Reward without risk? Innovation in PFI

Matthew Tulley, Senior Auditor with the National Audit Office, examines how risk is managed in the public sector…

Last year, in *Public Service Review: Central Government* the Comptroller and Auditor General of the National Audit Office argued that the biggest risk the Government faces in the provision of high quality public services is not taking any risk. In a modern and complex society the provision of high quality public services means fashioning programmes and projects that involve risk. There can be no programme that is risk-free but a successful programme involves the intelligent and comprehensive assessment and management of risk.

The Public Audit Forum, which comprises the public sector audit bodies in the UK, have said that they will adopt a supportive approach to innovation and risk taking. At the National Audit Office we have said well thought through innovation will be supported. Yet there is still the perception that auditors are a disincentive to innovation. It should be made clear that auditors should not be used as an excuse to prevent public sector managers from taking initiatives which may involve taking some risks, but which nevertheless have good potential to result in long term sustainable improvements in service delivery. This article looks at the question of risk and innovation in the context of PFI and draws on our experience of examining a number of PFI projects to assess how risk and innovation can be harnessed by the public sector to improve public service provision.

The activities covered by PFI deals range from the provision of hospitals, prisons and roads to processing passport applications and providing helicopter training. To harness PFI to full effect the public sector must be open to innovative methods of service delivery and also identify and manage risks intelligently. One of the keys to getting good value for money from PFI is to identify all of the risks associated with a project and then allocate these risks to the party best able to manage them.

From our experience of observing public sector organisations as they manage change, the National Audit Office have seen many examples where risk management lessons can be learned. These suggest it is not that Whitehall culture is risk averse, as is often said. Rather it is risk ignorant – taking huge risks without knowing it is doing do. This has often been the case with large IT projects that have often been over ambitious and IT PFI deals have not been immune from these problems. What this shows is that even when risks have been transferred to the private sector there are some risks that the public sector cannot transfer, ie, the business risk of providing a service and the political risk of a failure to do so.

However, the PFI process has made the public sector much more aware of the risks that are associated with a project and has firmly introduced the notion of risk pricing, a concept which the private sector always uses in project evaluation. It is only by identifying and pricing risks that the public sector can start to manage the risks efficiently, concentrating on those that are likely to have the greatest impacts. But, as PFI has matured the public sector has quickly learned that Best Value will be obtained by optimal risk allocation not maximum risk transfer to the private sector. An early example of this was identified in the prisons sector. The

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first prison contracts were let on the basis that the contractors' payments were dependent (to a certain extent) on the number of prisoners housed within their jail. Effectively the Prison Service had transferred 'demand' risk to the contractor, a risk that the contractor was not in a position to manage. The payment mechanism was soon altered to an availability based mechanism, recognising the fact that private sector contractors can manage the number of places available to house prisoners, but not the number of prisoners that are given custodial sentences.

PFI has been successful in making the public sector identify and manage risks and although there are occasional failings this is an area where public sector performance has undoubtedly improved. But the treatment of risks is only one area where PFI has improved public sector procurement. Another key tenet to PFI is that the public sector needs to articulate the service required, not how the service should be delivered. This has two important impacts:

- The public sector must be very clear about the service it wishes to provide
- Expressing the service in output based terms should allow the private sector to suggest innovative service provision solutions. It is this mindset, being open to innovation whilst understanding the risks, that will produce benefits from doing things in new ways

Imaginative approaches by government bodies entering into partnerships with private sector organisations can bring innovative solutions to traditional problems. For example, our report on the Radiocommunications Agency's Joint Venture with CMG[1], a global Information and Communications Technology Group, developed an innovative solution to the problem of obtaining IT services and exploiting the intellectual skills base of the Agency – whilst securing a wider range of skills and resources than available in-house and obtaining IT services at a lower cost than existing arrangements. Although, strictly speaking, this particular deal may not be PFI, the same principles were applied to define and procure the services that CMG now provides.

The public sector should be encouraging innovation into all areas of service provision where it appears sensible to do so. However, innovation should not be restricted to service provision. The recent report by the National Audit Office on the Treasury Building PFI project[2] examined the innovative use of a funding competition to provide the financing for this deal. This innovation, which had not been used in the public sector before, resulted in a saving to the taxpayer of £13m over the lifetime of the deal. The decision by the Treasury to insist that the contractor secured funding in this way was not without a significant element of risk but by working together the two parties successfully managed these risks and the project was financed with funding priced more competitively than had previously been offered.

Finally, the National Audit Office's most recent report on PFI[3] looks at the ongoing risks to a project after the deal has been signed. Although risks must be identified before a deal is signed the risks remain to be managed during the lifetime of any project. Monitoring projects to ensure that they continue to provide the desired service must occur and the public sector should use risk management skills to identify any potential threats to successful service delivery in a timely manner. Good risk management underpins worthwhile innovation and experimentation. Having a sound approach to risk management will encourage staff to have the confidence to look for innovative solutions to service delivery challenges safe in the knowledge that adverse consequences can be minimised and value for money safeguarded.

[1] The Radiocommunications Agency's joint venture with CMG. Report by the Comptroller and Auditor General HC 21 Session 2000-2001.

[2] Innovation in PFI Financing: The Treasury Building Project. Report by the Comptroller and Auditor General HC 328 Session 2001-2002.

[3] Managing the relationship to secure a successful partnership in PFI projects. Report by the Comptroller and Auditor General HC 375 Session 2001-2002.

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