INTOSAI

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ANNEX

Illustrations of Risk and Good Practice in Managing Risks

SAIs are invited to offer new examples to this section – see www.nao.gov.uk/intosai/wgap/menuco.htm for contact details.

A Clarity about partnership objectives

- States typically have more than one objective when entering partnerships; these include achieving economic goals, protecting the taxpayer's investments, safeguarding services and service/quality levels, and securing supply while protecting consumer interests (May 2001 report on survey of Working Group Members).

- The United Kingdom Radiocommunications Agency sought a commercial partner both to deliver its information technology needs and to market the Agency's skills in radio wave management to potential wireless customers. It experienced difficulty in securing a partner who could deliver both, but was eventually successful and the early indications are that its partnership with CMG plc is delivering against both objectives (NAO report: "The Radiocommunications Agency's Joint Venture with CMG": HC 21 Session 2000-2001, 8 December 2000).

- In Australia there is growing recognition that the most successful outsourcing organisations are those which have a clear idea of the outcomes they want (Auditing in an Outsourced Environment, June 2001)

- In the United Kingdom, there is evidence that major construction projects carried out by the private sector either for private or public sector clients, which are based on partnership principles (focus on co-ordination and collaboration rather than relying solely on a legal contractual framework) are delivering substantially improved projects (NAO reports: "Modernising Construction": HC 87 Session 2000-2001, 11 January 2001and "PFI: Construction Performance". HC 371 Session 2002-2003, 5 February 2003).

- Guidance recently issued by the SAI of Australia emphasises the importance of not only dealing effectively with risks in contracts but also of developing and maintaining a relationship with the contractor that supports the objectives of both parties and focus on the agree results to be achieved (Auditing in an Outsourced Environment, June 2001).

- Joint venture companies are usually established because the parties have identified complementary objectives and each party has a contribution to make to the delivery of a successful venture, which they would have difficulty delivering independently. British Waterways decided to ask a partner to explore the potential to use the UK's canal network as a telecommunications network, laying high-capacity optical fibre network alongside the canal. The resultant joint venture is now a successful company (UK Treasury Guidance August 2001 draft).

- In Poland, Rybnicka Spólka Węglowa, a public entity invested assets worth €30 million in a partnership without any estimation of the effects of the agreement. After operations began the public entity allowed detrimental changes in the capital structure of a subsidiary partnership. As a result, the public entity lost its influence on decisions concerning the distribution of profit.

- In the United Kingdom, a number of successful joint ventures between state research establishments and commercial partners suggest that scientists are the most likely people to identify the commercial potential of their own research. Partnerships have prospered where it has been possible to align the interests of these staff with those of the research body as well as those of the private sector partner. The UK government has amended the civil service code to allow scientists to take equity holdings within their terms of employment so that they can have a financial interest in the success of the enterprise.

B Negotiating an appropriate partnership

- Public sector bodies in the United Kingdom have been advised by the Treasury that well managed risks are those where the staff of the public body engaged in negotiating the joint venture have the necessary skills, or access to those skills through advisers (UK Treasury Guidance August 2001). The SAI has backed up this message (NAO report: "Supporting Innovation: Managing Risks in Government Departments": HC 864 Session 1999-2000, 17 August 2000).

- In Hungary the management and workers in formerly state owned companies with considerable domestic and international markets have formed successful management buy-outs (e.g. the Herend China Manufacture Company, in which the state has a 25% shareholding – and the Rába Hungarian Wagon and Machinery company – now fully in private ownership).

- In the United Kingdom some additional public funds have been made available to help build commercial capabilities in state research establishments and to provide initial support for launching particular projects. Demand for the available funds has considerably exceeded availability.

- In Poland, the Gmina Office understated the value of land contributed to a partnership with a private company. This in-kind contribution was made without an independent valuation, and was undervalued by €500,000.

- In the United Kingdom, Treasury guidance and SAI reports have stressed the importance of following a competitive bidding process. If this is not possible, departments should put in place mechanisms (e.g. benchmarks) for addressing the risk that, in the absence of competitive tension, the contract may not represent value for money. Public bodies can help minimise the cost to bidders of tendering by thinking through the project requirements and stating them clearly, in good time. An NAO survey of public bodies and contractors responsible for managing 121 public/private contracts showed that 71 per cent of the public bodies had assessed bidders' attitudes to partnership working when procuring the contract. The SAI has urged all public bodies to consider this when assessing bidders (NAO report: "Managing the Relationships to Secure a Successful Partnership in PFI Projects": HC 375 Session 2001-2002, 29 November 2001).

- In Poland, the audit of a World Bank funded project to rebuild after a flood showed that 10% of the $200 million facility was spent on consulting services. The facility agreement required the appointment of highly-paid consultants who performed simple services that did not require expertise.

- The achievement of value for money is a key issue in the overall procurement process. For example, in Australia the Commonwealth Procurement Guidelines advise that value for money is the core principle governing Commonwealth procurement. It is supported by the underpinning principles of: efficiency and effectiveness; accountability and transparency; ethics and industry development: officials need to be satisfied that the best possible outcome has been achieved taking into account all relevant costs and benefits over the whole of the procurement cycle.

- The United Kingdom Highways Agency gives different weightings to quality and price when evaluating tenders, depending on the complexity of the project. For example, for innovative projects the split is 40% on quality and 60% on price, whereas for repeat projects or where a standard design can be used, the split is 20% on quality and 80% on price. And the Ministry of Defence put emphasis on selecting prime contractors with a proven ability to manage both design and construction and who have demonstrated an ability to manage their supply chain (NAO report: "Modernising Construction": HC 87 Session 2000-2001, 11 January 2001).

- In Poland, the management board of a town concluded a preliminary agreement for the sale of property, including 100 dwellings. The advance payment made by the board was €1 million, despite the fact that the contractor was not in possession of the dwellings and did not own the land.

- An alternative to or aspect of the public procurement process might be requiring potential partners to go through a pre-qualification process via an expert panel set up by and accountable to Parliament (Hungary).

- In Australia the greater involvement of the private sector in providing a wide range of public services has underlined the lesson that clear identification and articulation of contract requirements at the outset can save considerable time, cost and effort later in contract management (Auditing in an Outsourced Environment, June 2001).

- In their current study of commercial partnerships formed by state research establishments, the UK SAI has found that there has been little formal assessment by the state of the value of the intellectual property involved. The SAI is recommending that the establishments should consider using a systematic categorisation (eg subject, market potential, competition, cost of manufacture, complexity and timescale), drawing on external expertise as necessary.

- As regards addressing issues of profit sharing (including possible future gains from property sales or refinancing) in negotiating the partnership agreement, experience in Australia is that it has proved very difficult for Commonwealth agencies to operate profit sharing provisions contained in contracts. Prominence is often given by agencies to benefits expected to be delivered by such profit sharing provisions (including clawback). But in the case of some major contracts that the SAI has examined these have proved to be either illusory or too difficult subsequently to determine what has been delivered.

- In the UK, the Prison Service was concerned about the safety of inmates at a Young Offenders Institution run by the private sector. They replaced the Prison Director with a public sector management team using powers under an Act of Parliament to intervene in a contracted-out prison in order to preserve the safety of people at the prison. The contract safeguarded the right of the public sector to use these statutory powers without terminating the contract.

C Protecting the state’s interests as a minority shareholder

- Nine of the eleven SAIs responding to the Working Group survey (May 2001 Report) said that in their countries the state was a minority shareholder in private businesses. Nearly all these SAIs reported that substantial minority shareholders could veto decisions, request shareholder meetings and require the company to be wound up. In the United Kingdom, in cases where the public sector partner is a minority shareholder, Treasury guidance details the consideration which the public sector body should give to deciding the extent of governance they wish to have in the joint venture vehicle. A balance needs to be struck between protecting the interests of shareholders and providing the greatest degree of autonomy possible for those responsible for managing the joint venture (UK Treasury Guidance, August 2001 draft).

- All except one of the respondents to the survey of Working Group Members said that the state had the same rights for its minority shareholding as a general minority shareholder. In Poland the state had the same or more rights, depending on the kind and/or status of shares (e.g. golden shares). In the United Kingdom, Treasury guidance notes that the public sector body can build in adequate protections through its voting rights at board and shareholder level. Legal protection can also be strengthened through defining e.g. in statutory regulations the minority rights to be written into the partnership agreement and any subsequent modifications (Hungary).

- In Poland, a public entity subscribed for less than 50% of shares in the partnership. This weakened their position and occurred because they were unaware of the value of the private entity's contribution.

- There are also a number of issues which confront governments with majority shareholdings in entities, particularly listed companies, which also have private investors. For example, in these circumstances, the government as shareholder is usually in a privileged position compared to the private investors. Significant effort is often required successfully to manage the achievement of an arms length governance relationship between government and the boards of such entities (Australia).

- In Norway, Government Ministries are required to manage the state’s investments in private businesses in accordance with requirements laid down by Parliament, which can range from the general requirement that the financial management of the business must be sound, to specific requirements relating to such diverse aspects as operations, geographical location, production, financial results and reporting (The Role of the State as a Minority Shareholder in Privatised Businesses; paper by the Office of the Auditor General of Norway, June 2000). In Hungary the partnership agreement enables the minority shareholders to obtain data on a quarterly basis.

D Monitoring the state's interest in the partnership

- One of the features in successful commercialisation ventures undertaken by state research establishments in the United Kingdom is engaging professional commercial staff, who supplement the skills of scientists in bringing business and intellectual property management knowledge, allied to commercial experience to assess opportunities realistically and to contribute to the success of the partnership.

- Good contract management calls for a comprehensive understanding of the key stages and the risks associated in handling them, regular monitoring and effective communication between all parties to the contract. In the United Kingdom, Kingston Hospital and their contractor Terrapin relied upon good project management to ensure the successful completion of a surgical block within twenty weeks. This included clear allocation of responsibilities, but with joint problem solving where necessary (NAO report: "Modernising Construction": HC 87 Session 2000-2001, 11 January 2001).

- In a partnership in Poland, (managing an airport) the public entity holds 95% of the shares. However, the decisions on strategic issues are made on the same footing by all shareholders, despite the fact that the remaining two shareholders hold only 5% of the shares.

- In their 1999 report on the acquisition of German Parcel by the state owned company Consignia (formerly the Post Office) the United Kingdom SAI drew attention to Stock Exchange rules, developed for investor protection and to secure the proper working of the market, which require private companies (including the private sector competitors of Consignia) to disclose key data when they make major acquisitions. The data include information on the price paid, the profits attributable to the net assets being bought and the effect of the transaction on the profit and loss account and balance sheet of the purchaser. Consignia's owner (the Department of Trade and Industry) accepted that there was a case for Consignia and similar publicly owned bodies to accept analogous rules (NAO Report: "The Acquisition of German Parcel": HC 858 Session 1999-2000, 24 August 2000).

- During the restructuring of the Polish State Railways, numerous subsidiaries were established. This resulted in the state losing control over the delivery of passenger railway transportation, despite the fact that it is co-financed by public money.

- A number of the SAIs responding to the Working Group survey stated that the public sector body had representation on some or all of the companies in which the state had a minority shareholding. These representatives need not necessarily be employees of the public body.

E The state's exposure in the event of difficulties

- In the United Kingdom, the Treasury guidance on commercialisation projects requires a comprehensive business plan to be drawn up with input from both parties at the outset. The plan will usually be updated annually by agreement of the directors of the company and can, if desired, be subject to approval by the shareholders.

- Six of the SAIs responding to the Working Group survey said that the state had introduced some measures in relation to its exposure, to reduce the moral hazard it faces. For example, in Turkey and Austria the state exercises its rights through a holding company. And in the United Kingdom, public sector partners are urged by the Treasury to avoid taking any action which might give rise to any unnecessary potential liabilities, and to ensure that the joint venture vehicle is responsible for taking out appropriate insurance to cover its activities.

- In Poland, the management of areas of paid parking and the collection of parking charges was transferred to a private enterprise by a public entity. After a period, the public entity decided that the performance of the private enterprise was unsatisfactory. However, the long term contract could not be terminated early without the public sector suffering material financial loss. This was because the contract did not allow parties to terminate the agreement in the event of a decline in public services.

- In October 2001 the UK government decided to put the privatised rail company Railtrack into administration. The government are seeking to form a new company that will take over Railtrack's business. The SAI has announced that it will be examining how the regulatory bodies have discharged their responsibilities, what are the likely costs to the taxpayer, and what are the lessons for the future management of the railway infrastructure.

- In Poland, a publicly owned airport entered into a ten year lease with a private company. This lease was used as collateral for a loan taken out by the private company for constructing the facility. The Airport's subsequent withdrawal from the contract was subject to a penalty of €25 million, despite the fact that the facility did not meet the airport's requirements and was unsuitable for daily business.

- In the United Kingdom, Treasury guidance on commercialisation projects emphasises that exit provisions are needed to enable the public sector partner to release its investment in the partnership (and thereby extract value) and to protect its investment. Such provisions are needed to cover both the anticipated ending of the partnership (eg the end of a public/private contract) and contingencies for example if the partnership or other shareholders fail to perform in accordance with the agreed objectives, or if the partnership becomes bankrupt or is otherwise wound up. It is important to provide for such eventualities in the partnership agreement. One possibility, where the state decides to withdraw from its minority shareholding, is for the state to seek to sell its shareholding either as a package or as individual portfolios eg in an auction (Hungary).

F Examining the process and the results

- In Australia, the SAI has through its audits drawn attention to the need for government agencies to treat risk management as part of sound corporate governance, noting that management of key business risks tailored to a contractual environment will ensure contracting achieves benefits such as increased flexibility on service delivery and greater focus on outputs and outcomes (Auditing in an Outsourced Environment, June 2001).

- In the United Kingdom, a report commissioned by the Government noted fear among some state research bodies that they might be criticised by the SAI if they invested funds where the outcome was uncertain. The report did not produce any evidence in support of this assertion. The SAI and Parliament have subsequently demonstrated support for innovation and for well thought through and managed risk taking, recognising the potential of partnerships to secure additional economic benefits without distracting from policy objectives.

- Eight of the nine SAIs responding to the Working Group survey reported that they had access rights to the public body responsible for the state's shareholding, and that these rights had been exercised annually or occasionally. Only four of these SAIs had access rights to the private business in which the state had a minority shareholding, held directly or indirectly. The other four stated that they did however attempt to establish how far the state was able to protect and promote its shareholder interests; methods included file and accounts review and performance audit of the public bodies responsible for the state's shareholding.

G Identifying worthwhile lessons

- The Working Group's guidelines on best practice for the audit of privatisations, public/private contracts and concessions, and economic regulation set out the need for the SAI to address its skills requirements, and a variety of ways in which these skills can be obtained.

- The UK NAO's recent reports on managing the relationship to secure a successful partnership in PFI projects (November 2001), on modernising construction (January 2001), and on managing risk in government departments (August 2000) include surveys identifying the extent to which public bodies are addressing the risks involved in these new relationships with the private sector, and their experience in a variety of partnerships. These reports set out key lessons and learning points.

- The INTOSAI Working Group is a unique vehicle for lessons of good audit practice to be identified, discussed and shared with other SAIs and with decision takers world-wide, both through its website and published guidance.

- In the United Kingdom it is recognised that developing a portfolio will help state research establishments to diversify and benefit from successful projects outweighing failures. Portfolio management requires however a certain level of activity and many of these bodies do not yet have a sufficient flow of projects to facilitate portfolio management.

SOURCES

Available on the Working Group Website (www.nao.gov.uk/intosai/wgap/home.htm)

1. Guidelines on best practice for the audit of
   - Privatisations
   - Public/private finance and concessions
   - Economic regulation
2. Papers relating to the Working Group's 6th meeting (October 1999)
   - External audit on the course of public property privatisation, October 1999 (SAI, Albania)
3. Papers relating to the Working Group's 7th meeting (September 2000)
   - The role of the state as minority shareholder in privatised businesses, June 2000 (SAI, Norway)
   - Users, September 2000 (SAI, Argentina)
   - Proceedings of the 7th meeting
4. Papers relating to the Working Group's 8th meeting (June 2001)
   - The role of the state as a minority shareholder in private businesses – report on the survey of Working Group Members, May 2001
   - Auditing in an outsourced environment, June 2001 (SAI, Australia)
   - Commercialisation projects in the United Kingdom and their audit (SAI, UK)
   - Auditing concession contracts, June 2001 (SAI, Hungary)
   - Privatisation in Hungary 1990-2000, June 2001 (SAI, Hungary)
   - Proceedings of the 8th meeting
   - Report of the Working Group to XVII INCOSAI (June 2001)
5. Papers relating to the Working Group's 9th meeting (June 2002)
   - Report on some accounting and financial transactions of Combus a/s, June 2002 (SAI, Denmark)
   - Proceedings of the 9th meeting

6. Papers relating to the Working Group's 10th meeting (June 2003)

- Proceedings of the 10th meeting

Available on the website of the SAI, Australia (www.anao.gov.au)

7. Commonwealth Policy:

- Principles for the use of private Financing (Ministry of Finance and Administration, October 2001)
- New South Wales: guidelines for Privately Financed Projects (November 2001)
- Victoria: Partnerships Victoria (June 2000)
- Governance arrangements for Commonwealth Government Business Enterprises (June 1997)
- The Compatibility of Risk Management and the Survival of Accountability in the Public Sector Environment (November 2000)

Available on the website of the SAI, United Kingdom (www.nao.gov.uk**)**

8. National Audit Office reports:

- Supporting Innovation: Managing Risks in Government Departments

(HC 864 Session 1999-2000, 17 August 2000)

- The Acquisition of German Parcel

(HC 858 Session 1999-2000, 24 August 2000)

- The Radiocommunications Agency's Joint Venture with CMG

(HC 21 Session 2000-2001, 8 December 2000)

- Modernising Construction

(HC 87 Session 2000-2001, 11 January 2001)

- Managing the Relationships to Secure a Successful Partnership in PFI Projects

(HC 375 Session 2001-2002, 29 November 2001)

- Public-Private Partnerships: Airwave

(HC 730 Session 2001-2002, 11 April 2002)

- PFI: Construction Performance

(HC 371 Session 2002-2003, 5 February 2003)

- The Operational Performance of PFI Prisons

(HC 700, Session 2002-2003, 18th June 2003)

Available on the website of Partnerships UK (www.partnershipsuk.org.uk/wider_markets**)**

9. Draft guidance

- Treasury guidance proposed by Partnerships UK (Consultation draft, 21 August 2001)