

National investment – op

Louise Pryor reports on a joint seminar held earlier this year by the Institution of Civil Engineers and the actuarial profession.

ABOUT 100 PEOPLE GATHERED in the imposing surroundings of the Great Hall of the Institution of Civil Engineers on 6 February 2002 to consider the opportunities and risks of national investment. Although the Institution of Civil Engineers and the actuarial profession, the joint sponsors of the conference, might not seem the most obvious partners, they have in fact been working together for some time. The first result of the joint working party was the RAMP (risk analysis and management for projects) method of risk management. RAMP is intended for use in managing the risks of capital projects, and among the largest of capital projects are those involving both the public and private sectors, through PPP (public private partnerships) and PFI (private finance initiative).

About 20 members of the audience were from the actuarial profession. There were a few actuaries who either practise or would like to practise in the area of risk management for capital projects; a few (mostly pensions actuaries) who were there in order to find out more about the area; and at least one who wished to know more about the area from an investment point of view, following the Myners recommendations. Those who were hoping to learn about the more technical aspects of risk assessment were to be disappointed, but those who were hoping to find out about the general climate in which such risk assessment is to be performed had a useful and interesting day.

Public sector perspectives

The speakers from the public sector were enthusiastic about the prospects for national investment, welcoming the contribution that private finance could make. The other speakers had more reservations, but none expressed the view, sometimes seen in the press and expressed by public sector workers, that there are major problems with the whole idea; the overall impression given by the speakers was positive. Despite the title of the conference, the word 'opportunity' was seldom heard. It was often implied by the public sector speakers, who gave the impression that there were significant opportunities for increased investment and improvements in services; perhaps not surprisingly, the profit opportunities for private investors were under-emphasised. Private sector speakers were more worried about the potential lack of opportunities, if limits are imposed on the upside without corresponding limits on the downside.

National investment is an area in which many different parties are involved, and there were presenters representing most of the possible roles. The government

has the most influence in the field: it sets policy and provides much of the necessary finance. Fittingly, the keynote speaker was Andrew Smith, chief secretary to the Treasury, who set the tone for the first part of the day: he talked about decades of under-investment in public service, public sector net investment rising by over 40% a year in real terms in the three years to 2003/4, and how the extra investment can be tied to reform in the public services. He talked of how improved delivery can provide a better service to the citizen, and was extremely enthusiastic about bringing together the public and private sectors in order to do this. A major theme of his speech was that money raised from the private sector through arrangements like PPP would not be used as a replacement for public sector investment, but would be additional investment.

Andrew Smith said that it was vital to harness the efficiency and management skills of the private sector, turning the powerful discipline of the markets to the service of the public good. The positive message persisted as he answered questions from the floor: he stressed the need to deliver improvements to services on the ground, so that the citizen-customers benefit from reforms. Individual schemes should not be judged on cost alone, but also on the quality of service provided: achieving 'best value' was the objective. And no, the Railtrack episode wouldn't diminish the confidence of the private sector in working with the government: PPP and PFI agreements are structured around clear contracts for delivery, so the private sector knows exactly where it stands.

The next three speakers, Tim Matthews of the Highways Agency, Peter Hansford of the Strategic Rail Authority, and Jim Lockie of the Schools Private Finance Team in the DfES, were also from the public sector, and maintained the positive, enthusiastic tone. Their presentations mentioned the common themes of decades of under-investment, and the importance of effective partnerships with the private sector. They all said that one of the big advantages of working with private finance was the ability to transfer risks to the private sector, which is better able to manage and price them. Tim Matthews described how the Highways Agency was changing its procurement practices in order to build better partnerships. Peter Hansford made the point that uncertainty, which the private sector dislikes, can be reduced by making the rules clear and equitable. Jim Lockie claimed that the biggest challenge in making partnerships with the private sector work is public perception: risk management and transfer can be complex, and difficult to understand. However, the improved risk management offered by



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opportunities and risks

the private sector is a significant contributor to the overall value for money of PFI projects. In answering questions, they all emphasised change: change in criteria for assessing bids, relationships with partners, and attitude to consumers.

The last speaker of the morning provided some antidote to the enthusiasm of the earlier speakers. Tim Congdon asked whether the economy could afford higher public investment, and concluded that it could, just. The big danger is of a sterling crisis; but, as long as there is not a huge increase in public sector construction spending, and the money is spent properly, we should be all right.

Private sector perspectives

After lunch Chris Waites of Tillinghast spoke about risk and insurance issues, emphasising the need for thorough risk assessment from the outset of the private sector's involvement. He said that there were serious doubts about some of the claims that have been made for PFI. It is often extremely difficult to make like-for-like comparisons with the public sector comparator. The quantification of risk transfer is crucial, and must get better if the value for money tests are to be credible.

The next two speakers, from the private sector, continued the theme of risk transfer. David Clements of WS Atkins talked about the overall financial structure of PPP/PFI projects, and how they are highly geared. He expressed some concern that a trend towards restricting the equity upside would greatly lessen the attraction of such projects to the private sector, especially in the light of a perceived increase in risks following the Railtrack events. Another problem is that the cost of a failed bid can now exceed the predicted NPV of the profits from a successful bid. Colin Reed, until recently of Halcrow, used his experience of two successful projects to identify some good practices, especially in the area of risk transfer. He made the point that if you pass risk on, you can't control how it is managed: it may be in your interests to retain those risks over which you want some control. Addressing an audience containing many civil engineers, he probably upset few people by claiming that engineers are better than lawyers at drafting construction contracts.

To round off the day we had brief presentations and a panel discussion from Tony Watson of Hermes Pensions Management, Joe Docherty of Barclays Bank, and Michael Wilkins of Standard & Poor's, all concerned with the funding of capital projects. Tony Watson argued that, on some fairly conservative assumptions, there may be enough private funding available from the institutions to satisfy government

targets for PFI. Joe Docherty described some of the inner city redevelopment projects that Barclays has been involved in, and Michael Wilkins gave us some background on credit ratings in general, and how S&P analyses individual projects in particular. Often S&P is involved at an early stage, so that the bid can take into account the fact that the bidders expect to be able to get an investment grade for financing. He also explained how monoline insurance can be used to upgrade a credit rating. During the panel discussion Chris Lewin, as chair, put some questions to the audience: about half those present believed that the government's investment programme will actually happen as planned, while nearly everybody thought that the process of investment could be significantly improved.

Concluding thoughts

Overall, the day provided much food for thought. There was a good selection of speakers, covering nearly all the possible roles: if we consider Tim Congdon, an economist, as representing the taxpayer as a provider of finance, we were missing only the taxpayer as consumer, and public sector workers. The message that came across most clearly was the difference in attitude between the speakers from the public sector in the morning and those from the private sector in the afternoon. The former were all smiles, radiating enthusiasm and optimism; the latter had definite reservations about the details of the process. The former said how good it would be to work with the private sector, who are so much better at managing and controlling risk; the latter said how it was important to take on only those risks that can be controlled and managed, and warned of the danger of the government's being seen as unreliable (the Railtrack problem). There is clearly the danger of a mismatch between the expectations of the public sector and the willingness of the private sector to accept risk; let's hope it is small. Better assessment and modelling of risk should help.

For actuaries on the lookout for possible areas of involvement, the message that the assessment of risk and the quantification of risk transfer could do with improvement was welcome. I would like to have heard more about the specialist insurance contracts that are used. In general, the profession is moving ahead in the risk area, with the existence of RAMP and its current extension into Stratrisk (a framework for the management of strategic risks in construction and other business). While RAMP applies only to projects, Stratrisk will deal with the overall success of large investment programmes and complex existing businesses. □

There are risks and costs to a programme of action but they are far less than the long-range risks and costs of comfortable inaction

– John F Kennedy

Presentations from the seminars are available on the profession's website at www.actuaries.org.uk/finance_invest/national_inv_sem/index.html

For more on RAMP see www.ramprisk.com