INTOSAI

Guidelines on Best Practice for the Audit of Risk in Public/Private Partnership (PPP)

Foreword

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It is now 10 years since the INTOSAI Working Group on the Audit of Privatisation held its first meeting. Since this gathering, we have witnessed a significant broadening of the privatisation audit field. Members now audit not just the sale of state assets, but also the economic regulation of newly privatised public services. More recently, SAIs have begun to evaluate price and service quality issues associated with Public Private Partnerships (PPP), co-operative arrangements of various kinds between the state and the private sector to deliver public services.

These guidelines identify key risks facing both the state and the SAI in auditing PPPs, and how they can best be managed. The guidelines are supported by a range of examples from the work of member SAIs, who have shown real commitment in contributing to the development of these guidelines, recognising the tangible and useful impact that previous sets of guidelines have had on their audits.

Given the ever changing environment in which we audit, not least because of the many new types of PPP that are emerging, the guidelines cannot hope to address every risk that may arise. But I am certain that the guidelines will be of practical benefit to SAIs as they continue to meet the challenges ahead.

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Introduction

1 States are increasingly working with the private sector in order to deliver services to their citizens. This is for a variety of reasons. The private sector may in some circumstances conduct activities more efficiently than the public sector, enabling the same service to be provided at a lower cost. Alternatively, competition may improve the *quality* of service through the innovative use of technology and a closer focus on customer needs. The state may also be investing heavily in infrastructure and may look to the private sector to bear the capital cost of this investment. Where the demand for the service is uncertain, the state may wish to share this risk with a private sector partner. Furthermore, public/private partnerships (PPPs) can form part of a programme of economic restructuring which aims to encourage private enterprise or provide jobs in areas of high unemployment. They can also be used to raise revenue by exploiting state owned assets (such as intellectual property and real estate) more effectively.

2 Co-operation between the public and private sectors can take many forms, as shown in **Figure 1**. SAI's have varying views on what constitutes a PPP as opposed to a privatisation. In many countries, these partnership agreements are recent developments. **Figure 2** shows the common elements to the varying definitions of "PPP".

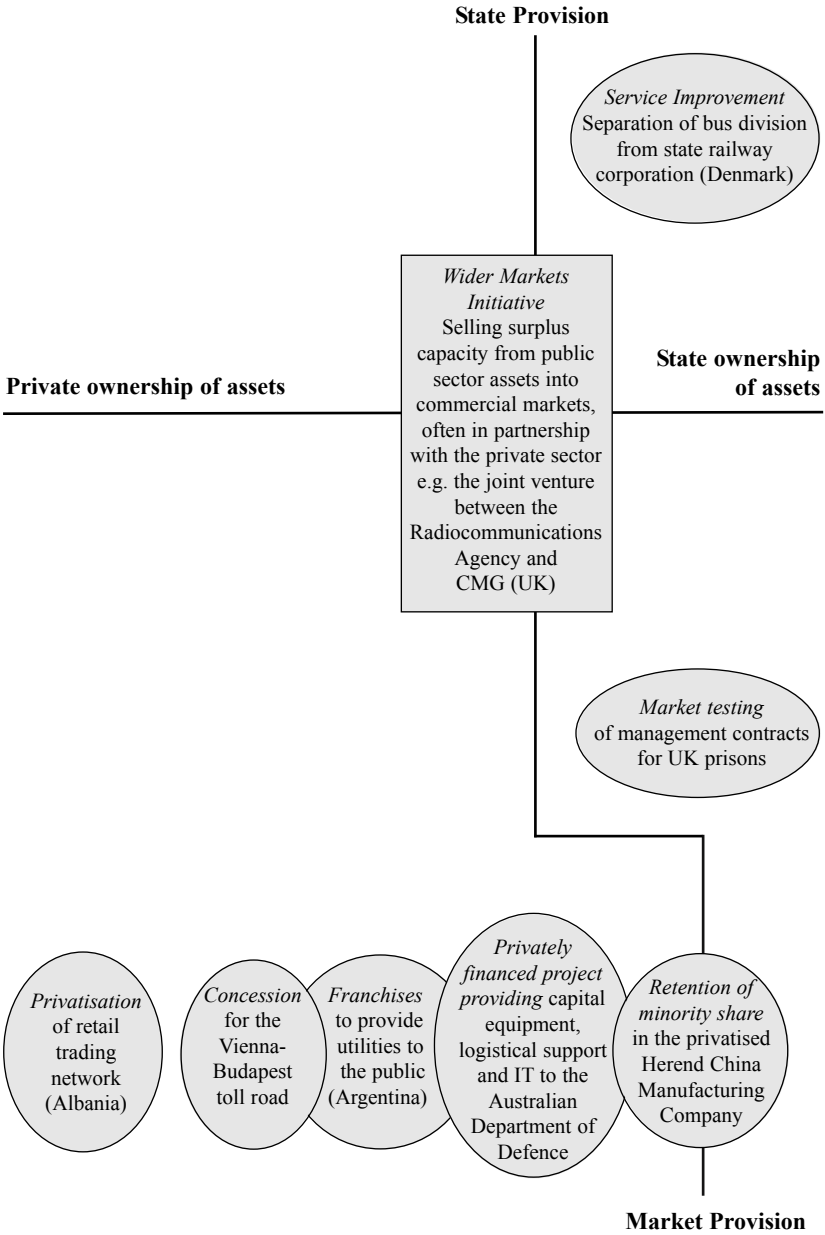
Figure 1: Types of public private partnership

Type of Public Private Partnership	Example
Joint ventures. The private and public sectors set up a jointly owned company to complete a project which brings benefits to both parties.	In the UK the Radiocommunications Agency has entered into a partnership with CMG plc to provide IT infrastructure and to market the Agency's skills in radio wave management to potential wireless customers.
Franchises. The private sector is permitted to provide and charge the public for services which would normally be provided by the state, in return for a fee.	In Argentina, the right to provide utilities to the public was granted to private licence holders in 1989. The licence holders operate under the regulation of Public Utility Control Bodies.
Concessions. Similar to franchise agreements except that the private sector will usually provide finance to build the necessary infrastructure, such as a bridge or road.	In Hungary, an international consortium constructed, developed and financed the toll road M1/M15, which connects Vienna and Budapest.
Privately financed investment projects. A private company obtains the funds to design, construct/refurbish and operate/maintain a public asset such as a hospital. Once the asset is operating a regular fee is paid by the public sector for a set period (usually 20-35 years). At the end of this period, the asset reverts to public ownership.	In the UK, O^2, a private company has signed a framework agreement to provide a new radio service to all of the police forces in England Scotland and Wales. O^2 will finance, design and build the fixed assets required to transmit radio signals. They will then operate the system for 19 years.
Privatisation. Publicly owned companies are sold to private investors.	In Albania, the wholesale and retail trading network was privatised in the early 1990s. The network comprised stores, restaurants, warehouses and small manufacturing facilities.
Retaining minority shares in privatised companies. The state retains an agreed percentage of the shares, in order to keep some control over the provision of services to the public.	In Hungary, the Herend China Manufacture Company was privatised through a management buy-out, with the state retaining a 25% shareholding.

Figure 1: Types of public private partnership *continued*

Type of Public Private Partnership	Example
Market Testing. Private companies are invited to tender for a contract to provide public services, in competition with the existing public sector provider.	In the UK, competitions have been held to manage five prisons. Bids were judged on the basis of cost, security and the quality of regimes provided for prisoners. Of these, two are now managed by private companies. The other three competitions were won by public sector teams. The management contracts will be re-let after 10 years.
Use of private sector methods in public bodies, such as performance measurement, incentive schemes for staff and the rationalisation of resources.	In Denmark, the bus division of the state railway (a public corporation) was split from the rest of the company, in order to ensure that the company competed on equal terms with private transport companies, thus improving the quality of service offered to the public.

Figure 2: The range of Public Private Partnerships



3 The common factor in all of these models is that the state delegates an element of day to day control over service delivery to a private sector entity. This delegation entails risks, both to the quality of service and to the state's investment. If not carefully managed, these risks may outweigh the benefits of private sector involvement.

4 SAIs have an important role in examining whether the risks involved in PPPs are managed effectively. The SAI's reports to Parliament can keep the public informed about the services they receive and also disseminate best practice. However, the SAI may itself face risks when auditing novel forms of partnership - it may not have the necessary specialist skills. Furthermore, the very fact of SAI scrutiny may inhibit well thought-through risk taking in the delivery of public services.

5 In response to the development of greater interaction between the public and private sectors, INTOSAI established a Working Group on the Audit of Privatisation. The Working Group consists of representatives from the SAIs of 39 countries:

Albania	Egypt	Paraguay
Antigua and Barbuda	El Salvador	Peru
Argentina	Estonia	Poland
Australia	Germany	Romania
Austria	Hungary	Russian Federation
Bahamas	India	Saudi Arabia
Bangladesh	Israel	Slovakia
Brazil	Latvia	Slovenia
Bulgaria	Lithuania	Turkey
Chile	New Zealand	United Kingdom (Chair)
Czech Republic	Norway	Uruguay
Denmark	Oman	Yemen
Ecuador	Papua New Guinea	Zambia

6 The Group has a remit to examine the impact of privatisation on public sector audit and accountability. Since 1993, the Working Group has produced three sets of guidelines addressing major aspects of the privatisation process:

- guidelines on best practice for the audit of privatisations (adopted by XVI INCOSAI in 1998);
- guidelines on best practice for the audit of economic regulation (adopted by XVII INCOSAI in 2001); and
- guidelines on best practice for the audit of public/private finance and concessions (also adopted by XVII INCOSAI in 2001).

7 The Working Group's previous guidelines focused on the SAI's approach to auditing government transactions, such as privatisations, and government activities such as regulation. INCOSAI XVII asked the Working Group to examine whether further guidance on the new forms of partnership - including issues arising when the state is a minority shareholder in private businesses - would be useful. The Working Group has accordingly developed this guidance, which, rather than setting out an audit methodology, focuses on the risks inherent in such partnerships, both to the state and the SAI. The state may not be able to achieve the benefits it seeks for public services without taking risks. However, the SAI has an important role to play in ensuring that government departments think these risks through carefully. The guidelines therefore take a practical approach, outlining how risks can be managed, with illustrations drawn from the experiences of Group members. SAIs are encouraged to share these guidelines with their auditees in order to promote a joint approach to risk management.

8 The key risk areas facing the state are:

A: clarity about partnership objectives

B: negotiating an appropriate partnership

C: protecting the state's interests as a minority shareholder

D: monitoring the state's interests in the partnership

E: the state's exposure in the event of difficulties

9 The SAI faces risks relating to:

F: examining the process and the results

G: identifying worthwhile lessons

H: following up their work

10 The following sections set out sub-risks for each category together with suggestions on how they might be managed. The risks are ordered chronologically, from the stage when the state first identifies a need for a partnership, through selection of the partner to the operation of the project. Risk 7 looks specifically at the potential for corruption when partners are selected. However, SAIs should be alert to the possibility of corruption and money laundering throughout the life of the partnership.

11 In auditing how risks are managed in the course of setting up a PPP, and ensuring that there are sound risk management procedures in place for the PPP itself, the SAI should take account of current good practice in risk management and evaluate whether this is provided for in the corporate governance of the bodies concerned. Sound internal control in public bodies that are entering into PPPs will help bring reasonable confidence that public resources are protected and institutional objectives are met. Such control should also help create the conditions for better external control, and would include the following:

- good information and communication systems;
- adherence to specific legal and technical rules (e.g. for accounting, budgeting, data processing, public debt, human resources, and asset management);
- mechanisms to identify, evaluate, analyze and treat business risks;
- environmental impact assessments;
- audit tests to evaluate administrative process, financial and operational activities; and
- management performance indicators that are in line with the mission, vision and goals of the organisation.

The key risks and their management

Part 1: Risks facing the State

A: Clarity about partnership objectives

B: Negotiating an appropriate partnership

C: Protecting the state's interests as a minority shareholder

D: Monitoring the state's interests in the partnership

E: The state's exposure in the event of difficulties

A: Clarity about partnership objectives

Risk	Managing the risk
1 The state is likely to have a range of public service objectives, some of which may be competing If it fails to identify and prioritise objectives for securing these interests, it may not identify all the realistic alternatives before deciding to enter into a partnership, and it is likely to be at a disadvantage when negotiating with potential partners. **Example -** ensuring universal service across a country (including remote areas) may require investment in infrastructure, which could raise the price of services for consumers.	■ Prepare a strategic plan setting out the public sector's objectives for the partnership, and the possible options for balancing competing priorities.
2 The state's need to fulfil a variety of public policy objectives may clash with the private sector's interest in concentrating on the most profitable elements of the service.	■ Consider how the private sector's commercial interests might reasonably be protected. **Example -** incentivise each party to help the other meet their objectives.

A: Clarity about partnership objectives

continued

Risk	Managing the risk
3 Variance between the public sector's interests and objectives and those of potential private sector partners may jeopardise effective joint working.	■ Identify the likely appeal of the project to various types of private sector partners, and consider which partner's interests are most likely to be aligned with those of the state.
4 Poor decision-making processes may result in the wrong partner being selected, or an inappropriate partnership vehicle being used for the project. PPP may be used so that the project is accounted for off balance sheet, rather than because it best achieves the state's objectives for improved services.	■ Consider a range of vehicles for the proposed partnership and select the structure which best suits the public sector's objectives, whilst also being attractive to private partners. The vehicle should be selected only after all options have been assessed against rigorous evaluation criteria, which include looking at actual cash flows as well as projected accounting profits. SAIs and government departments can agree an appropriate accounting framework for the financial evaluation, which includes rules on the balance sheet treatment of assets and liabilities.

A: Clarity about partnership objectives

continued

Risk	Managing the risk
5 The public sector may not provide sufficient leadership and incentives to its managers to encourage them to take well managed risks in order to secure viable partnerships. Furthermore, public managers may not always act in the state's best interests (due to conflicts of interests or pressure from lobby groups).	■ Performance based rewards linked to user satisfaction can be an incentive to public sector employees to take well managed risks, and to act in the public interest.
6 There may not be sufficient competition for the project. If there is only one potential partner, it is difficult for the state get a deal that is good value for money.	■ Take market soundings at the feasibility stage to assess the level of private sector interest in the project.

B: Negotiating an appropriate partnership

Risk	Managing the risk
7 Specialist financial and legal advisers may be necessary, but the public sector may become over-dependent on external advice and pay consultants more than the market rate. There is also a risk of corruption. Advisers and public employees may be bribed to favour a particular company in the procurement process, or to agree a partnership agreement that is not in the public sector's best interest.	■ Appoint advisers after a competition, which focuses on the skills required and quality as well as cost. ■ Consider how the advisers can transfer knowledge and skills to public sector staff. ■ Set clear budgets at the outset. ■ Consider linking advisers' remuneration to achievement of the public sector partner's objectives. ■ Identify potential conflicts of interests and how these could be resolved e.g. through the use of Chinese walls. ■ Ensure that a third party reviews the selection process and the agreed terms and conditions before the partnership is finalised.

B: Negotiating an appropriate partnership
continued

Risk	Managing the risk
8 Negotiating and setting up a partnership frequently involves additional public expenditure up front which can be recovered if the partnership is successful. Failure to provide for this initial expenditure can put the enterprise at risk.	■ Calculate the likely costs as well as the benefits of the partnership, and establish whether costs falling on the public sector are affordable.
9 If the public sector makes large contractual payments up front, they may be effectively financing the partner, which may contravene international rules on state aid. If a large percentage of the contract price is paid initially, the partner may have less incentive to deliver quickly or to a high standard. The state could also lose its money if their requirements later change.	■ Link contractual payments to the achievement of milestones and the standard of services delivered.
10 The public sector may be subject to political pressure to only enter into partnerships with local companies, in breach of the procurement requirements of international institutions.	■ Obtain legal advice on the national and international procurement requirements to which the partnership is subject.

B: Negotiating an appropriate partnership

continued

Risk	Managing the risk
11 The need to comply with public sector procurement requirements (which involves the expense and uncertainty of competitive tendering) may deter competition.	■ Ensure there is good communication with potential partners from the early stages of preparing for a partnership; There should be clarity about what the private sector partner will be expected to contribute and a focus on the desired outcomes from the partnership.
12 The public sector may choose an unreliable partner with a poor track record in delivering value for money in the type of services required, or one who may have been involved in corruption.	■ Design thorough procurement and appraisal processes which assess the dependability and probity of potential partners.
13 The public sector partner may not have sufficient legal authority to enter into the desired form of partnership, or to transfer assets to a private sector entity.	■ Ascertain in advance of commitment that the necessary statutory basis and other legal authorities are in place.
14 The government may not secure adequate rights to unanticipated profits arising from the exploitation of assets (including intellectual property rights), that they contribute to the partnership.	■ Obtain an independent, expert valuation of the assets. ■ Ensure that issues of profit sharing (including possible future gains from property sales or refinancing) are addressed as clearly as possible in the partnership agreement.

B: Negotiating an appropriate partnership

continued

Risk	Managing the risk
14 (*continued)*	■ Ensure that the state's interests are protected if contributed assets are disposed of by the partnership (e.g. guaranteeing the state a share of the proceeds).
15 Once assets have been transferred to the private sector, the public sector will lose control over them, but there are some assets (e.g. transport infrastructure) that the state cannot allow to fail.	■ Consider whether assets of national importance can be leased to the private sector rather than transferred outright. The partnership agreement could give the public sector "step-in" rights in the event of a major failure in the delivery of services or the bankruptcy of the partner. However, these should only be defined in detail where strictly necessary, as they may effectively underwrite the partner's investment. If the private sector knows the state will step in if there are problems, the incentives for the private partner to perform well are reduced.
16 The guarantees and indemnities given to the private sector partner may not be fully priced into the agreement.	■ During its examination of the deal, the SAI should consider whether the contract price fairly reflects the risks borne by both parties (in particular any guarantees or indemnities given by one party to the other).

C: Protecting the state's interests as a minority shareholder

Risk	Managing the risk
17 If the public sector accepts a minority stake in the partnership it risks its interests being overridden by its partner. The public sector may accept a minority stake because the private sector partner insists on a controlling interest, or to avoid the partnership being classified as a public undertaking with the restrictions on commercial freedom this may imply, or to limit the partnership's exposure to audit by the SAI.	■ When negotiating the agreement consider the value to the private sector of having control. ■ Ensure the partnership agreement includes protection for the public sector partner as regards structure, governance and management. However, European Union members should note that "golden shares" are contrary to a recent European Court of Justice judgement. ■ Clarify in the partnership agreement or company articles the responsibilities of the directors.

C: Protecting the state's interests as a minority shareholder *continued*

Risk	Managing the risk
18 Failure to evaluate the implications of different levels of minority holdings (e.g. holdings of 25% or more may give more protection under general company law) or failure to make sufficient investment to gain control of the partnership.	■ Carefully consider the rights attached to different levels of minority shareholdings before commitment to the partnership.
19 The state may lose the value of its investment.	■ Obtain regular information on performance and whether the partnership is meeting its obligations to the public sector partner so that any risk of loss is identified as early as possible, enabling the public sector partner to consider how best to protect its interests.

D: Monitoring the state's interests in the partnership

Risk	Managing the risk
20 The public sector partner may not obtain sufficient financial, legal, technical or other relevant expertise to enable it to manage its relationship with the private sector partner. It may therefore fail to exercise the rights attached to its shares in the partnership.	■ Identify the range of skills needed in monitoring and managing the relationship, and consider how to retain or access such skills.
21 Even where the public sector is a majority shareholder, unclear governance and dispute resolution arrangements may lead to exceptional privileges being granted to the minority shareholder. This may lead to the public sector forfeiting control over the partnership.	■ Provide for these arrangements in the partnership terms.
22 The public sector partner may not seek sufficient information to provide assurance on how the partnership is performing. The partnership company may set up subsidiaries to perform some of its functions, making it more difficult for the public sector to monitor overall performance.	■ Sources of information include the partnership's strategy for investments and operations, the accounts and details of contract performance against business plans. The SAI should ensure that the assets, liabilities and results of subsidiaries are consolidated into the accounts of the parent company with enough business segment information to present a true and fair view of the partnership's performance.

D: Monitoring the state's interests in the partnership *continued*

Risk	Managing the risk
23 The public sector partner may be prevented from obtaining sufficient information about the partnership's performance because the partnership's articles of association, or general legislation may not allow information to be provided to one partner on demand that is not supplied to all partners.	■ Ensure that the articles of association allow for performance information to be supplied, on demand, to the public sector partner, as far as this is permitted by legislation. Where the state is acting as a lender or guarantor it will be entitled to additional information from the partnership in order to ensure the security of its loan.
24 The performance measurement targets used by the public sector partner may have perverse incentives. **Example:** inducing managers to focus on the accounting treatment of assets in order to meet targets, rather than on the actual performance of the partnership.	■ Use a portfolio of performance measures to evaluate the partnership, including both financial and qualitative measures (such as customer satisfaction). Monitor the cash-flow of the partnership, in addition to financial measures which may be distorted by accounting policies.
25 As the partnership develops, disagreements over strategy or performance may escalate into contractual disputes.	■ Appropriate governance and review arrangements (e.g. representation on the management board of the partnership, joint monitoring of risks to the partnership and open book accounting). ■ Appropriate dispute resolution arrangements.

E: The state's exposure in the event of difficulties

Risk	Managing the risk
26 The state may become a partner in, or administrator/owner of, a private business involuntarily, e.g. because the business is at risk of imminent failure and supplies an essential public service. In such cases the state is at reputational risk.	■ The state will need to secure the best possible advice and analysis for the construction of a viable resolution of these difficulties.
27 The partnership may become bankrupt, or the state may wish to withdraw from the agreement. If the state has not identified such scenarios before entering into the agreement, there is a danger that the state could find itself unable to exit except at punitive cost.	■ In its risk analysis before entering the partnership, the state should carefully consider these possibilities and make provision for them - either in the terms of the agreement (e.g. the power to withdraw in the event of poor performance without unreasonable financial loss) or by way of contingency planning (e.g. share disposal).

Part 2: Risks facing the SAI

F: Examining the process and the results

G: Identifying worthwhile lessons

H: Following up their work

F: Examining the process and the results

Risk	Managing the risk
28 The SAI may lack the commercial expertise needed to evaluate either how well the public sector partner is protecting the state's interests or whether the public sector has taken unreasonable risks.	■ The SAI should identify its audit responsibilities and how best to carry these out, including securing access to any specialist skills needed.
29 In many cases the SAI may not have access rights to the partnership itself. Even when the SAI does have such rights the private sector may be reluctant to provide information due to fears over commercial confidentiality.	■ The SAI will however have access to the public sector partner and can examine and report publicly on how well the state has exercised its responsibilities. ■ The SAI can inform Parliament of restrictions to its access rights. This may encourage the public sector to make access rights for the SAI a condition of future partnerships. ■ The SAI can contact the private sector partners, to emphasise the SAI's impartiality and explain that they are interested in good practice as well as what went wrong.

F: Examining the process and the results

continued

Risk	Managing the risk
30 Either due to a lack of expertise or a desire not to interfere with the commercial freedom of the partnership, the public sector may resist SAI efforts to probe how effectively the public sector partner is protecting the state's interests, (e.g. by arguing that the SAI is inimical to commercial risk taking).	■ The SAI should demonstrate that it supports well-managed risk taking by the state by issuing a press statement to that effect. It should focus its examinations on identifying good practice and contributing to the development of constructive guidance for decision takers.
31 Existing methodologies may not equip the auditor to assess the performance of new types of PPP. Benchmarking the quality of services is difficult when there are few comparable projects, and when the public sector has not made the partnership's objectives clear. This also makes it hard to judge what would be a reasonable return on investment for the private sector partner.	■ Consider re-examining long-term projects at regular intervals. These reviews should consider i) if the state's objectives are still being met and ii) whether all partners are receiving a fair return for the risks they bear. ■ Information for benchmarking the partnership's performance could be gathered from unsuccessful bidders or comparable projects in other states.

G: Identifying worthwhile lessons

Risk	Managing the risk
32 The SAI's examination of the transaction may have too narrow a focus - **for example:** ■ It may be tempted to focus only on what went wrong. ■ It may not take account of other relevant examinations or experience - this may lead to an undue burden on the partnership company if they are audited by several different public watchdogs.	■ Lessons can be learned from failure as well as success, but the SAI should take care to place any failures or shortcomings in context, recognising in particular that, however well identified and well managed they are, the risks in novel forms of partnership may materialise. ■ The SAI should disseminate any good practice it discovers through conferences, newsletters and informal contact with other public sector bodies. ■ The SAI should ascertain what other investigations and research have been carried out into similar arrangements at home and abroad, so that such work can inform its own investigation and help test its findings. **Example:** investigations by other audit offices and academic bodies.

G: Identifying worthwhile lessons *continued*

Risk	Managing the risk
33 Where the business lends itself to the development of a portfolio approach that there are contrary risks for the SAI: on the one hand, it may fail to recognise that the essence of the portfolio approach is that some projects are likely to fail while others succeed; on the other, it may not evaluate the reasons for the failure of particular projects.	■ While recognising that the essence of the portfolio approach is that some of the projects are likely to fail, the SAI should ascertain whether the public sector partner ensures that the partnership subjects each of its projects in the portfolio to rigorous appraisal at key stages of development, so that the costs of failure are minimised.
34 The SAI may build a model of good practice in procuring and monitoring partnerships. In applying this to the deals it is examining, the line between managerial and audit functions may become blurred, jeopardising the SAI's independence.	■ The SAI and the public entity should agree their respective roles at the outset of the audit; specifically although the SAI may make recommendations, the responsibility for implementation should remain with the audited body.

G: Identifying worthwhile lessons *continued*

Risk	Managing the risk
35 The SAI may concentrate on technical procurement issues and ignore the wider economic and social effects of PPPs, such as the risk of replacing a state monopoly with a private monopoly.	■ The SAI should consider examining whether the partnership met its economic and social objectives. However, the SAI should ensure that such studies do not question the merits of a Government's policy. **Example:** focus on the *implementation* of objectives rather than on what the objectives themselves should be.

H: Following up their work

Risk	Managing the risk
36 The state may incur liabilities through a PPP that are not fully disclosed in their accounts.	■ The state could include a risk register in its accounts, which includes an assessment of the likelihood of intervention occurring and an estimated value for the liability. The state will need to be aware in developing such a register of the need to balance the possibility of intervention with the need to incentivise the private sector (see Risk 15). The register would be audited by the SAI who would have to assess the reasonableness of the state's assumptions.
37 The state may not implement the SAI's recommendations, leading to the same problems recurring on later deals.	■ Undertake follow up studies of projects they have previously reported on, or report on new partnerships in order to assess the state's response to the SAI's findings. They can then report to Parliament on whether the state has improved its operations.

Annex

Illustrations of Risk and Good Practice in Managing Risks

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 agreed 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 (e.g 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 e.g 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.

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