally not in the currently recorded costs.

The schools maintenance contractors faced a number of risks, including:

(1) The risk of misjudging the total cost. They had to estimate not only the cost of bringing the assets up to scratch, but the cost of keeping them there. There was little information to inform this decision. Contractors knew the current condition of assets but had no trend information on maintenance. Not that trend information would have been particularly helpful since the assets were now being required to be maintained to a standard higher than in the past.

(2) The risk of managing the cash flows. They would have had to borrow to finance the large capital investment at the beginning of the period and, hopefully, they will recoup sufficient on the remaining four years to pay off the loan and make a profit, after expenses.

In the absence of the contract, the NSW Government, would have faced these same problems and would have had to pay the costs involved. Since these costs are implicit in the system, it is unlikely that they would have been previously identified and measured. Can the contractors manage these costs more efficiently than the government? Only if they have better knowledge of the situation.

Message:

Know these costs and weigh up the alternative ways of achieving your goals, objectives, and values. Often, it may pay to increase your own knowledge (of assets, condition and demand trends) and then accept the risks yourself.

Risk Transfer

Does the Transferor benefit?

It can—but benefits must be paid for

Benefits to the risk transferor result from the previously unidentified risks now being better managed for being made more visible. But this only happens if the costs are explicitly recognised and paid for.

If a government agency (or, indeed, any private firm that outsources work to another) thinks to see benefits in the form of reduced explicit costs, then for the most part it is deluding itself.

In the instance cited on the previous two pages, that of the schools maintenance contracts (but note that this is true of any similar contracting arrangement), what has really happened is that the contractors have provided a package of services to the government:

- The upgrade and maintenance services paid for in the contract
- The management of uneven cash flows that are inherent in the task
- and the avoidance of political problems inherent in dealing with uneven cash flows.

Unless the costs of all of these services are rewarded, the contracts will fail.

If a contractor 'goes to the wall' is this a cost to the government? Indeed, it is. The government now has to find a replacement contractor. Not only that, the market is now smaller for the next round of contracts. It is smaller by the absence of this one contractor, but it may also be smaller by many more if the word gets around that no-one can make a profit on the contracts being reached. With less contract competition, the government may end up paying non-competitive rates just to get the job done!

The implication for all agencies is to improve knowledge of risk elements.

Message 1:

When a contract is written that includes risk transfer, recognise that the acceptance of risk by the contractor is a service that it is providing. And services have to be paid for!

Message 2:

The best that you can hope for is that your risk management assignment will result in lower overall costs and that you will share in the benefits. Any attempt to take more than your share will result in failure – and ultimately in higher costs, and higher risks.

Risk

and the Asset Management Strategy

Summary:

To be successful at managing risk, both in-house and outsourced, agencies need to know what risks need to be managed!

This seemingly obvious statement is deceptive. Risks of a project running over time, or over budget, or failing to deliver what was required of it, have usually been well identified in the various sets of guidelines on risk management. (See, for example.....) But the really strategic risks, the ones that go to the heart of the ability of an agency to thrive, even survive, are usually not the project related risks. They are broader. We have dealt with some of them here:

- Correctly identifying the nature of risks – and the options available
- Recognising that the risks to an agency are wider than those that affect its immediate bottom economic line
- Trying to transfer risks that inherently reside with the agency
- Failing to identify the nature and purpose of risk transfer
- Understanding where the risk cost savings come from, and
- Recognising that many of the risk cost savings were previously unidentified costs and may result in a higher explicit price (even while the real cost is reduced!)

These ideas are not uncontroversial.

You may not agree. That's ok. You may even strongly disagree. That's even better. We can do something about that, and we have - we have provided a discussion site where you can voice your objections (or your support) and engage in dialogue with others.

Of all the subjects in asset management, strategic risk management is probably the most in need of really passionate and thoughtful dialogue.

In the next issue (SAM 92)

there is a case study of the contract that made headlines here and overseas for its radically aggressive way of transferring risk. Its high profile made its subsequent demise all the more painful. This is the Latrobe Hospital Contract. There are many lessons to be learnt here.

Also you may care to refer back to **SAM 70**, which looked at a number of portfolio and expectation risks—both strategic in the sense in which it is defined here. You may now see these in a different light after reading the issues on pages 305 to 311.