

**'Issues in the Delivery of PPP/PFI Contracts Over the Long Term'**

by  
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**1. A contracting fable:** Since we are meeting in Denmark – the home of the great storyteller, Hans Christian Anderson – I thought it was appropriate to begin with a fable. It is a fable about competition and contracting. And in this case, the story is real.

It is the story of Australia's first two convict fleets – all of the convicts that were transported to Australia from 1788 until about 1868, when transportation stopped, were carried by contractors. It is a story in which I have a personal interest – the reason that I speak English with an Australian accent is that my great, great grandfather was transported to Australia in the 1840s (for stealing books).

By most standards, the First Fleet was an outstanding success. 1,500 men, women and children – and a great deal of livestock – was transported half way around the world to a continent that only half a dozen European ships had ever visited before.

And, excluding an outbreak of typhus before the ships left port, only 45 convicts and children died, a remarkably low death rate of around 3 percent. By contrast, with the Second Fleet, 267 convicts died at sea and another 150 upon arrival, a death rate of more than 40 percent.

Some historians have claimed that the significance difference between the two fleets was that the First Fleet was managed by government itself. But this is not true.

As it turns out, the difference between a death rate of 3 percent and a death rate of 40 percent lies not in who delivers the service but in the design of the contract – the evaluation criteria, the performance regime, and the manner in which the contract is managed.

*Evaluation criteria:* The contract for the First Fleet was, in essence, a cost-plus arrangement. Given the uncertainty about the length of the voyage and the cost of provisions to be purchased at foreign ports, it is not difficult to understand why such a payment mechanism was adopted.

Cost-plus contracts require close monitoring, and this was provided by the Governor of the new colony, who was more concerned about performance outcomes than cost control. When the final bill came in, the First Fleet had cost around £70 per prisoner, in all, the staggering sum of £55,000 (around

£45 million or €67m in today's values).

Of course, some of these costs were associated with the establishment of a new colony, but Treasury officials were appalled and when the tender was issued for the Second Fleet, the Home Secretary instructed that it was to be 'with the least expense to the public'. The new contract was awarded to the lowest bidder, at a fixed price of £17/7/6 per prisoner – less than a quarter of the cost of the First Fleet.

The government had been extremely fortunate in their choice of contractor for the First Fleet. William Richards was a humanitarian, an evangelical Christian and almost certainly an abolitionist.

But when it came to the Second Fleet, no one inquired too deeply into the credentials of the winning contractor. Camden, Calvert and King were the largest firm of slave traders in London, and they brought with them practices that were not acceptable (even by the standards of the day) for prisoners being transported half way around the world.

No one in the Treasury or the Home Office seems to have understood (or cared much about) the role that reputation could play in ensuring quality outcomes.

William Richards belonged to a community that would have judged him harshly if it were known that the convicts were not well-treated.

As slave traders, Camden, Calvert and King had no reputation of that kind to protect. The people with whom they mixed may have passed judgement on their commercial acumen, but none of them can have cared too much about their humanity.

*Contract management:* A naval agent was appointed as the contract supervisor for the First Fleet, but the de facto contract manager was the new Governor. He insisted on changes to the prisoners' diet, including the provision of fresh food while they were in port. He instructed the ships to stop three times on the journey out, directing that the prisoners were to be left free of their irons while in the out ports and negotiating to purchase additional food.

By contrast, there was no one other than the naval agent to act as contract monitor on the Second Fleet. He was a relatively junior official and 'an ineffectual hack of questionable competence' (as one historian has described him). He ignored concerns about the quality of the food raised by the ships' surgeons, he was allowed to cohabit with one of the female convicts and it appears that he was plied with alcohol for much of the voyage – an early example of regulatory capture.

*Performance regime:* We do not have the final contract for the First Fleet, and it is possible that none was ever signed. Performance management was

largely left to Arthur Phillip. Undoubtedly, his relationship with the contractor was made easier by the fact that they were operating on a cost-plus basis.

By contrast, the contract for the Second Fleet contained detailed provisions on the standard of accommodation and the level of security. It specified the rations for convicts and soldiers in significant detail. It required the employment of a qualified surgeon, and named a variety of medicines that were to be provided for the sick. At first glance, this looked like a well-designed contract.

But it also provided extremely heavy financial penalties for escape, with the result that the contractors kept many of the prisoners in heavy slave shackles for much of the voyage. There was no contractual provision as to how many stops were to be made on the way out, and as a result, they stopped only once.

The captain had also been instructed that he should sell any unused food and supplies at the end of the voyage. So it is unsurprising that claims were later made that prisoners had been deliberately underfed. As one of the military officers noted during the voyage: 'the more they can withhold from the unhappy wretches, the more provisions they have to dispose of at a foreign market.'

Of the £17/7/6 that was to be paid to the contractors for each prisoner, £5 was paid once the cabins and bulkheads had been fitted to the ships, and another £10 once the stores had been loaded. The remaining £2/7/6 was to be paid at the end of the voyage, when a certificate from the Commissary in Sydney was produced, verifying that the stores had been received. There were no financial incentives whatsoever for the safe delivery of the prisoners.

Undoubtedly, the contract for the First Fleet had its difficulties. But the contract for the Second Fleet was fatally flawed, with tragic consequences for the prisoners. A fixed-price contract was awarded to a low-cost bidder with the wrong reputation and qualifications, and this was undermined by weak contract management and the introduction of performance measures that created perverse incentives.

The First Fleet contractor, William Richards, was subsequently re-employed for the transportation of two more shiploads of convicts to Australia, with a fixed price contract of £17 per prisoner and a £5 bonus for each one landed alive. On his very next voyage, only one prisoner died.

It is difficult to think of a more dramatic illustration of the maxim, 'What gets measured gets done'. Let me take the insights from this contracting fable and apply them to the topic that I have been asked to address today.

**2. Procurement design:** The first lesson is that success in long term delivery begins with the design and conduct of the original procurement.

- In a powerful article in the *Harvard Business Review* in November 2004, entitled 'Getting Past Yes: Negotiation as if Implementation Mattered', Danny Ertel noted that 'People who see the contract as the conclusion. . . behave very differently from those who see the agreement as just the beginning.' Good procurement should lay the foundation for a successful long-term relationship.' Ertel's fundamental point is that the people we appoint to conduct the procurement often have a totally different set of incentives than those who will later be charged with implementation.
- Good procurement will build trust and a culture of respect of cooperation from the outset. The Swiss economist Bruno Frey, looked at the economics of courtship some years ago and concluded: 'Exploiting the opportunities presented by the marriage market tends to crowd out internal values such as trust . . .' Frey asked why is it that, when faced with one of the most important decisions in our lives – the selection of a life partner – we do not conduct a rigorous competition process.

Why is it that we sometimes exclude those people closest to us (our parents) who have the greatest experience with making such a decision? Why don't we conduct a 'beauty parade' of the potential candidates? Why don't we hire a private investigator to check out the leading candidate? Why do we go in with our eyes half shut?

The answer, Frey concluded, is that when we are courting we are doing two things simultaneously – we are selecting a life partner and we are building trust – and the second appears to be more important than the first.

The same is true with long-term contracting. Some of the procurement practices pursued by government agencies may appear to be commercially clever by those up front, but they are corrosive of a quality, flexible long-term relationship.

- The remaining issues are concerned with a problem that economists refer to as 'the winner's curse' – the kind of auction where the winner always bids too high (or low) and as a result, always loses.

This looks like a clever game for procurers to play in the short term, but playing 'beggar thy contractor' results in the most reckless bidder winning. Over the longer term, it leads to poor delivery, it encourages game-playing by irresponsible players and it thins the market.

Our research suggests that there are two conditions that lead to the winner's curse – poor communication between the procuring authority and the bidders (so that companies are, in fact, bidding on completely different propositions) and an aggressive price-based auction. The only way for a bidder to win such a game is not to play.

Public officials concerned with creating sustainable markets and sustainable long-term contracts need to avoid creating a winner's curse environment.

3. *Market design*: Which brings me to the next of the conditions necessary for a public service contract that is sustainable over the long term. In some situations, it is not enough for policymakers to conduct sound procurements – they also need to look at the design of the market as a whole.

This is particularly the case with public services, where there is often no existing market and where in conducting a series of procurements, government is actually creating a new market.

This is an area of active interest in the UK at present, although mostly with a view to creating a more competitive market. There is a great deal that could be said about this subject, but let me refer to just a couple:

- Where you have markets with ongoing transactions (as opposed to single procurements), then issues like refinancing and secondary markets are only short-term concerns. Of course, the politics still has to be managed, and government can protect its own interests by insisting on profit-sharing, but what has made these a non-issue in the UK is repeat business.
- Sign contracts with partners that plan to be around at the end of the contract. I have just come back from Australia, where many of the recent PPP contracts have been signed with consortia led by investment banks. I made some comments in the press about that. What kind of market is being created there? What does this tell us about where real innovation lies? Of course, investment banks have a vital role to play in PPP contracts, but their interest often lies in selling down their interest at first opportunity. I am baffled as to why government would seek to create a market where they dominate in successful consortia.
- In his ground-breaking book, 'The Evolution of Cooperation', dealing with the so-called prisoner's dilemma in game theory, Robert Axelrod wrote that: 'What makes it possible for cooperation to emerge is the fact that the players might meet again.' Repeat business – the creation of sustainable and well-designed markets – creates an incentive for companies with long term contracts to be cooperative.

If a company wins a 30-year contract and does not expect to bid for another such contract for another decade or more, then they are much less likely to respond to the customer's demands. But where – as in the UK prisons market – there is another competition each year, with a reasonable prospect of winning (that is, there are not too many players

in the market), then companies will be much more amendable to approaches by the government customer about contract variations.

**4. Contract design:** There is a great deal that could be said about contract design. It is obviously highly important to the long-term success of a long-term contract. Again, let me touch on a limited number of points that seem to me to be important.

- There is no getting round the importance of clear objectives. Both sides need to understand clearly what the contract is about.

The importance of this to our contract managers is evident from a study which the Serco Institute has just completed. We interviewed around 150 of our contract managers, two-thirds of whom used to manage public services inside government under a traditional bureaucratic management regime.

A number of the questions related to the importance of clear performance objectives to the success of their jobs. 79% agreed or strongly agreed with the proposition that having a contract with specified outcomes gave them a much stronger sense of mission.

80% went on to tell us that these performance objectives required them to have a more detailed understanding of their business – the fact that they were being held accountable for outcomes meant that they had to have a much more intimate understanding of the linkages between inputs and outputs and outcomes, so that they could turn the business around if they failed to perform and were being penalised.

- But beyond that, it is important that there is a real sense of shared purpose – that the contract is a win-win proposition for both parties. Both sides have to believe that it is a positive sum game – that when one party profits, that it is not at the expense of the other.

To be frank, this is difficult to sustain in a long-term contract. The origins of the alliancing model are to be found in the North Sea oil industry, where the benefits of collaboration were immense. Alliancing tends to work best in construction projects, which have a relatively limited life and a focused set of objectives.

It is much harder to achieve in long-term service contracts, and it demands good design at the contract negotiation stage and deliberate management over the life of the contract.

- Successful long-term contracting requires both sides – but particularly the customer – to have realistic expectations. A partnership can be undermined from the beginning if the commissioning organisation seeks to shift risks that cannot be managed by the private sector, or

prices the contract at an unrealistic level, or sets standards of perfection in the performance regime that cannot be sustained.

- Finally, the contract model needs to be designed with a view to the desired level of flexibility. HM Treasury is saying that it now recognises that some contracts for front line services may not be suitable for PFI because of their complexity and the need for flexibility. They are not saying that these services are not suitable for contracting – just that the strict contractualism involved in PFI contracts may not be ideal for such a service. Plan for flexibility in the design of the contract up front.

**5. Contract management:** Finally, there is the stage that is perhaps most obvious and about which I propose to say the least – contract management – because by the time you get to this stage, if you have selected the wrong partner and written the wrong kind of contract, then there may be very little that good management can do.

I want to discuss this under four headings:

- Commitment – far too often contract management fails because the customer imagines that having contracted *out* the service, there is little more that they have to do than engage in some light-handed monitoring.

When he spoke to a Serco Institute seminar earlier this year, Danny Ertel told us of a major North American utility which had recently contracted out its support services – a deal worth \$300 or \$400 million – and the CEO was proposing to assign a single contract monitor. Danny and his colleagues managed to convince him to assign a team of eight.

This belief that contracting out the management of a service acquits the customer of responsibility for managing the relationship infects the private sector in North America just as much as it does the public sector in the UK.

- Of course, there must be consequences for failure to perform. Financial penalties sharpen the minds of our contract managers wonderfully. But contract managers must draw on the entire toolkit – they must look beyond the mere use of financial sanctions to the use of powerful motivational tools such as reputation.
- Communication – this is so obvious that it should not need to be said, but a failure to really communicate – often over the smallest of issues – lies at the heart of many a relationship failure.
- And finally – built a culture of cooperation and respect, where the parties develop shared values, mutual respect and openness.

**6. Conclusion:** In summary, let me return to British prisons in the late eighteenth century. Around the same time as the First Fleet was being prepared to sail to Botany Bay, the great utilitarian philosopher Jeremy Bentham was proposing an alternative solution.

He proposed to build a new prison using state-of-the-art design and construction on the bank of the Thames that he himself would manage. It was to be known as 'Panopticon'.

This is not a fascinating sideline in the history of prisons management. In fact, Panopticon provides us with the origins of modern public service contracting - because Bentham was prepared to embrace the principle that underlies all successful public service contracting – from that day to this – payment on performance.

For all of the fancy words and clever models, the message is remarkably simple: What gets measured (and rewarded) gets done.