

‘A Contractor’s Perspective on Dealing with Change’

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Serco comes to this issue as a public service provider. More than 90% of our business is with government. And unlike many of our competitors, we are often engaged in delivering front-line services across a wide range of sectors -- health, education, justice, transport, science, defence and local government.

We are engaged in close partnerships with government in managing Local Education Authorities at Bradford and Walsall; the Atomic Weapons Establishment at Aldermaston and the National Physical Laboratory at Teddington; Docklands Light Rail, Manchester Metrolink and Merseyrail; five prisons from Bristol to Glasgow and half of the country’s home detention scheme; the Manchester Aquatic Centre, and 50 other leisure centres across the country.

We provide key services for the nation’s traffic management system, the ballistic missile early warning system, and police engaged in the fight against serious organised crime. We provide support to the joint services staff college at Shrivenham, NHS hospitals at Norwich and Wishaw, and local authorities at Winchester and Woking.

We have a number of service contracts that will last for thirty years. The oldest of our contracts – the ballistic missile early warning system – we have been operating for more than forty years. We understand the challenges of coping with change in long-term contracts.

Change is a fact of life, as we all know. I recently returned to my old University and was chatting to my ex-economics teacher. I asked to see the exam papers being used today, and was quite surprised to find that they were exactly the same ones that I had answered years ago. When I asked about this, I was told, “Chris, the questions are always the same – only the answers change”.

An economics professor is a surprising source of philosophy, I know, but the sentiment is no more true than in the delivery of efficient and effective public services – the question remains the same, only the answers change, and in speaking to the question of managing change, I want to emphasise three key points:

- Firstly, change is inevitable and it is good. Change implies innovation and flexibility, a recognition of reality.

- The one exception to this is during the bidding process. Here change results in delay and indecision, driving up costs for the taxpayer, reducing competition and encouraging what economists refer to as ‘gaming behaviour’ on the part of suppliers.
- Throughout the operation of a contract, change should be anticipated, not written out of the contract – by purchasing outputs not inputs, by demanding high standards but not unerring perfection, and by building partnership into the framework of the contract.

1. Change is inevitable

Let me begin with the first of these – change is inevitable and good.

According to lawyers, contracting is about specifying obligations in advance, so that change is avoided. According to neo-classical economists, my only interest in contractual change should be to realise short-term profits.

The reality, as we all know, is that in PFI and PPP contracts, change is a constant, and that, by and large, it is accomplished to the mutual satisfaction of both customer and contractor. (You may recall that the NAO’s survey in 2001 showed that, at that early stage, 55% of authorities had already used change procedures to update their PFI contracts.)

There are several good reasons why in public service contracting, change is a constant:

- a. The first and most obvious is that *the world outside of the contract keeps changing*. A fortune-teller once told me, ‘Predicting the future is easy; it’s getting it right that’s hard’.

Service contracts can last for as long as thirty years, so it is inevitable that the contract will need to adapt to economic, political and policy disturbances. Over such a long period, issues of affordability can arise (on either side), management priorities can change, underlying policy assumptions can shift. Change will happen and not all of it can be anticipated and specified in advance.

At RAF Fylingdales – the ballistic missile early warning system – we have provided facilities management and technical support since the facility was first opened in 1963. The entire project – then involving three large mechanical radars monitoring space traffic to the north and east of the UK – was developed over a remarkably short period of time following the launch of Sputnik 1 in October 1957.

It progressed through successive re-bids and technical upgrades until the early 1990s when, with the advent of submarine-based missile launch capabilities, a single ‘solid state phased array radar’ was introduced with 360 degree coverage.

b. A second explanation for the ubiquity of change is *the sheer complexity of service delivery*. This can make it difficult for customers and contractors to fully model the service that is really required, so that some adjustment will always be needed.

As the NAO's recent report on the London Underground PPP demonstrates, it can become very expensive to model the performance regime in fine detail from the outset. It makes a lot more sense to build some flexibility, some room for learning into the contractual framework.

c. And finally, the innovative nature of public service contracting in the UK means that *we are forever breaking new ground*. It is unsurprising that sometimes we have to come back and revisit whether we have the best solution.

So the world keeps changing, customers and contractors are trying to deliver extremely complex solutions and in so doing we are breaking new ground. It is hardly surprising therefore that *change is inevitable* – it enables the customer and supplier to continue to match delivery with demand in an environment of constant change.

2. During procurement, change is expensive

Having said that, significant change during the bid process is costly and therefore not in the interests of the potential customer or potential contractors.

The UK can proudly proclaim to be at the leading edge of public private partnerships, and we have been keenly promoting the UK model overseas – with a large amount of success. Unfortunately, our procurement processes have not always matched the demands that we have placed on them. The result is that the UK risks losing global credibility and seriously undermining value for money.

In a number of markets, procurement behaviour has become increasingly unpredictable. The degree of delay, indecision and gaming behaviour that we are starting to see in public sector tenders is unprecedented – and Serco's experience goes back forty years.

If you look back over the past ten years, there has been a series of government reports that have recognised this problem. And not only has the position not improved, but there is a real risk that delay and indecision are coming to be accepted as the norm in large and complex bids. The consequences of this for suppliers are serious enough, but consider what it means for government:

a. Firstly *bid costs have increased dramatically*. Bidding is now one of our largest and most closely-monitored lines of spending. I recently reviewed the top ten bids we have submitted over the last couple of years, with a

combined value of £8bn. Every one of the projects has been delayed substantially, sometimes by up to 2 years.

Many of you will be familiar with the tender for the Colchester Garrison which was finally signed in February this year. It was locked at the preferred bidder phase for more than four years – longer than it took for us to fight the First World War.

Bid costs are eventually paid by the customer and the taxpayer – either explicitly through a ‘winner pays loser’ mechanism (after which the winner adds it to their price) or indirectly through increases in the market’s cost base.

b. Secondly, *bid costs have become more uncertain*. Delay involves additional cost, but it also means additional uncertainty about future bid costs. This has a number of impacts, among them a tendency for suppliers to become far more selective in their bidding. The result is that the supply market will thin. Competitiveness will suffer, as will value for money. In some cases, we may see competitions collapse completely.

We have already seen several examples of competition thinning out, so that customers are left with only one or two companies in the race. There has been a tendency on the part of government to ascribe this to market capacity, and while that may be part of the problem, let me say from a contractor’s perspective, that the quality of bid processes has also played a significant part.

c. Finally, in some markets, the emphasis of bid evaluation seems to have shifted quite substantially towards cost and risk transfer and away from purchasing service quality. As a result, we have seen, and we will continue to see, *gaming behaviour* as some suppliers do their best to ‘hide’ services they know are required just to cut out the last pound of cost. Suppliers are encouraged to deliberately underbid in the expectation that they will be able to make up the difference during the preferred bidder phase or through variations after contract award. Such an approach inevitably damages the market and will ultimately harm the customer.

Therefore let me repeat, change is good but please, not during the bidding phase. We recognise that experience is different sector by sector. We welcome the initiatives that the OGC, Partnerships UK and other specialist procurement units have taken in an attempt to improve the situation but we remain unconvinced that significant improvements are likely to be made soon.

3. *During operations, change should be anticipated*

Many of our bids do make it to a decision point, they are signed and become operational. Given that change is inevitable, given that it's something we should welcome, how can we prepare for change in the way we structure the contract?

There are a number of different mechanisms for ensuring that change takes place without either party suffering unduly, and time does not permit me to do more than refer to some of the key ones here:

- contract for outputs not inputs;
- demand partnership, formally as well as informally;
- contract for high performance not perfection;
- and finally ensure that your partners have a real public service ethos and shared set of values.

Let me dwell on some of these for a moment:

a. One approach lies in *specifying outcomes or high-level outputs* in the contract rather than prescribing detailed inputs – in other words, describing what it is that's actually required. This leaves the contractor free to experiment with different service models and adapt as circumstances change.

Looking at our contract base in recent years, we have generally seen a shift in the direction of output-based performance criteria. However, in contracts where there is great uncertainty about the service model (for example where a service is being contracted for the first time), it is not unusual for customers to specify input criteria at the outset and to develop output criteria over time, as both sides develop confidence.

b. Another approach is to *build partnership into the contractual framework*. And I don't mean the kind of partnership described by Quentin Crisp who said that 'any partnership demands that we give and give and give and at the last, as we flop into our graves exhausted, we are told that we didn't give enough'.

Partnership is what Samuel Pepys was talking about when he wrote three hundred years (about naval contracting): 'My work is likeliest to be best done by him whose profit is increased by the well doing of it without increase of charge to me that employs him.'

An outstanding example of real partnership is a major contract we have with the Ministry of Defence. This contract is underpinned by a high-level 'partnering agreement', which spells out the joint values and objectives, and the underlying principles of the relationship. The memorandum assigns roles and responsibilities, with the MOD monitoring and evaluating outputs and the contractor managing inputs.

It also spells out some of the behaviours that are essential if a relational contract of this kind is to succeed - active listening, information transparency and adopting a no-blame culture (for example).

In this case, the contractor identifies the *key performance measures* out of all those measures that support its strategic plan, and these are negotiated with the customer and formally agreed. And while there is continuity in this measurement regime so as to compare performance over time, it is reviewed and renegotiated on an annual basis.

We have a number of contracts where the performance regime is renegotiated or reviewed regularly in this way. This means that a great deal less effort has to be invested into anticipating and negotiating the contractual conditions for events that will occur five or ten years in the future.

c. I look also for *contractual criteria that are not tuned to near-perfect performance*, so that it is possible to recover from error. Of course, there must be consequences for the failure to meet performance targets, but if there is no possibility of recovery, then the contract has created perverse incentives with the contractor shifting focus away from service delivery to loss containment.

Imagine working in a job where every mistake is penalised heavily, but every instance of innovation, partnership or high performance is accepted without reward. It isn't pleasant and funnily enough it doesn't provide value for money either.

In one recent bid, the performance regime was so harsh that millions of pounds of extra cost had to be injected into the model to pay for penalties that would be expected under even a high-performance scenario. A punitive regime of this kind will result in a higher costs to the taxpayer and poorer services to the end-user.

d. And finally, *there should be an explicit focus on finding partners with shared values*.

A large number of Serco's staff have worked at some time in the public sector. Our Serco Institute is partway through a research project, interviewing former public sector managers who are now performing similar jobs in the private sector. We are looking at senior managers in fields as diverse as education, and transportation, science and corrections. What we are exploring with these men and women is what is different about the two environments.

And one of the most striking findings so far is what's the same – the people and the values. Every one of these people has expressed a deep sense of vocation. Of course, they have strong commercial imperatives that were not previously part of their jobs, but they have made it clear that they would not let that compromise the service that they owe to their clients.

Of course, that shared sense of vocation, that community of interest does not guarantee that customer and contractor will be able to overcome their differences, but it certainly makes a difference.

One example in this country is the custodial sector, where the Prison Service (now the Home Office) has assisted in the creation of a market that is as much about service quality as it is about cost efficiency. Yes, the Home Office has designed its contracts and selected and managed its contractors with service quality at the front of its mind. But it is also because public and private prison directors have a common professional background.

Martin Narey sometimes complains about the number of senior managers he has lost, but I believe that the transfer of highly professional prison governors from the public to the private sector has made a huge contribution to the two sectors having a common culture.

So that when the Home Office needed to refresh its prison contracts to reflect recent changes in corrections policy, it found that the contractors were not only willing to cooperate but were enthusiastic about updating the performance regimes.

So I would repeat, change can be managed successfully, as long as we are both focused on outputs, have formally adopted and recognised the importance of partnership, aim for high-level performance but not for perfection and make sure that we share a similar set of values

4. Conclusion

Firstly, *change is inevitable*. It is impossible to predict the future accurately, and any attempt to tie down the government customer or the service solution in an environment of change would be most unwise. . .

. . . except during bidding. *Procurement behaviour is becoming increasingly unpredictable* and the subsequent change, delay and indecision that is beginning to characterise the UK market is not good value for the taxpayer.

In designing a contractual framework and in managing the contract, change should be anticipated. There are ways of crafting contracts and relationships that will enable them to flex as change occurs.

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