

Risks, rewards and reliability



“Those who would give up essential Liberty, to purchase a little temporary Safety, deserve neither Liberty nor Safety”
Benjamin Franklin

The real problem is the denial by many state sector managers that much beyond cost of service is important

by Michael Mainelli and Ian Harris

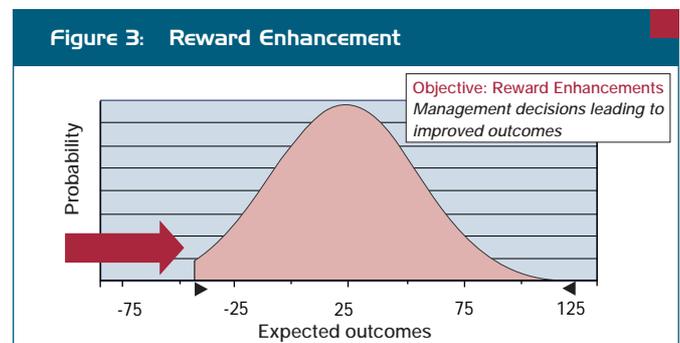
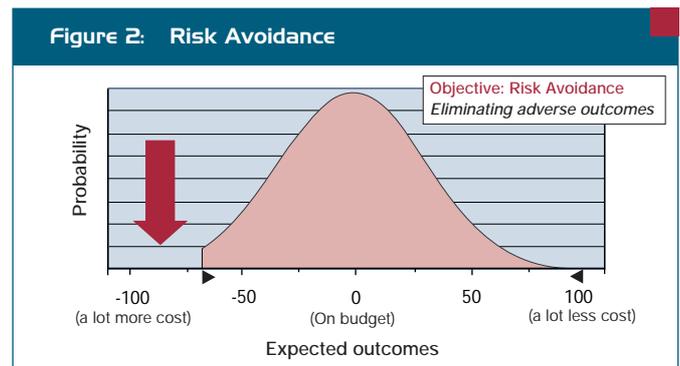
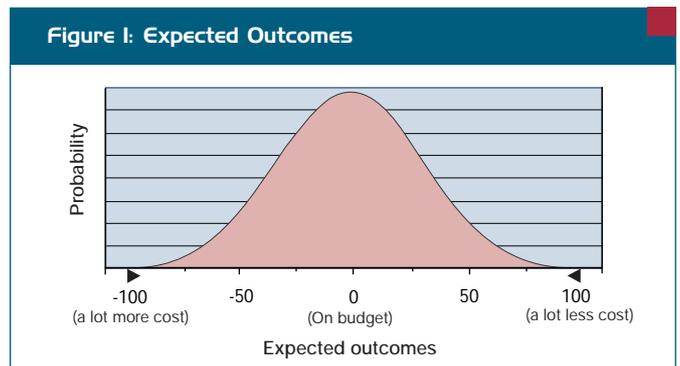
Public sector entities devote a tremendous amount of time to avoiding risk, especially political risk. It feels far safer to spend a large number of small sums of money on ten different studies, rather than solve one problem for the same cost. If a political problem arises, then the response “we had it under review” is of more political value than “we ignored nine similar problems because we hoped to eliminate one long-term problem once-and-for-all, but this one of the nine caught us out”. Infrastructure, however, needs to be reliable, not a subject of political whimsy or backside-covering. How can we go about setting public policy that sensibly balances risks, rewards and reliability of infrastructure?

Risk/Reward management defines three types of activity that improve organisational performance - risk avoidance, reward enhancement and volatility reduction (Harris, Mainelli & O’Callaghan, 2002). Risk avoidance activities reduce large exposures, e.g. continuity planning, insurance or legal compliance. Reward enhancement activities are normal management projects to increase performance such as training, cost reduction or production improvement. Volatility reduction is more subtle, yet activities that reduce volatility or improve consistent delivery add measurable value.

Risk/Reward management can be summarised in four diagrams. Imagine an organisation seeking to reduce cost. Expected outcomes might range from ‘on budget’ (0.00) to a lot more cost (-100.00) or a lot less cost (+100.00). See Figure 1.

The first objective is risk avoidance: managers look to ensure that they can, through better skills, insurance or knowledge, eliminate particularly adverse outcomes. See Figure 2.

The organisation can also look to reward enhancement. See Figure 3. Managers will often promote reward enhancement in terms such as increased productivity, improved staff workplace satisfaction or better contracting. A whole range of typical management decisions such as cost reduction, sales, marketing, logistics improvement or training may lead to improved outcomes. The outcomes ‘shift’ positively to the right.



Finally, and more subtly, the organisation can reduce volatility, by delivering consistently on costs and sales and thus 'tightening' the range of possibilities. See Figure 4.

In this example, all three activities, risk reduction, reward enhancement and volatility reduction combine to move from a starting range of -100.00 to +100.00 with a mean of 0.00 to a range of -30.00 to +125.00 with a mean of 25.00, and a much higher likelihood of hitting that mean (Figure 5).

So far, so basic, so subtle

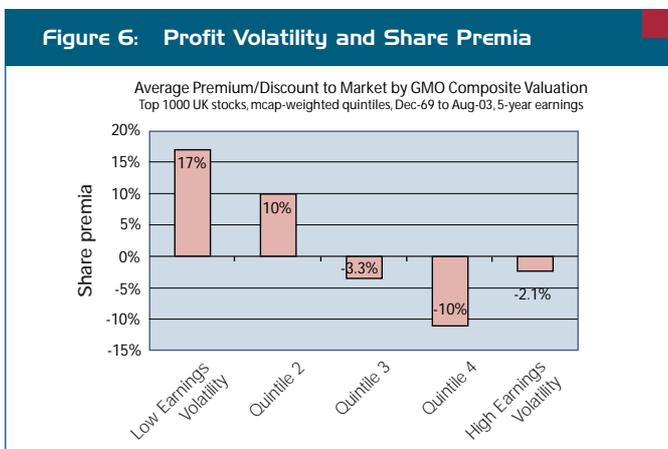
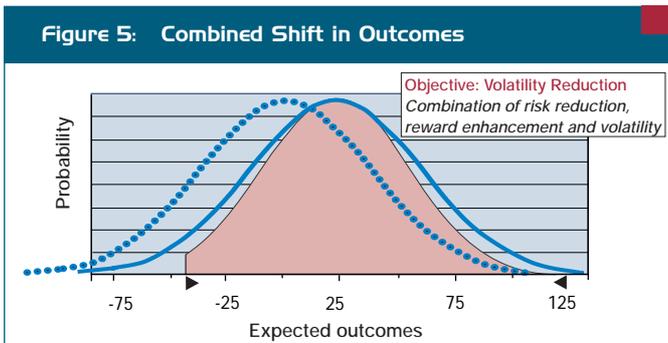
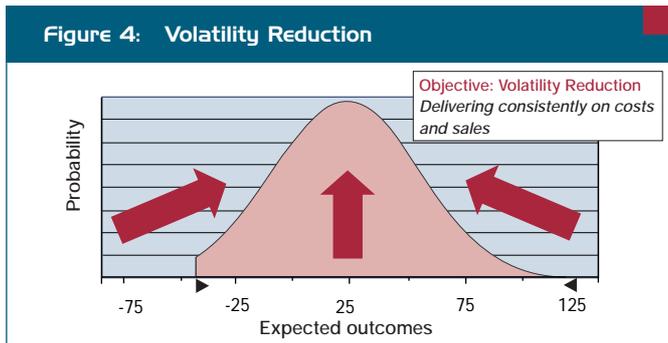
Nothing in the above section is particularly novel for business decision-makers, but the public sector rarely gets close to optimum performance in the trade-off between risk, reward and volatility. In the private sector, businesses strive to reduce volatility in numerous areas, e.g. supply chain reliability, profits, budgets and service delivery. The economic benefits across the economy of reduced volatility (or greater consistency) are tremendous: less wasted capital tied up handling fluctuations, less wasted time, less wasted labour, in short a more efficient and reliable economy. For instance, a few years ago Z/Yen estimated that an environmental NGO seeking to reduce fish stock volatility by up to 25 per cent might benefit the economy by up to 50 times its expenditure.

Consumers may not care that some retailer is training staff so intensively to reduce inconsistent service that it amounts to 45 per cent of total staff costs - what matters are cheap, reliable products. In the public sector, significant cost deviations for the sake of volatility reduction increase political risk - 'Government Department Hires the Useless: Training Costs as Much as Pay' or some such newspaper headline.

The problem for the public sector is that risk avoidance dominates and therefore rewards and volatility/reliability suffer accordingly. In a business, high volatility levels frequently lead to its demise. In the public sector, such volatility is considered the norm. Take transportation infrastructure, for example. The public sector cares about the risk of high transportation costs, so the public sector controls those costs with two resultant volatilities - first, maintenance retention (putting off today's maintenance until tomorrow) leads to increased, unpredictable 'outages' and, second, there is a high variance in travel times.

Maintenance retention leads to unpredictable outlays in refurbishment and immense discomfort, merely transferring today's problems into larger problems for tomorrow. The high variance in travel times leads to enormous societal costs. A Londoner, for example, wishing to be 'on time' verges on psychotic. Think of a journey that ought to take 30 minutes on average by public transport, if all goes well. It could take 25 minutes with a 'fair wind' but has been known to take up to 70 minutes, so what is a punctual person to do? Take 70 minutes and waste, on average, 40 minutes waiting for meetings to start? Or take 30 minutes, but still be late for many meetings? Or cut it fine at 25 minutes, after all that is known...? Further, there are the knock-on effects of people waiting for the various people who make different decisions leading to meetings trying to be re-arranged to start early, while other meetings are rearranged to accommodate late travellers. But then the public sector holds up the cost of an average fare or road taxes as the key indicator, rather than quality or reliability, perhaps at higher headline prices. The hidden costs are enormous, but they are at least hidden.

Transportation infrastructure is but one example. Any public utility or service could be analysed similarly; power, water, health, education and many others. In all these cases, the basic economic



components of demand and supply apply. Market forces are crucial for any complex interplay of demand and supply. It is hardly surprising that public sector entities cannot deliver customer satisfaction once it expands beyond necessity, or at least cost. Unfortunately, this is a core European problem - using state-owned vehicles to deliver core services that involve trade-offs among risk avoidance, reward enhancement and volatility reduction leads to inefficient economies.

Two privates good, four publics bad?

So, can you safely pigeon hole us as ideological privatisers? Well, no. Clearly the state sector has a problem managing beyond risk avoidance, but that may be correctable. The real problem is the denial by many state sector managers that much beyond cost-of-service is important. Where economies need to move beyond simple cost efficiency, it is clear that transferring public

infrastructure to the private sector will be part of the debate. By denying that consistency of delivery is important, economic damage results.

In many areas, the importance of branding is directly related to the importance of consistency. Consumers favour brands that help them anticipate in advance what they will receive. Without consistency, the brand is dissonant, subtracting value. Unfortunately, public sector service branding often misses the importance of consistent delivery. How many people in Europe believe that their public utilities and services are good brands or that they are good value for money? A commercial brand would go out of business if it were perceived by its customers as negatively as many public utilities and services are perceived.

Consistency crucial

For listed companies, volatility reduction can be estimated and the value calculated using risk/reward option theory. One study (Mainelli, 2004) showed that companies in the lowest quintile of profit volatility had share premia relative to the market of 17 per cent (Figure 6). In other words, rewards and reliability should correlate positively. Increased reliability should lead to improved rewards.

Of course, rewards can be hard to define and measure in cases where profit *per se* is not the overriding objective. We and others have coined the phrase ‘evidence of worth’ to describe the definition and measurement of rewards or value where the profit motive is absent or secondary. Evidence of Worth concerning volatility

reduction is difficult, but not impossible, to demonstrate as empirical evidence with corporates and NGOs shows (Harris, Mainelli & O’Callaghan, 2002). Public sector debate tends to be solely about measurement of raw inputs, i.e. costs, rather than results.

Richer management of public assets

Best value in the public sector needs to move beyond ‘least cost’. While this is widely accepted, it is frequently difficult to place a value on ‘additional cost’. We would propose that public sector strategy, particularly along the frontiers of private contracting, recognise the importance of rewards and reliability over ‘least cost’. We believe that ‘best-value’ calculations should explicitly evaluate presumed volatility reduction and give it a specific value. This will require better definition of objectives, better measurement, better decision making and a recognition that rewards and reliability are inextricably linked. Yet, rarely in the public sector does the debate move from cost levels to reliability. Perhaps public sector bodies providing infrastructure should also spend time educating citizens about what they should expect from their public service, consistently.

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