Built to Serve: Commissioning Service-led PPPs

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1. Introduction to the Serco Institute

Serco is a public service company, listed on the London Stock Exchange, with a turnover of around £2.5bn (HK$38bn) and a staff of more than 50,000 in 30 countries around the world. More than 90% of its business lies with the public sector – running the Atomic Weapons Establishment and the National Physical Laboratory in the UK, air traffic control in the Middle East, transcontinental railways in Australia, prisons in Britain, Germany and Australia, recruitment and outplacement services for the US military, and hospital services in Britain and Hong Kong. It has been working with the Hong Kong Government since early 90s.

The Serco Institute is a corporate research institution, established 13 years ago to study competition and contracting, and (increasingly) the design of sustainable markets for public services. Over the past couple of years, we have played a major role in creating industry associations for the public services sector in the UK and Australia. And drawing on Serco's practical experience and working with the academic literature, we conduct research into the conditions for successful competition and contracting

2. Commissioning successful outcomes – a case study

I have a personal interest in good competition and contracting – my great, great grandfather was transported to Australia as a convict in the 1840s – by a private contractor.

In fact, all of the British and Irish convicts sent to Australia, starting with the First Fleet in 1787, were transported by private contractors. And for the most part, it was a system that worked well.

When my great, great grandfather was sent out in the 1840s, the death rate on his ship was less than 1%. And the mortality rate on the First Fleet was around 3%. But not everyone was so lucky. My wife's ancestor was sent out on the Second Fleet in 1791, and that had a death rate of around 40%.

Over the past month, I have spent long hours at the Public Record Office in London, poring over the original files relating to the establishment of a penal colony in New South Wales, and the contractual arrangements through which the convicts were fed, clothed and transported.

It turns out that the difference between a death rate of 3% and a death rate of 40% lies not in who delivers the service – public or private sector – but in the design and management of the contract.

The First Fleet was successful more by luck than by design, and its success was largely due to the personal intervention of the Governor of the new colony, Arthur Phillip, who acted as the de facto contract manager.

But the government was also willing to listen to Arthur Phillip's arguments for contractual amendments, and without really planning it, the government had chosen a contractor with a social conscience, one who cared how the convicts were treated.

The same cannot be said for the Second Fleet:

- The contract was a fixed price arrangement, awarded to the lowest bidder, without regard to experience or reputation.
- The successful bidders were a firm of slave traders that brought with them practices familiar to that sector.
- The contractors were rewarded not for how many healthy convicts they landed in Australia, but based on the quantity of stores they delivered.
- The contractors were allowed to sell whatever food was left over at the end of the voyage.
- And the contract monitor was a risk-averse bureaucrat who was reluctant to challenge the ships' masters, and who died part way through the voyage.

In terms of the convicts' welfare, it is difficult to imagine a worse set of performance incentives.

The government agency used to manage the contracts for the First and Second Fleets was the Navy Board – a specialist contracting agency that had done a remarkable job transporting troops and provisions during the American War of Independence.

But they had no experience whatsoever in transporting convicts, and the contract models that had worked well enough for shipping men and provisions across the Atlantic were poorly suited to sending ill-nourished convicts halfway around the world.

No real thought had been put into what kind of service the merchants were being asked to deliver, the type of contracts that should be written, the performance incentives that might be used to ensure that the prisoners were well-fed and well-treated, or the evaluation criteria that should be used to select an appropriate contractor. And little thought was given to the kind of private sector expertise that might be drawn upon to deliver these services.

The blame for this lies not with the Navy Board – which managed the procurement process professionally and in accordance with its instructions – but rather with the Home Office and the Treasury, who commissioned the Navy Board to undertake this task.

In fact, the Home Office had done a great deal of work beforehand. They had estimated a benchmark cost (or public sector comparator) for transportation and settlement. They had undertaken detailed calculations in estimating the provisions that would be required to feed and clothe 750 convicts. They had prepared a long list of tools and implements. They had consulted with botanists on the seeds that should be planted in this new land.

But they had not thought about the ultimate outcomes for this project, the challenges associated with achieving them and the kind of contractual regime that would be necessary to ensure that they were delivered.

For an expatriate Australian with a convict heritage, this is a fascinating field of study. But there are important lessons that we can all learn from this example:

(i) Public private partnerships are not new. Indeed, they have been extraordinarily common throughout history.

(ii) Competition and contracting are powerful tools, and for that reason, they must be used well. Good contracting can be used to deliver significant improvement; bad contracting can result in perverse incentives.

(iii) An exceptional contract manager can work around a poorly written contract, but it is hard work.

(iv) It is not enough that procurement is done well. There is a pre-procurement phase (increasingly known in the UK as the 'commissioning phase') where the project can won or lost.

3. The PPP market is mature

Let me turn, then, to public service contracting in the early 21st century. I have been asked to make a few remarks about public private partnerships, with particular reference to the UK which is, of course, the most developed PPP economy in the world.

The first thing that should be said about the PPP market in the UK is that it is already mature – in the 15 years since the Private Finance Initiative was launched, more than 800 deals have been signed by the UK government with a combined capital value in excess of £55bn (around HK$830bn).

The earliest PPP contracts, such as those in the custodial sector, have been operational for almost a decade, so that we already know a great deal about how well these arrangements work over the long-term.

And while we are still grappling with challenges, the evidence suggests that the government has largely accomplished what it set out to achieve.

a. *Cost savings:* On the latest information available, using the somewhat hypothetical ‘public sector comparator’ as the benchmark, construction costs have fallen by 5 to 30 percent (depending on which project and which sector we are looking at).

   The evidence on operating costs is more complicated, although where there had been little competition prior to the introduction of PFI (as in prisons), then the evidence suggests value-for-money savings in the order of 15-20 percent.

b. *Construction times:* In the prisons sector, where there was good data about the old procurement models, construction times fell by 40 percent.

c. *Optimism bias:* PPPs are highly effective in dealing with ‘optimism bias’. Prior to PFI, fewer than 30% of projects were completed on time. Under PFI, around 80% are completed early or on-time.

   Prior to PFI, around 70% of projects ran over budget. Under PFI, only one in five failed to deliver on budget, and in every case, that was driven by changes in user requirements.

d. *‘Whole of life’ asset management:* After years of talking about it, we have finally introduced ‘whole-of-life’ asset management through PFI, although we still do not have a great deal of evidence on how much difference it has made.

e. *Risk management:* We are in the process of identifying the risks associated with the procurement of complex, large-scale infrastructure, and we have developed a much more sophisticated understanding of which parties are best positioned to manage those risks. But after 15 years, this is still an ongoing process.

f. *Service innovation:* In one or two areas – prisons and, more recently, hospitals –procurement through PPPs has opened the way for innovation in the way in which public services are delivered.

Of course, there is now a significant international market for PFI and PPPs. Numerous countries around the world are experimenting with this approach to the procurement of infrastructure services.

China, India and Japan are among these countries, and their economies are of such a scale that if any one of them were to fully embrace this policy, it would alter the character of the market.

For the present, however, the elephant in the room is the United States, which has just begun to explore the market for PPPs, and thus far, has largely confined itself to one sector – tollroads. But when the Americans take up an idea, they do it in on a grand scale.

In 2004, the City of Chicago leased the Chicago Skyway for 99 years for US$1.8bn (HK$14bn). That was followed last year by a tollroad in northern Indiana, leased for US$3.9bn (HK$30bn). Recently there has been talk about the government of Pennsylvania granting a concession over its turnpike system, a deal said to be worth up to US$30bn (HK$235bn).

4. We are still learning. . .

However, to say that the PPP market in the UK is mature, is not to say that we are not still learning. Let me mention just a few of the areas where debate has been active of late:

Procurement capability: While there have been significant improvements in the capabilities of procurement officials, the complexity of projects has also increased. The National Audit Office (NAO) reported last week that the tendering process for PPP projects is still too long and expensive, that material changes are still frequently made during the preferred bidder stage, and that project teams are still not planning well enough or sharing best practice.

Operational issues: Over the past couple of years, the National Audit Office and Partnerships UK (a central government agency that specialises in advising on PPP procurement) have concentrated increasingly on the operational aspects of PPPs – how well they perform over the long haul in delivering better maintained infrastructure and better quality services.

One aspect that has been of particular interest to the NAO is the turn-around of underperforming PPPs. And there has been growing concern about the amount of flexibility that is possible in long-term service contracts and the possibility for contractual refresh.

Benchmarking & market-testing: It has been usual for PPP contracts to contain a provision requiring services to be bench-marked or market-tested after 5 or 10 years, to ensure that government is still getting value for money. The first market-testing and bench-marking processes are now being worked through and are being studied closely.

Secondary markets: One issue that has attracted significant controversy are the super-profits made when some of the very early PFI projects were refinanced. This was a short-term problem that was quickly addressed through policy changes and market adjustments.

But the increasing involvement of equity funds – welcomed at one level as a sign of a maturing market – has raised some challenging questions about the sustainability of long-term partnerships in a market where the private sector partner has a short-term financial focus.

Accounting treatment: Another of the emerging issues is the accounting treatment of PFI and PPP projects. Around half of PFIs in the UK are on-budget, and it is expected that a review of the relevant accounting standard will insist that a much larger proportion to be placed on the government's balance sheet.

New models: There has always been a great deal of diversity in PFI and PPP models, and the government has continued to push the boundaries with long-term partnerships, joint ventures and franchises, and innovative employment arrangements to protect public sector workers. It is widely recognised that government must continue to explore new models, and this is being done at a practical level, through contract negotiations, and at a conceptual level, through more theoretical studies.

5. Learning to commission

One of the most interesting developments in the field of public private partnerships – using that term in its broadest sense – lies in the growing recognition of the importance of the pre-procurement or 'commissioning' stage.

If we think of procurement as a game – a competition between a defined number of players, conducted according to an agreed set of rules – then commissioning is the process by which we decide which game we are to play, invite the players to participate and agree on the rules. (Note that, using this metaphor, the person conducting the procurement is also a player, since it is also their intention to win this game.)

To a considerable extent, 'commissioning' is what the Efficiency Unit means when it refers to the development of the business case – scoping the service, identifying and analysing alternative solutions, and developing the procurement strategy that will ensure that the services in question are actually delivered, and under the most favourable of conditions.

In the UK, 'commissioning' is still an emerging concept, and while it is being actively discussed in government White Papers and policy forums, you won't find it fully spelt out in any single document. Indeed, in some places, it is still used as a softer and more politically acceptable alternative to the word 'procurement', although this is changing.

(i) *Clarifying outcomes:* At its most basic, commissioning is concerned with understanding what outcomes government is hoping to achieve through a particular policy, and ensuring that the solution is fit for purpose. Government documents link the concept of commissioning to 'being open to using the best possible ways of securing service outcomes'.

That might include a decision to use policy instruments that are much broader than service delivery – tax concessions, grants and subsidies, vouchers, franchising, regulation and/or certification. Or it might involve managing the conditions of delivery more closely through a franchise or contract.

(ii) *Understanding the service model:* In the case of public services, successful commissioning implies an intimate understanding of the service in question – the ways in which inputs are connected to outputs and outcomes, and how different kinds of management structures (including contracts) can contribute to that particular service model.

The term 'service commissioning' has been used in this regard, referring (among other things) to the design of services in close consultation with end users and the public at large. Policy papers refer to the 'commissioning cycle' – identifying needs, planning, sourcing and performance management.

(iii) Separating what from how: Commissioning has been described as 'separating decisions about what services are required from the provision of the services'. It is associated with, but separate from, competition and contestability in the provision of these services.

(iv) Ensuring services are integrated: By distinguishing commissioning from provision in the National Offender Management Scheme (NOMS), the Home Office hopes to achieve greater integration of offender management, both across different government agencies and end-to-end across the offender's entire experience of the criminal justice system

'By doing this NOMS will be better able to ensure that the right service is provided at the right time in the right place to the right offenders.' This new policy recognises that a 'one size fits all' approach to offender management is not going to bring down re-offending rates.

(v) Designing and developing markets: Increasingly, commissioning is associated with the design and development of entirely new markets for public services – for elective surgery, children's services, offender management, the transition from welfare to work, and so on.

In other cases, it involves the reconstruction of existing markets that are no longer fit for purpose. A classic example of this is the market for waste management, which is under pressure to change because of demanding new regulatory standards coming out of Europe.

Market design is a new and extremely challenging role for public officials, since there is very little experience in the public or private sectors from which to draw – we are all on a steep learning curve.

Of course, the preparation of the business case for a particular project is one of the most important aspects of commissioning. However in the UK, we have discovered that in a relatively deep market, where the services in question are relatively complex, this function is somewhat broader than just the business case.

6. Learning to manage the market

One of the most challenging aspects of commissioning lies in managing the relationship with providers (and in a mixed economy this includes voluntary and public sector providers as well as the private sector).

The starting point lies in recognising that public service markets are not *free* markets. These are artificial markets, brought into existence to meet specific public policy ends, and governments are entitled to shape these markets to ensure that those objectives are served.

An important part of market management lies in ensuring that there is sufficient capacity on the supply side to meet government's needs. In some cases, this has involved public officials talking companies into the market – from other sectors or from other countries.

In the newly-created market for elective surgery, it was necessary for government officials to explain to British companies how they needed to change their business model in order to win contracts. (They failed on the first round of tenders and North American and South African countries won all the contracts.)

In the UK, it has been necessary for government to educate private companies over time as to what it expects in terms of workforce relations, public accountability and social responsibility. Public service companies have had to develop a public service ethos in order to succeed in these markets.

And of course, government is entitled to exclude from the market those organisations that fail to meet acceptable standards of conduct, particularly those relating to honesty and integrity. To carry this off with confidence, markets must have sufficient depth so that companies can be disciplined without destroying the market or undermining services to the public at large.

Market-management also requires public officials to understand commercial constraints. The UK government is only just beginning to recognise the severe limitations that companies face in terms of bid costs. If the probability of winning is too low, then companies are unlikely to invest large sums in developing detailed proposals. Likewise, if the model for competing and contracting services does not allow adequate scope for organisational change, then companies may be reluctant to enter the market.

It may also be necessary to regulate the rate at which projects come onto the market so that different agencies of government are not competing against each other for limited capacity and artificially driving up the price. It has been necessary for government agencies to reschedule some of their projects to fit in with plans for the London Olympics.

7. Commissioning for service innovation

When government engages with the private sector, when it commissions PPPs, we need to remember that the ultimate objective is to deliver better services, not merely to procure new infrastructure.

In a report published last year, the UK Treasury observed that it did not appear that the inclusion of 'soft services' in PPPs had delivered the same step change as contracting for construction and 'hard' facilities management (engineering maintenance and the like) had done.

If this is true – and Treasury did not provide much evidence – then it is likely that there are a number of explanations. In many cases, soft services (such as cleaning and catering in hospitals) have been subject to competition over many years. These are now very mature markets, and it would be unsurprising if the latest round of competition, bound up as part of a PPP contract, did not deliver significant further savings.

But there is another important reason why some PPPs might not have delivered the same benefits in terms of service improvement – in many cases, PPP contracts had been signed with consortia led by construction companies rather than by service companies.

Many PPPs had been commissioned as construction and FM projects, and those responsible for drawing up the rules of engagement have already locked out the opportunity for service innovation long before the procurement process has actually begun.

When we at the Serco Institute undertook some research into this question, we discovered several sectors where those undertaking the commissioning had taken a broader perspective, and in those cases, they had been able to secure significantly better service outcomes.

Prison contracting was one of the examples. In this case, government had gone to market with the specific intention of stimulating innovation in service delivery. What emerged was a very different kind of management regime, one that placed much greater emphasis on the wellbeing of the inmates, one that made a marked improvement in the decency with which prisoners are treated.

Public service companies dominated the consortia bidding for contracts, rather than construction companies, with the result that service design was placed at the heart of the solutions offered to government, rather than civil or financial engineering.

Of course, there are inevitable trade-offs, but with the service provider at the heart of the consortia, the compromises tend to be made in favour of service delivery, rather than construction costs.

The other sector where customers have begun to demand significant innovation in the service solutions is public hospitals. In one recent PFI procurement, the customer asked the bidders to develop a solution that separated the movement of people around the hospital from the movement of food and linen.

By encouraging the bidders to be innovative about their service model, the customer invited the development of a radically different approach to facilities management. The winning proposal was based on the use of robotics to deliver food and linen to the wards, and pneumatic tubes to transport samples and documentation around the hospital, a solution that has reduced costs and enabled the service company to concentrate on improving the people skills of its porters (since they now spending their time moving people rather than trolleys). Of course, it has also improved the lives of staff, patients and visitors, since they are no longer competing with trolleys in the aisles and corridors.

8. Where is the source of innovation?

In conclusion, let me challenge you with two thoughts: The first is to ask, ‘What is the source of innovation and competitive advantage in your market?’

Which part of the private sector is leading the consortia that are bidding for your PPP contracts – are they financial engineers, construction companies, property developers or service providers? Because that will tell you where the risks currently lie in your market, and where the significant innovation is taking place.

Now ask yourself whether that is where you *really* want the innovation to be taking place as a result of your engagement with the private sector.

For many years, the Australian PPP market has been dominated by investment banks, because under the contracts that governments were commissioning, the real source of competitive advantage lay in financial engineering.

In the Japanese market, consortia have been dominated by the construction partners, since the opportunities that were coming to market were largely ‘box PFIs’ (as they call them) – the real challenge lies in designing and building a better box.

As I understand it, the Hong Kong PPP market has been dominated by the property industry, because of the particular role that real estate plays in this economy. The winner’s competitive advantage will probably lie in innovative planning arrangements rather than groundbreaking service solutions.

My first challenge, then, is to ask you where you would like the real innovation to be taking place.

If the market believes that the government's real objective is to find new approaches to the delivery of public services – if they believe that that is where the real source of competitive advantage lies – then the winning consortia will typically be led by service providers.

This is a matter over which government has a choice. This is not a *free* market. It is *your* market. And depending on the decisions that you make in the commissioning phase, it can be a financial market, a construction market, a real estate market, or it can be a market for infrastructure services.

The kind of game that you design (intentionally or by default) will determine the qualities of the players that turn up to play.

9. Hong Kong infrastructure abroad

My second challenge is to ask whether you have thought about exporting your public infrastructure abroad – your bridges and tunnels, your hospitals and schools, your prisons and leisure facilities.

Of course, you can't actually export a tunnel or a prison. But what you can do – what a number of overseas countries have done already – is to unbundle the various service components that help to make up the physical infrastructure, and to make it possible for those services to be sold abroad.

Let me explain what I mean. A road or a tunnel doesn't just consist of cement, steel and tarmac. Someone has to put all of the pieces together in a way that delivers value for money.

The road has to be designed in the first place – so that civil engineering skills are involved; construction has to be planned and supervised – so that project management skills will be required; funding must be found; the facility must be maintained throughout its lifetime; and if it is a tollroad, then someone will have to manage the interface with the road user, among other things, convincing them of the advantages of paying for the use of this particular road.

Starting in the late 1980s, Australian governments have been extraordinarily successful at unbundling their roads infrastructure, developing a domestic infrastructure services industry and making it possible for several of the leading providers to export their models abroad.

The most successful of these has been Macquarie Bank, which has gone from being a small regional investment bank to become the dominant player in the European and North American markets for tollroad financing.

Transurban is another Australian success story, having created a new model of tollroad management based on direct interface with road users, and now successfully exporting that model to the United States.

Hong Kong was one of the pioneers in PPP tollroads, starting as long ago as the 1970s with tunnels that were privately designed, built and managed. Why is a Hong Kong bank not dominating PPP road financing around the world? It has nothing at all to do with market size – the Australian tollroads industry has been largely driven by the Sydney market, which is somewhat smaller than Hong Kong.

The answer lies in the opportunity that was created by government in unbundling its physical infrastructure and creating a predictable stream over new opportunities over time.

Look at PPP markets around the world – using the term PPP in its broadest sense – and you will find that there is a 'first mover advantage' in this area – those countries that developed these capabilities first gave their companies a significant competitive advantage in overseas markets.

Even today, the international water industry is dominated by French and British companies, because those countries moved first. The French water companies were investing heavily in membrane technology in the 1980s, at a time when publicly-owned water utilities around the world were struggling to find capital just to maintain existing facilities.

The Americans dominated the market for PPP prisons in the early years, simply because they had moved first. In recent years, they have been largely supplanted by British companies who seem to have a model that is more easily transferable abroad.

I would challenge you to transform the way that you think about PPPs. This is not just about value for money. PPPs are not just a tool for delivering capital projects on time and on budget.

Rather, they provide the Hong Kong government with the opportunity to unbundle the capabilities that lie buried within its infrastructure services sector, to stimulate investment in the development of those capabilities, and prepare Hong Kong business to take advantage of the immense market opportunity that is developing just across the water.

Looked at from that perspective, might I be so bold as to suggest that when you are developing your business case for PPPs, in addition to considering the immediate value-for-money benefits to the Hong Kong government, you might also think about the long-term benefits for the Hong Kong economy as a whole.