

**‘The Operator’s Perspective on Risk and Uncertainty
in Long-Term Contracts’**

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1. Introduction

Serco has been providing public services for more than forty years now. Today we are engaged in delivering front-line services across a wide range of sectors – health, education, justice, transport, science, defence and local government – in 36 countries around the world.

Over that time we have seen contract terms expand from three to five years in length to around ten years in the case of purely service contracts, and up to thirty years in the case of PFI/PPP contracts.

We have also seen a great deal of change in the amount of risk transfer – the extent to which the customer tries to specify the future, often years in advance, in a tightly-worded contract.

Our oldest contract – providing facilities management and technical support for Britain’s ballistic missile early warning system – has been held for more than four decades through successive rebids.

Each of these were relatively short-term contracts, so there has been significant scope for contractual refresh and the adjustment of risk and reward through a series of tenders and negotiations.

On the other hand, one of our hospital PFI contracts, signed in the past five years, has a thirty year service contract, with the option of another thirty.

Needless to say, a contract of this length raises significant questions about the ongoing relevance of performance requirements. And no doubt, our customers are also concerned about our responsiveness to their changing needs.

As a service provider, our interest in PFI and PPP contracts is somewhat different from other private sector participants.

Typically, construction companies will not be engaged in the day-to-day management of the facility after the first few years.

And while finance companies will be concerned about operational performance and may even choose to intervene where profitability is at risk,

typically, they do not see themselves as committed to service delivery over the life of the contract.

The service provider, on the other hand, is engaged with the customer for the duration. For us, it is not just a transaction or a project – it is an ongoing commitment to deliver services, day in and day out, for the ten, fifteen or thirty years of the contract.

It is understandable, then, that we will be acutely concerned about the allocation of operational risks.

We will worry about how the external environment of the contract may change throughout its life.

And we pay a great deal of attention to the ways in which government seeks to manage this uncertainty.

2. Reasons for uncertainty

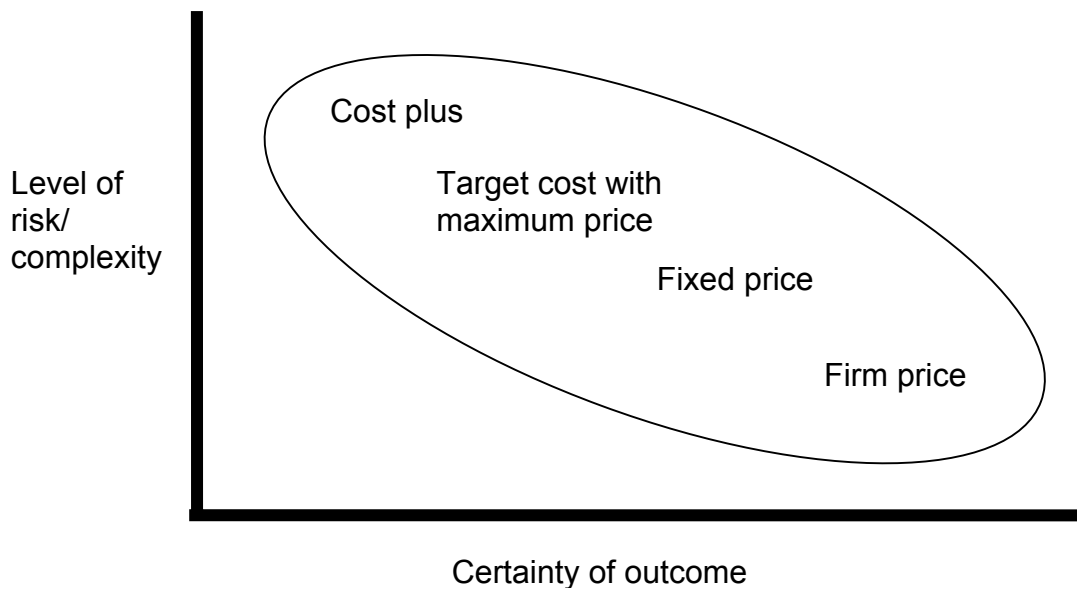
I sometimes get the impression that government officials feel embarrassed about their inability to specify detailed contract conditions years in advance. They don't need to be.

One of the brute facts of good contracting is that the world is uncertain and that there is a trade-off between certainty of outcome and the amount of risk that can be transferred.

Research over many years into US defence procurement has shown that cost-reimbursement contracts are much more common in the early stages of the procurement life cycle and in contracts for high-technology and non-standard equipment.

And two weeks ago – in a report on major defence contracts – the Public Accounts Committee of the House of Commons illustrated this trade-off between certainty and risk transfer.

Their diagram recognises that fixed price contracts (and thus significant risk transfer) works best where there is high certainty of outcome and low levels of complexity.



What accounts for this uncertainty?

(i) No one can know the future that far in advance

It is impossible to know the future 30 years in advance, and it is foolish to write contracts as though we can.

Policymakers may not understand this simple point, but public service providers most certainly do. In a recent focus group on PPPs, the principal of a UK secondary school spoke of his anxiety about mortgaging his school's future. As he expressed it:

‘It seems to me that if you do not get the initial negotiations right and the terms of the contract absolutely spot on at the very beginning, you are tied into something you may not want to be in, for a very long time.’

In fact, there has been a surprising amount of flexibility in PFI/PPP contracts. The UK Treasury last year reported that one in every four PFI contracts has been adjusted during the construction period to take account of changes in scope required by the customer.

And if change is necessary through the construction phase, how much more inevitable is it that change will be required throughout the 30 year life of the service contract.

(ii) Contracts have to be signed without complete knowledge

In the real world, because of time and cost pressures, it is often necessary (and absolutely correct) to sign a contract without a complete understanding about precisely how the service model works and thus how the contractual performance regime should be structured.

To sign a fixed price contract under these conditions can be very expensive, both in terms of bid costs and risk premiums.

Those responsible for commissioning public services need to acknowledge these real-world limitations and design contract models that leave room for learning (on both sides).

(iii) Many of the newer PPPs are inherently complex

In the United Kingdom, we have seen the emergence of much greater complexity in contracting opportunities – complexity in terms of scale and scope, the number of clients and stakeholders, and the level of accountability to end-users.

Failure to acknowledge and manage this complexity can result in extensive delays to bid timetables and a much greater risk of failure.

In its recent report on defence contracting, the Public Accounts Committee observed that ‘long-term fixed price contracts covering development and production for complex defence equipment programmes [are] not workable’.

And this principle applies just as much to complex and long-term service contracts. Earlier this year, the National Audit Office reported on the 30-year PPP contracts for the London Underground.

It concluded that the scale of the work, the attempt to shift risk through output-based contracts and the limited understanding of the condition of the existing infrastructure had resulted in a delay of several years in signing the contracts and massive increases in bid costs.

(iv) The world changes

Finally, change is inevitable. In a public service environment, we should expect that even with relatively short-term contracts, changes will be necessary to take account of technological, political, economic and policy disturbances.

Again, there is nothing to apologise for here. The UK Treasury argued in a major report last year that departments should pull back from using PFI in technology contracts where ‘the fast pace of change makes it difficult for the public sector to effectively define the outputs it requires in a long-term contract.’

Surely the same principle applies in services where there is significant fluidity in the economic or policy environment.

3. Contracting for uncertainty

So how do we manage this uncertainty? The starting point, I would argue is not to wish it away (or rather, to attempt to contract it away).

PFI has been an extremely powerful tool for delivering better procurement of public assets. It has forced procurement authorities to face up to the whole-of-life costs of new public infrastructure. It has demanded much more effective cost-benefit analysis. And it has stimulated a highly informative debate over the allocation of risk.

But with complex and innovative projects, there are limits to what can be known up-front and the extent to which risk can be shifted to private partners. And where government has attempted to push that boundary too far, it has wound up with precisely those problems that PFI was meant to avoid – project delays and cost overruns.

How, then, does government contract for uncertainty?

1. Service providers must be fully engaged throughout the procurement cycle

The solutions start well before the contract is signed. If these uncertainties are to be intelligently managed, contractors must be intelligently engaged throughout the procurement process.

(i) This starts with early engagement of potential suppliers at a stage when the service requirements are still being defined – a stage prior to formal procurement that some have referred to as the ‘commissioning’ phase. European procurement law recognises that there is a place for ‘competitive dialogue’ at this early stage.

However, this commissioning function may continue in parallel with the actual procurement. In complex and lengthy procurements, high-level governance and policy questions may be revisited throughout the tendering process, as new risks are identified and new external challenges emerge.

At the moment, these commissioning-level issues intrude into the actual procurement process in an ad hoc way, resulting in projects being delayed, altered and in some cases, entirely abandoned without proper consultation with industry.

The cost to government and industry, and the damage to the integrity of the procurement process, are immense.

The question needs to be asked whether it might not be possible to engage bidders at this commissioning level throughout the course of an ongoing procurement, without compromising the formality of the actual procurement.

(ii) In the UK, customers have also begun to adopt risk management techniques throughout the procurement process. This has the effect of

reducing the level of uncertainty due to a failure of customer and contractor to understand each other's models.

For example, in a recent competition for the electronic monitoring of prisoners on home detention, the customer prepared a risk register on the operational solution of each of the bidders, and provided them with an opportunity to deal with those risks that were likely to prevent them winning the bid.

Instead of engaging with us in an extremely formal and legalistic manner at the BAFO ('Best and Final Offer') stage, they entered into a dialogue with us (and our competitors).

This enabled us to understand the customer's requirements properly, rather than being forced to guess.

And it enabled the customer to understand the details of our service solution, in part by enabling us to submit discussion papers explaining the implications of particular elements.

The technology solution was checked by a separate team, with field tests and a similar kind of risk register.

This was vastly superior to the procurement that is outsourced to external consultants with very little knowledge of the service in question, who conduct the process according to an extremely rigid set of rules.

(iii) Another way of reducing uncertainty is to break the procurement process into several phases, as the UK Ministry of Defence does with its 'smart acquisition' methodology.

In the procurement of defence equipment, the MOD has a rule of thumb that up to 15 percent of initial procurement costs should be spent in an assessment phase, as a way of reducing risk prior to demonstration and manufacture.

This is a rather obvious innovation – one that has been used on and off for many years now – and yet the MOD is spending less than 5 percent, on average, in the assessment phase.

And there are major technology procurements elsewhere in government that have been conducted as traditional PFIs, that should have used this approach.

2. Contracts must be written with a view to flexibility in implementation and interpretation

The second stage at which uncertainty can be managed is in the negotiation of the contract itself. Contracts need to be written with a view to flexibility in implementation and interpretation.

(i) Cost-reimbursement pricing is an extreme form of flexibility, where the customer is obliged to carry a significant amount of the risk on cost control, and typically it will be used where there are high levels of uncertainty.

(ii) Profit and cost-sharing arrangements are now much more common in the UK, with the contract setting a target cost that is in the mid-range and both parties sharing both the upside and downside risk.

Both these models – cost-reimbursement and target cost – demand a high level of transparency on the part of the contractor.

(iii) Performance-based contracts are another way of managing uncertainty, with the contractor being paid a fixed price (and/or an availability/usage fee), with additional payments or deductions depending on performance against measures agreed at the outset.

Again, the customer has significant freedom in the design of performance regimes, depending on how well the service model – the linkage between inputs and outcomes – is understood.

If the customer wants to manage the risks associated with service design, then it will contract for input or low-level outputs; if it is willing to shift that risk to the contractor, then it will contract for high-level outputs or outcomes.

(iv) Another way around the uncertainty associated with long-term service contracting is for government to insert periodic break clauses, when the terms of the contract can be reviewed.

In the case of the London Underground PPPs – which are nominally for 30 years – contractual commitments on price and performance have been made for only 7.5 years. As the National Audit Office reported:

‘This was because there was limited information available about the condition of some of LUL’s assets, and no one had experience of pricing against output specifications for such a large and extended programme of work. In addition, LUL wished to retain flexibility to re-specify its output requirements on a periodic basis.’

It is not unusual now to see contracts with a clause allowing for the review of the contract twelve months or two years after signing. This enables both parties to develop an understanding of the risks associated with the service before signing an ironclad agreement.

In the United Kingdom, we have two similar contracts to turn around failing public services. Contract A is performing exceptionally well in terms of service outcomes and delivering acceptable returns; Contract B is turning around more slowly, and for that reason is performing much less well in financial terms.

The challenges are roughly the same. And the company is the same. What accounts for the difference in performance?

The major difference, as we see it, lies in the structure of the contracts – Contract A uses a more flexible contracting model and performance regime compared to Contract B.

For example, at Contract B, the performance measures were negotiated at a time when very little was known – on either side – about the delivery of the service in question, and they are set five years in advance.

In the case of Contract A, only a small part of the service was contracted to begin with – although this was more by accident than design. But this enabled both parties to study the issues associated with performance improvement before writing the larger contract. Moreover, targets are set every year based on the previous year's performance.

Contract A has a flexibility that enables the service to be tailored to meet local need.

(v) Government can also plan for uncertainty and change by building partnership into the contractual framework.

An outstanding example of this is a major contract we have in the UK defence sector. The contract is underpinned by a high-level 'partnering agreement', which spells out the joint values and objectives and the underlying principles of the relationship.

A memorandum of understanding assigns roles and responsibilities, with the Ministry of Defence 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, informational transparency and a no-blame culture (for example).

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

3. Successful long-term contracts depend heavily on the quality of long-term relationships

Sometimes it is not possible to anticipate the need for change and build this into the contractual model. In that case, customer and contractor have to renegotiate the basic structure of the contract mid-term.

Contrary to what academic economists have predicted, this is being accomplished with long-term contracts such as prison PFIs.

The Home Office has recently renegotiated these contracts after only several years of operation, to take into account changes in the government's overall performance management regime for the custodial sector.

We are also in discussion with the Home Office about refreshing the contract for an industrial prison which we manage. Changes in government policy have placed a much greater emphasis on education rather than employment, so that we find ourselves delivering a service that is fully compliant with our contractual requirements but out of step with current government policy.

What are the conditions that enable this kind of flexibility?

It helps if there is a shared sense of mission, a sharing of expectations and knowledge, a preparedness on both sides to 'open the books', and a willingness to communicate about the triumphs and share the challenges.

Both sides must believe that the other is committed to the relationship. Both sides need to feel that they are getting a fair deal out of existing contracts. The great English parliamentarian and philosopher Edmund Burke told the House of Commons in 1780 that 'an honourable and fair profit is the best security against avarice and rapacity.'

There must be give and take. Negotiations must take place in a genuine spirit of reciprocity. And not unlike human beings, organisations are more inclined to be responsive and responsible when they are part of an organic community.

When they are engaged in repeat business with the same suppliers, customers are able to learn from their mistakes and improve the quality of contractors' performance.

Likewise, when suppliers believe that they are likely to encounter the same customer again in future procurements, they will be more inclined to cooperate and pay greater attention to their reputation.

4. Conclusion

Lest there be any misunderstanding, let me say that PFI and PPP contracts have delivered huge public benefits in terms of the clarification of uncertainties associated with large-scale asset procurements.

Treasury has obtained much greater certainty about the true costs and benefits of new infrastructure over the entire life of the assets, and it has provoked a robust debate over the allocation of risk.

But there are limits as to how much certainty we can bring into a contract that has a thirty year time horizon.

Where complex public services are being delivered in a highly changeable environment, government needs to work with its contractors to secure more flexible models.