Public-private partnerships and effective risk management for local government

Author: Ronald Aspin

This paper reviews the many facets of risk and risk management relevant to public-private partnerships for affordable housing provision and explores the preparedness of local governments to deal with them effectively.

According to some research on public-private partnerships a lack of skill in determining, assessing, valuing, and transferring risk factors by government has resulted in some highly publicized poor outcomes. While contractual arrangements may transfer initial risks of financing, construction, and operating costs to the private partner, longer-term outcomes reveal secure private profits while the public bears the losses (Hood and McGarvey 2002; Grimsey and Lewis 2002; Quiggin 2002).

In Australia, entrepreneurial activities by local government, and public-private partnerships as one form of that, have attracted some academic attention, but very little of that literature discusses the associated risks (Corporation of the City of Adelaide 2000) (Robinson 1995). Two examples of the growing tendency for local government to become involved in this type of entrepreneurial activity into affordable housing are; the Balfours and Franklin Street Bus Station sites under public-private partnership development by the City of Adelaide, and the City of Port Phillip's two developments of The Regal and Inkerman/Oasis (Jon Hall and Associates (JHA) 2002; Spivak 2000).

Of the three levels of government in Australia, when it comes to engaging in public-private partnerships it would appear local government is the most vulnerable to exploitation by a better skilled and more experienced private sector in terms of recognising and allocating risk. While their smaller size and financial base necessarily means the value and type of projects they are likely to engage in will be of a lesser scale than the major infrastructure projects we see at state and federal levels, relatively speaking they are no less significant. However it is the very fact of their small size and finances that make them vulnerable as they do not have the capacity to carry 'in-house' the sort of specialist expertise necessary in the lead up to a partnership formation, and the cost of contracting these expert advisors can be prohibitive.

Taking Victoria as an example in the area of addressing entrepreneurial activities undertaken by local government, the Local Government Act 1989 was only reviewed to the stage of a Democratic Reform Act in 2003 in a way that adequately addressed section 193 'Entrepreneurial powers'[1] (Local Government (Democratic Reform) Act 2003). The Democratic Reform Act 2003 requires local government to "assess the total investment involved and the total risk exposure" (Section 89, Subsection 5A), while section 5C requires

[1] The Local Government Act 1989 is likely to be amended in the very near future to include the provisions of the Democratic Reform Act 2003, and at that time guidelines for the new Section 193 will be released.

councils to consider a risk assessment report “from an appropriately qualified person” for any activity where the total investment or risk exceeds $100,000 or 1% of council revenue. The question is; does the Act remove the danger of councils entering into contractual arrangements that put public money at risk? A few ready examples suggest this is not the case. The 2002 example of Surf Coast Council’s questionable accounting practices might serve as a warning that the costs involved in various projects are open to ‘interpretation’ (Rose 2002). The Footscray Quay West Development locked the Maribyrnong City Council into a headlease arrangement and additional commercial risks for refurbishment, maintenance and repairs to the building and site, all with the support of the state government, in a deal that finished up costing the city millions (Local Government Division 2000:Appendix 2).

It was perhaps examples such as those noted above that prompted the review of Section 193 which comprised a process of consultations in which a surprisingly small number of voluntary representatives from local councils across the state engaged, some fifteen in all (Local Government Division 2000; Local Government Division 2001). An obvious omission from the outcomes of the review is the absence of guidelines to support councils in their interpretation and procession through the minefield that is risk assessment, allocation and management. Considering Knox and Cardinia councils recommended that training and other facilitation tools should be arranged to assist Council’s to manage risk, the Local Government Division decided to only consider these recommendations after the legislation was introduced. The inference here is that such training and tools would be highly specific to the Act and therefore not useful unless legislation was enacted. As a result the current act is still open to (mis)interpretation and possible manipulation. Given this obvious and declared need, it is surprising that the VLGA (Victorian Local Government Association), LGPro (Local Government Professionals Organisation) or the MAV (Municipal Association of Victoria) have not taken on the task of organising systematic training or special publications applicable to Section 193 and risk assessment, allocation and management to support local governments in their understanding or capacity to deal with risk.

How does this situation compare to what is happening at state government level? Strongly driven by trends to New Public Management and neo-liberal ideologies, the engagement with public-private partnerships began with a need to show a reduction in capital expenditure by government and a reduction in debt. The justification has since moved on to a more general philosophy of showing ‘value for money’, however, many writers argue that the basis for calculating and proving value for money is flawed on a number of counts and that ideology has taken over logic in the pursuit of private financing (Fitzgerald 2004; Quiggin 2002; Allen 2002; Davidson 2002b). Adding further to the pressure on state and federal governments to engage in public-private partnerships are professional lobby groups such as AusCID (The Australian Council for Infrastructure Development). AusCID actively promote private investment in public infrastructure through direct representation and policy submissions on behalf of its member organisations (The Australian Council for Infrastructure Development 2004).

In Victoria, the policy document 'Partnerships Victoria' has been produced to provide both the private and public sector with a point of reference and understanding for any potential public-private partnership project for the supply of infrastructure or services where the total value of the partnership will be worth over $10 million (Department of Treasury and Finance 2000). The policy is supported by a range of guidance material, of which the risk allocation and contractual section comprises some 200 pages of very detailed information (Department of Treasury and Finance 2001). In addition to this the state owned Victorian Managed Insurance Authority (VMIA) runs an active web site and a series of education training seminars on risk assessment and management for government officers (Victorian Managed Insurance Authority (VMIA) 2004). Given the emphasis placed on entrepreneurial activities by the Victorian State Government, backed by policy, guidelines and training, none of this is directed towards, or developed for, local government. It is worth noting that even with these supports in place for the public sector at state level as recently as 2004 the Auditor General commented in the forward to his department's document 'Managing Risk Across the Public Sector' that there still existed a lack of understanding and capacity to deal with risk (Auditor General Victoria Victorian Auditor General's Office). If this is so for state government, where does that leave local government?

It is useful at this point to review the multiplicities of risk inherent in a typical public-private partnership to help understand the difficulties in conducting risk assessment. While there are many models to categorize risks, the one shown below by Grimsey and Lewis (2002:265) is as good as any but typically fails to identify a significant stage in the process. They suggest risks can be divided into developmental and operational stages, into quantifiable and unquantifiable risks but omit an earlier stage of conceptualisation that I have identified through my research into local government entrepreneurial activities.

The conceptual stage can take many years from first discussions to the beginning of more formal negotiations around design. Local governments have minimal resources in terms of people to commit to projects that, during this stage, are still highly speculative, even abstract, and the main driving force behind it may be a single person with a vision. Even once the vision starts to take a more concrete shape and moves toward the design stage there are many risks and hurdles that would often require the determination of a project champion to overcome. By the time the 'vision' becomes a project on the table it may already have accumulated a dollar value of tens, even hundreds, of thousands of dollars in time and money devoted to it.

I have outlined here some of the risks that were identified during this conceptualisation stage for a significant affordable housing project here in Melbourne that I am using as a case study. This project was two years in this stage.

State Political – In Victoria the Kennett government sacked all local governments as part of a restructuring process. During this time the priorities of the state appointed CEO in the municipality of my case study had

affordable housing low on his priority list so any projects that were not already bound by contractual agreements were at risk. The case study project survived but the amalgamation process delayed the conceptualisation work for some time. Joint state/local government funding is another aspect of this risk factor that did not impact on my study but on the Adelaide City Council. They sought financial assistance from the South Australian Government for a large affordable housing project which was turned down. Considerable time and money expended in the early part of conceptualisation may be lost if a project relies on state funding support.

Intra-Council – Divisions within council also generated a risk for the case study project and some other affordable housing projects within the municipality. These divisions concerned differing opinions over the need/value of such projects. The divisions underwent some changes with each election cycle as the make-up of council changed.

Organisational Changes – For the project to progress past the conceptual stage it was championed from the beginning by one person. At any time in this process this person could have been lost from the department or council. As stated above, with limited people resources few projects would survive the conceptual stage without a champion.

Market changes – Here “market” refers to the real estate market. Land and housing prices over the last eight years since the case study project was first conceptualised have changed considerably. The current softening in the demand for city apartments has created difficulties for the project. Because of the long gestation period initial conceptualisations and rough costings that give a project momentum may be at risk from an unfavourable turn in the market. While this risk holds true for any project, the limited capacity of local government may unnecessarily extend the conceptualisation stage thereby increasing the risk factor.

Community consultations – After considerable time and expense to the point of concept drawings and costing, a proposal for the study project was put to the community through a public meeting and advertising. While this project was supported by the majority of local residents with few dejecters others have met with varying degrees of resistance that have put them at serious risk.

Thus the model by Grimsey and Lewis (2002) as shown has been modified to include the conceptualisation stage I propose as being highly relevant to local government.

Conceptualisation stage – risks encountered in moving a project from first concept to design

- State Political
- Intra-council
- Organisational change
- Market changes
- Community consultations

Developmental stage – risks associated with capital costs

- Design
- Construction
- Commissioning

Operational stage – risks relate to revenue and recurrent costs

- Wages
- Utilities
- Asset maintenance
- Insurance

Quantifiable specific risks include

- Specification/design
- Construction cost
- Operating cost
- Changes in other underlying costs
- Obsolescence
- Residual value (includes market changes)
- Performance risk – penalties etc
- Demand
- Commercial – exposure to 3rd party revenues

Unquantifiable (also referred to as non-commercial) risks include

- Force majeure
- Regulatory and Legal
- Socio-political

In addition to the conceptualisation stage risks observed in my local government case study project discussed above, other risks identified include; inter government negotiations over utility charges, a financial crisis for the private partner, body corporate management issues, and higher than expected body corporate fees (recurrent expenditure). Being a significant project for this council a number of experienced and expert consultants were engaged well before tenders were let, and are still called on from time to time as the need arises to resolve contractual issues. In essence, from somewhere mid-way through the conceptualisation stage onwards this project has encountered many unexpected risks that would have been difficult to predetermine and assess.

The above discussion highlights the purpose behind the Democratic Reform Act (2003) in requiring a risk assessment report. Nonetheless Figure 1 below is indicative of the number of consultants needed for a full risk assessment by both the public and private partners in a major project.

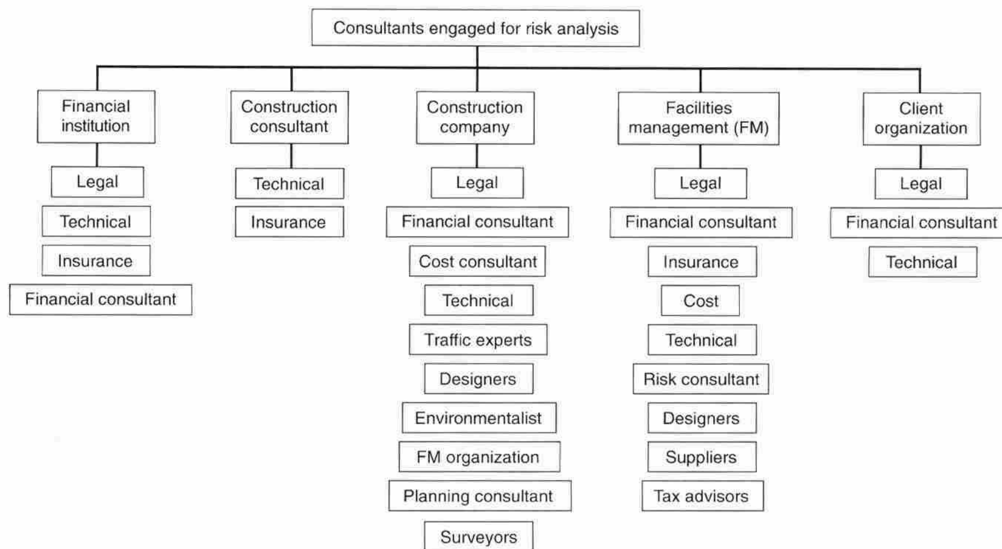

Figure 1: External consultants involved in PFI project process by PFI participants
Source: (Akintoye et al. 2003:468)

Noting the large number of consultants needed to fully assess risk in a major PPP, it is not surprising a former risk manager in Sydney said that risk management studies tend not to take a holistic approach that would cover all assets and liabilities, but tend to focus on engineering risks (Tomlinson and Tilley 2001). Assessing risk from a whole-of-life perspective is both complex and difficult, and local governments are unlikely to be able to afford such comprehensive analysis, but it is worth questioning whether one or two specialists would be able to adequately assess even a moderately large project.

Beyond the process of risk assessment is the problem of risk allocation. The received wisdom is that risks should be allocated according to a party's ability to control or influence that risk, or to that party most able to bear the risk. Conceptually this approach minimizes not only the risk itself but the cost of carrying the risk, and therefore the overall cost of the project. The argument follows that returns should then be proportional to risk carried.

At the local government level there are very few risk areas that are theoretically controllable by a council. Certain planning provisions, land use and height limitation rezoning, public access via roads and pathways, waiving or reductions in rates for a period of time, and assurances of fast tracking permits do reduce some risks and construction times, therefore reducing costs, but in the larger scheme of risks and costs for a significant building project these are minimal. Councils, unlike higher levels of government have no control over or special insight into socio-political risk factors such as interest rates, industrial relations, or employment incentives. Nor do they have influence over stamp duty, or market demand risk where that risk is based on direct public usage as opposed to contracted usage/demand by the council. In essence they are better off leaving most, if not all the risk (and

therefore returns) with the private sector, but that also carries the cost of paying a risk premium on their recurrent expenditure when accessing the service/facility. Interestingly this is the state governments preferred position according to the Partnerships Victoria guidelines (Department of Treasury and Finance 2000). It is also worth noting here that Quiggin argues the risk premium charged by the private sector, often as high as six to eight percent, is based on false assumptions of the risk and that in fact the premium is really only covering "inefficiencies and transaction costs associated with private financing" (Quiggin 2002:17).

While many of these risks would be considered beyond the concern of the public partner, especially where the contractual arrangements are on a BOO (Build Own Operate) or similar 'hands off' basis, examples such as the failure of National Express and the La Trobe Hospital show that not even the State Government can walk away from essential infrastructure if the private contractor/partner/operator fails. Public money is inevitably spent to prop up the system (Davidson 2003).

Local governments seeking to leverage services or infrastructure in return for council owned land in what might in all other respects be a purely private project still carries multiple risks. Should the private developer fail not only would the project be at risk of not being completed, but creditors often receive very little in return for their investment, and re-contracting will not reclaim all lost value. In the case of a physical facility that the council is to be contractually involved in through some form of investment, by not having ownership they effectively lose control of future facilities management, renovation, operating costs, or other changes that might come about if there is a change in ownership. This loss of control has led in at least one recent case to an unexpected increase in recurrent expenditure that has created considerable concern (private communication with public officer, 2004).

Risk mitigation is of course essential to both parties in a public-private partnership. Not having guidelines for local government I again draw on those noted in Partnerships Victoria (section 6). The document states that the private sector has many options open to it to pass on or insure against risk, but also notes that, while government has access to most of the same options "many of the risks retained by government are not insurable" (Department of Treasury and Finance 2000:35). The main actions offered are based on obtaining the best advice possible (which means contracting more highly priced consultants), doing the homework before progressing too far, keeping to best practice, and developing contingency plans. Without passing on risk and not being able to insure against it the government is open to bearing costs and putting public money at risk, hence the opening for writers such as Kenneth Davidson who regularly criticise the governments pro public-private partnership position with headlines like "Brumby ignores Labor and we pay the price" (Davidson 2002a).

Short of not entering public-private partnerships, a position held by writers such as Quiggin (2002), what can be done to reduce the risk to the public purse? Essentially there are no easy answers. While Peter Fitzgerald

suggests in his review of Partnerships Victoria that the policy and supporting guidelines go a long way towards improving the state government's understanding and capacity to effectively engage in these activities, he still questions the basis on which they are promoted, ie value for money through the use of the Public Sector Comparator. At the local government level the model of private construction and public ownership, as recommended by Quiggin, reduces some risks but increases others, and also means smaller projects as local government finances are small; leaving the entire project to the private sector carries long term costs via high recurrent spending and the possibility of being 'locked-in' by unfavourable terms and conditions. The model of land grants or title transfers as leverage with private developers puts the value of the land at risk should the developer fail, and represents a loss of public assets; finally public-private partnerships still leave government with a commitment to step in if things go wrong, and they do so at public cost.

In practical terms the only real solution is to judge every case on its merits for risk and 'value for money' ignoring the artificial comparators that presume to produce competitive neutrality; to not follow government preferred positions based on neo-liberal ideology and New Public Management practices; underpin the ability of local governments to make sound judgments through effective training of local government officers in risk assessment, allocation negotiation, and management, and the production of guidelines equivalent to those produced for Partnerships Victoria.

Reference List

Akintoye, Akintola, Cliff Hardcastle, Matthias Beck, Ezekiel Chinyio, and Darinka Asenova. 2003. Achieving best value in private finance initiative project procurement. *Construction Management and Economics* 21, no. 5: 461-70.

Allen, Lisa. February 2002. Contracts blamed for partnership losses. *Australian Financial Review*.

Auditor General Victoria. Victorian Auditor General's Office. Managing Risk Across the Public Sector. Melbourne.

The Australian Council for Infrastructure Development. Web page, [accessed 2 September 2004]. Available at http://www.auscid.org.au/home/index.php.

Corporation of the City of Adelaide. 2000. Affordable housing strategy: Discussion paper. Adelaide: City of Adelaide.

Davidson, Kenneth. 23 May 2002a. Brumby ignores Labor and we pay the price. *The Age,* sec. Opinion, p. 15.

———. 19 August 2002b. John Brumby - pin-up boy of the '5% Club'. *The Age,* sec. Opinion, p. 11.

———. 4 December 2003. Are Public-private Partnerships Worth the Risk to Taxpayers? *The Age,* sec. Opinion, p. 19.

Department of Treasury and Finance. 2000. Partnerships Victoria. Melbourne.

———. 2001. Partnerships Victoria: Risk Allocation and Contractual Issues - a guide. Melbourne.

Fitzgerald, Peter. 2004. Review of Partnerships Victoria Provided Infrastructure - Final Report to the Treasurer. Melbourne: Growth Solutions Group.

Grimsey, Darrin, and Mervyn K. Lewis. 2002. Accounting for Public Private Partnerships. *Accounting Forum* 26, no. 3: 245-70.

Hood, John, and Neil McGarvey. 2002. Managing the risks of public-private partnerships in Scottish local government. *Policy Studies* 23, no. 1: 21-35.

Jon Hall and Associates (JHA). 2002. Developing affordable housing through financial innovation - Attachment A: Adelaide Rental Housing Program, prepared for Adelaide City Council . Sydney: JHA.

Local Government (Democratic Reform) Act 2003Victoria: Victorian State Parliament.

Local Government Division. 2000 *Risky Business: Improving Council's Management of Entrepreneurial Risk - Discussion Paper*Victoria: Department of Infrastructure.

———. 2001 *Improving Risk Management in Municipal Enterprises*Victoria: Department of Infrastructure.

Quiggin, John. 2002. Private financing of public infrastructure. *Dissent (Melbourne)* Autumn/Winter: 13-17.

Robinson, Sue. 1995. Public/private partnerships in development. *Australian Planner* 32, no. 3: 156-60.

Rose, Michelle. 1 November 2002. Council in Money Jam. *Herald-Sun,* p. 13.

Spivak, Gary. 2000. Towards 2005 - City of Port Phillip Community Housing Program. Melbourne: City of Port Phillip.

Tomlinson, Damien, and Kate Tilley. 2001. Aussie dispute highlights building risks. *Business Insurance* 35: 17.

Victorian Managed Insurance Authority (VMIA) . 2004. Web page, [accessed 2 September 2004]. Available at http://www.vmia.vic.gov.au.