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RISKY BUSINESS

De-risking construction within complex projects – what the Farmer review means for the market

Delivering a PPP is a complex undertaking. By using the term “complex project”, I mean that the setting up, construction, and the operation of a facility needs the engagement of many stakeholder groups. Further complexity comes with the inclusion of first tier funder and investor stakeholders and planning for secondary market trading and investors.

There is a growing awareness in the construction industry that stakeholder engagement needs greater priority, from project initiation to asset operation. However, the government-commissioned Farmer review, ‘Modernise or Die – Time to decide the industry’s future’ (October 2016), highlights a far greater need for improvement in construction sector performance. The review leaves all who read it with the stark realisation that construction is inherently high risk. This is particularly striking to those not directly involved in construction delivery, such as investors and funders.

Mark Farmer’s review is a call for better risk management of construction. As with all change management, high-level processes have the greatest effect. The best place to introduce risk management is to embed effective risk processes within the business case. The benefits then cascade down throughout the project delivering the business case.

Such high-level risk management gives the greatest opportunity for influencing project culture. This is the way to create the culture of collaboration that Mark Farmer’s review calls for. Embedding risk management within the business case is particularly crucial for PPPs, where the most important process is risk monitoring.

In its simplest terms, risk monitoring is a control process run throughout the project cycle for setting up, evaluating, and tracking known risks, checking residual risks, finding new risks, and developing and evaluating risk mitigation through response plans. The cornerstone of risk monitoring is the setting up of a risk profile and then continually checking change in relation to this profile as a project progresses.

Stakeholder engagement is important in risk monitoring for the simple reason that stakeholders know where the risks are and what is happening, and are best able to develop mitigation plans.

All too often, risk monitoring pays inadequate attention to behavioural risks, those risks arising from the interaction of individuals and the related potential to generate positive or negative outcomes. The risk register is central to risk management of PPPs.

However, the wide scope of stakeholders, many of whom do not actively engage in construction activity, and the fact that construction itself is only a stage in the creation and lifecycle of an asset extending to perhaps 25 years, means that data collection for the risk register needs to be much better than it now is.

Improving stakeholder engagement is a sure way to mitigate risk, improve futureproofing of the asset and lessen the possibility of asset degradation. Translated into investment terminology, improving stakeholder engagement potentially improves return on investment for those funding and investing in PPPs.

At its highest level, risk management of PPPs is about creating the best culture for designing the output that is to form the operational asset and then delivering this output in as risk-free environment as possible. What, then, is the ‘best culture’ for output design and delivery?

A key driver of PPPs is risk transfer. Effective risk transfer is only achievable by creating a culture of openness and transparency. It is only in a culture of openness and transparency that it is possible to take the first step in transferring risk. This first step is risk identification.

Critics of PPPs point to failure of risk identification and its consequential effect of lack of effective risk transfer. The critics cite that all too often there is a failure to find and properly transfer risk during the period leading to financial close. Without a culture of openness and transparency, there is suspicion and confrontation, which brings with it the burying of risk.

Burying of risk has two effects. For the public sector, it frustrates effective risk transfer from the public to the private sector, resulting in the public sector not getting what it is paying for.

For the private sector, it pushes risks down the supply chain so that often the party least equipped to manage a risk ends up holding it. The holder of an inappropriate risk that it cannot manage then seeks to push it back up the supply chain in the form of claims and disputes. In extreme cases, the holder of the inappropriate risk becomes insolvent. Whatever the outcome, the shockwaves travel back up the supply chain and the public sector pays not once but several times over. This is what gives PPPs a bad name.

How is risk monitoring improved? I refer to the ‘Guidance on Risk Management, Internal Control and Related Financial Business Reporting’, published by the Financial Reporting Council (FRC).

Aligning PPP risk monitoring with the FRC guidance not only improves the potential for better outcomes generally, it also gives a real opportunity to de-risk the riskiest part of PPP procurement – the construction of the asset.

To be fit-for-purpose, risk monitoring should give a clear channel of communication for reporting risks and concerns and provide timely and good quality information from numerous sources. Setting up such a system is an important step towards the reforms of the Farmer review. PB