

OUTSOURCING OF PUBLIC SERVICES IN AUSTRALIA: SEVEN CASE STUDIES

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ABSTRACT

The paper starts with a brief introduction to the main principles of outsourcing and a description of the recent history of outsourcing in the two largest states, New South Wales and Victoria. The main part of the paper then describes seven case studies which exemplify the process and possible outcomes of outsourcing. The case studies are not randomly selected. Indeed reported results of outsourcing are likely to be biased towards success stories because governments usually suppress poor results. Consistent with other studies, in five of the reported case studies, outsourcing cut costs or raised the quality of services, or both. These examples indicate that there are significant potential gains from outsourcing. However, the potential gains are not always achieved. To achieve these gains, contracting out often requires significant structural reform of an organization and always requires detailed planning and ongoing agency commitment. As the other two case studies show, with poor management contracting-out can produce expensive outcomes or major service failures.

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1 Introduction

This paper discusses the outsourcing of public services in Australia with the main focus on New South Wales (NSW) and Victoria. Outsourcing is the purchase of goods or services previously provided internally in an organization. The paper focuses on outsourcing the delivery of recurrent services that are financed by government. It does not discuss contracting out of capital works.

The paper starts with a brief discussion of the principles of outsourcing. There follows a brief history of contracting out the delivery of public services in New South Wales and Victoria. The following sections describe seven outsourcing case studies, including four cases that may be considered successful, one where the results are mixed, and two where there have been significant costs or other problems.

2 Principles of Outsourcing

There are two main economic arguments for the in-house supply of public services — exploiting economies of scale and minimising transaction costs. Economies of scale provided the traditional basis for public production. If there were only one supplier of a good, competition would not be feasible and could not provide lower production costs. However, it is now recognised that, even if there is a sole supplier, a competitive auction for the *right to provide* this supply may produce significant cost savings. Competition can be combined with economy of scale and private sector supply.

Transaction costs are the costs of negotiating, monitoring and enforcing contracts. Public officials cannot keep constant surveillance over private firms. Firms may take advantage of this lack of surveillance by not fulfilling their contracts or by exploiting loopholes in their contracts to cut services or to seek extra payments. In contrast, the continuous and vertically integrated nature of government organisation reduces the need for regular formal contracts, transaction and monitoring costs (Khursheed and Borcharding, 1998). When it is hard to describe and measure services, the link between effort and reward, which is a characteristic of competition, is weakened and contracting increases transaction costs.

On the other hand, the public sector suffers from various structural problems, such as rigid appointment procedures and wage setting. The public sector tends consequently to be less flexible, innovative and efficient than the private sector. As Lundsgaard (2002) points out, contracting has other organisational advantages.

- It focuses the attention of service suppliers on core objectives and user needs;
- It provides suppliers with clear incentives to operate efficiently;
- It reveals best practices so that slack cannot be hidden;
- It makes budget constraints harder.

Thus, even allowing for transaction costs, private delivery may be lower cost than public delivery. Moreover, competition between suppliers ensures that the most cost-effective means of production can be obtained. Competitive tendering introduces competition even when only one supplier is selected. Contracting encourages clear specification of the services required, passes the risks associated with service delivery to the contractor, and allows the public service to focus on providing a slimmer set of in-house services.

There is considerable evidence that the private sector generally supplies services at lower cost than the public. Borchering et al. (1982) provided a detailed review of comparative studies of public and private costs in 52 studies of productive efficiency in 19 economic sectors in five OECD countries, mainly in Germany and the US. The authors concluded that in 40 of the studies, private supply was 'unequivocally more efficient'. Only in three cases was public supply less costly than private. Khursheed and Borchering (1998) cite many studies of the cost advantages of the private sector from the 1970s and 1980s. Lundsgaard (2002) and Bailey (2002) provide more recent case studies. These results show that competitive contracting of services traditionally supplied by the public sector, such as waste collection, office and street cleaning, water supply, printing, and road and park maintenance, produced large savings often of 20 per cent or more.

In general, work is contracted out most efficiently when the key elements of supply (quantity, quality, delivery times and so on) can be precisely specified and when the transaction and monitoring costs are low. Preferably, the service can be regularly competed for. Thus contracting for services works well for relatively routine services, such as street or office cleaning, vehicle maintenance, printing, and waste collection, for which complete contracts can be written. Experience has shown that contracting can also work efficiently for more complex services such as property maintenance, construction of roads, hospitals and schools, prison management, and management of recreational and sporting facilities. It may also work well for specialised services such as architectural design, traffic modelling, or some policy advice, which can be contracted on an as need basis. Indeed the scope of contracting for services is very large indeed. Contracting for services is not likely to be efficient when contracts are vague and incomplete because of the many contingencies that have to be allowed for.

3 Outsourcing in New South Wales and Victoria

New South Wales State Government

Following its election in 1988, the Liberal-National Party Coalition state government introduced a series of reforms aimed at improving public sector management and increasing efficiency. It opened monopoly public services to private competition, and gave greater autonomy and accountability to its agencies. Contracting-out was a core part of this program, especially for budget-funded agencies where there was a lack of effective measure of financial performance. Government trading enterprises (GTEs) outside the budget sector were expected to be motivated by the required rate of return on assets to implement contracting at efficient levels in any case.

The Government required all agencies to evaluate the suitability of each function for market testing and contracting. Agencies would retain the savings achieved by contracting. Contracting progress and savings targets were monitored in annual surveys. Costing Guidelines were issued, case studies published and research commissioned to assess results and identify areas for improvement. The private sector was invited to propose innovative approaches to meet public sector needs. The central agencies (NSW Treasury and Premier's Department) were given responsibility for promoting contracting initiatives. NSW Treasury (1993) published principles for outsourcing services (see Appendix).

In 1995, the newly elected Labor government announced its continuing commitment to Service Competition Policy in its June 1995 Financial Statement. It broadly adopted the Coalition government's outsourcing policy with the following two additional provisions:

- the essential factor is the pursuit of best value for money rather than adoption of particular means to achieving that end, and
- market testing should include testing in-house performance against market offerings. Tenders should be invited only where efforts to improve in-house performance have not shown clear potential for substantial benefits.

The new government set up an Office of the Council of the Cost of Government to provide research and information to departments.

However, the government did not promote contract and market testing and, after an initial survey (*1996 Survey Findings*), stopped monitoring the progress and related savings. In 1997 the Government issued *Service Competition Guidelines*, with inputs from the Labor Council and public sector unions. These *Guidelines* gave protection of public sector employment a high priority and, where activities were to be contracted out, contractors who offered comparable employment to displaced staff would be preferred. Some services that were then contracted out are now provided again in-house.

The current government focuses on shared service arrangements between government agencies, particularly for corporate support and information technology services, to increase productivity and achieve savings. Agencies are directed to buy services from other government service providers. Some agencies have been established specifically for this purpose. Government-wide service agreements are encouraged.

Surveys of contracting in NSW between 1993 and 1996 (such as Domberger and Hall, 1996; NSW Treasury, 1997) revealed that:

- Between 1994/95 and 1995/96, expenditure on contracting in the budget sector increased from \$966 million to \$1762 million and the number of contracts more than doubled from 13,852 to 28,479.
- The estimated average saving resulting from contracting was 19.6 per cent.
- Ten agencies accounted for over 90 per cent of the total contracting expenditure and numbers of contracts in place.
- The services with most contracted expenditure were health and welfare, transport, property, training and education, and information technology. Collectively they accounted for over 80 per cent of total contracting expenditure for 1995-96.
- Over 90 per cent of agencies nominated efficiency and effectiveness as primary reasons for contracting. Seventy two per nominated a lack of internal resources.
- Approximately 63 per cent of contracts had durations greater than or equal to one year and less than 5 years, 15 per cent of contracts were without fixed term. Premature termination of contracts occurred in a very few contracts (34 or 0.12 per cent), representing expenditure of \$5.7 million (0.32 per cent).

- Almost half the in-house staff affected by contracting was retained within the agency after contracts had been awarded. Other staff were transferred to the contractor, redeployed within the public sector, or accepted redundancy.

The major issues that emerged in the review of contracting policy in NSW were the need for competitive neutrality, fair and effective competition, value for money, transparency and effective management of the tendering process and contract.

It is uncertain whether the efficiency gains achieved through service competition in the early 1990s have been maintained, or perhaps eroded, with the emphasis in recent years on whole of government internal efficiency. Because government does not report results, there is little comparative evidence.

Victoria

In 1994, the newly elected Liberal Victorian Government was committed at the outset to reform of public administration, in particular by subjecting it to market pressures. The central agencies drove contracting and an Outsourcing and Contract Management Unit was created in the Department of Treasury and Finance. The contracting guidelines to assist public agencies closely followed the NSW 1993 guidelines but included industry and regional development as objectives for outsourcing.

Achievements in contracting were reported in 1998 following a survey of contracting activities across government departments (Victorian Government, 1998). By the mid-1990s, the state government was letting out nearly 5000 new contracts in a year and the total value of contracts was nearly \$1500 million. This was double the amount of a few years previously. The Justice, Education, and Infrastructure Departments accounted for 86 per cent of contracts. Transport services accounted for the largest proportion of the expenditure, followed by information technology, infrastructure maintenance, and building and property services. The major reasons cited for outsourcing were access to skills/expertise, improved service quality, and an ability to manage fluctuations in demand. Lower cost was among the less important reasons for contracting. However, agencies reported, on average, savings in excess of 28 per cent of the cost prior to contracting.

After a new (Labor) government was elected in 1999, the emphasis switched (as it did in NSW) to sharing services with other government agencies, government-wide procurement contracts, and use of information technology to increase productivity. Where the private sector was involved, government moved from outsourcing to partnering agreements. The aim of these agreements has been to reduce the adversarial nature of traditional contracts by adopting a team approach that pursues common agreed objectives. The parties work out the method of selection, assignment of risk and dispute resolution procedures. However it is not clear how much this change to partnering reflects a change in practice or a change to a more acceptable terminology. Outcomes from this change in policy direction have been largely unreported.

Local Government

In 1993, the NSW State Government introduced, through the *Local Government Act 1993*, a more managerial style of local government. The *Act* replaced the traditional job of town clerk

with the more business-like position of chief executive officer or general manager. This change coincided with a move within local councils towards outsourcing, partly in response to fiscal pressures.

In 1994, the Victorian Government introduced *compulsory* competitive tendering as a requirement in the *Local Government Act*. The legislation required all local councils to subject at least 50 per cent of their operating budget to market testing within five years. However, following a change in state government in 1999, the compulsory feature was dropped and councils were required to adopt measures that would demonstrate that best value is achieved in service delivery.

The City of Sydney

Within NSW, the Council of the City of Sydney is an example of the significant role of outsourced services, especially before the 2000 Olympics. Council had always outsourced swimming and recreational centres and child care services. However, in 1996 the general manager estimated that \$50 million of funds would be required for the 'City Improvements Program' and that a large part of this would be achieved by reductions in corporate support costs and competitive tendering.

Starting in 1996, the Council worked within a two-year industrial agreement that gave a framework for change and included a commitment to market testing, measuring performance, and specific outputs. The Council embarked on staff training, including contract management, and provided business support so that in-house bids could be successful. It realigned the organisation into purchaser and provider groups and separated responsibilities for asset management and asset ownership. Council developed a schedule for plans for 13 core services and started a program for market testing. As a result of competitive tendering, services such as property management, parks maintenance and light fleet management were outsourced, while the tender for street cleaning was won by the in-house team.

However, after the 2000 Olympics some contracts were not renewed and some activities were brought in-house again. Following the amalgamation of the City of Sydney with South Sydney Council in 2003 and the election of a new Lord Mayor, the council has focused on combining the administration of the two former councils and outsourcing has not been a priority.

Overall, it appears that outsourcing in the City of Sydney was efficient. Council reports that the outsourcing achieved savings of \$7 million per annum. It appears that reviewing activities, specifying output, and market testing gave a good indication to the Council of what they were doing well or poorly.

4 Contracting Parks and Gardens Services in Mosman, New South Wales

Mosman Municipal Council, a small council with 28 000 residents situated on the north side of Sydney Harbour, is a pioneer among local government jurisdictions in NSW in contracting out of services. Since 1990, Council has opened virtually all of its works and services to the marketplace. These include road and footpath maintenance, beach and reserve cleaning, bush

regeneration, parks and gardens maintenance, grass cutting, tree management, sporting field maintenance, weed spraying, irrigation maintenance, playground inspection and maintenance, garbage and recycling collection, street sweeping, toilet cleaning and building maintenance. In that time Council's approach to the various contracted works and services has altered considerably with improvements and enhancements added to each generation of contracts as they have come up for renewal.

Many contracts are now in the third generation. They have evolved from highly prescriptive, activity based contracts to asset based contracts where outcomes and performance measures are specified. The contractor determines the work practices and methods that will allow him to achieve the desired results. In many instances this has enabled Council to deliver an increased level of service at a similar or lower cost to the local community.

In this paper we focus on the management of open space areas. When the decision was first taken to outsource works and services, specifications were developed for activity based contracts including grass cutting (small and large areas), bush regeneration, weed spraying, tree trimming, turf wicket preparation and garden maintenance. Successful contractors were responsible for these activities in a range of areas across Mosman. For example, the grass cutting contractor had to mow the grass in passive reserves, sporting fields and in larger areas of open space such as unmade roads. Another contractor sprayed the weeds in the same areas.

The contracts in place today are asset based with one contractor responsible for all activities to maintain the particular asset. For example, the contractor for maintenance of sporting fields is responsible for preparing the turf wickets, mowing the outfield, spraying the weeds, installing and removing the goal posts at the change of season, re-turfing worn areas, and so on. This has produced greater ownership from the contractors, eliminated unclear areas of cross responsibility between contractors, and reduced Council supervision and administration requirements. It has delivered considerable savings to the Mosman Community.

Establishing the Outsourced Project

In the early 1990s, Mosman Council considered that that spending on wages and related overheads was excessive. Moreover, Council often did not know exactly what its workforce was doing. Work often responded to political pressures—the elected Councillors who made the loudest noise obtained most attention for their areas. Also, Council was experiencing difficulties in attracting and retaining reliable staff for outdoor workforce positions due to the high cost of living in the area.

In order to improve service quality and reduce the cost of providing services, Council decided to test the market for provision of most of Council's works and services. The General Manager took responsibility for the change in management and ran the process along with some key employees whose expertise was brought into the organisation. Council was reorganized with the Engineer's department split into a contracting section and an in-house supply section. However, while the Council initially had an in-house purchaser/provider split, this is now not necessary because there are no internal bids for work.

Key Features of Outsourced Project

Councils traditionally provided most services by employing qualified staff to undertake the necessary work. The decision to outsource works and services required a rethink of this philosophy. Council still determines the services to be provided and the standards, but relies on the private sector to do the work. Council has become more proficient at determining the levels of service to be provided, measuring whether the required levels of service are provided and supervising and auditing the performance of its private sector contractors.

Each contract has a series of performance indicators in place to measure the level of compliance of the contractor with the requirements of the specification. For example the bushland management contracts have fixed photo points where photographs are taken over time to measure the level of improvement. They also have reporting requirements and an annual assessment is undertaken of the native vegetation density to ensure that continuous improvement, to the level required under the contract, is occurring.

There are several issues associated with risk management of outsourced projects. The direct risks associated with the performance of the work have been transferred to private sector contractors. Appropriate requirements are included in the contract document to achieve this. However, Council must ensure that its contractors are properly managing the risks associated with their particular contract. Under the *Occupational Health and Safety Act 2000*, Council can be held responsible for accidents and incidents that occur with its contractors if it has not taken reasonable steps to ensure that contractors have appropriate systems in place. Thus, the risks for Council have shifted from the direct risks associated with carrying out the work to risks associated with auditing the systems and performance of others. To ensure the appropriate level of service is achieved, contract supervisors undertake regular audits of the work undertaken to check compliance with the specifications. Staff audit every site covered by the specification at least once per annum and more regularly for higher use areas.

Several independent performance measures are also in place to assist in assessing contractor performance. For example, the sporting fields used for cricket are rated by the NSW Cricket Umpires Association. The cricket fields as prepared by the contractor must achieve a minimum rating of 7 out of 10 as independently assessed by the umpires.

In the bushland management contracts, the native vegetation density was measured initially by a contractor who undertook a flora and fauna survey for Council. The findings of this survey provided information as input to the development of the specifications for the contract. A further flora and fauna survey will be undertaken half way through the life of the ten-year contracts to measure, among other things, native vegetation density. This will give an independent validation (or rebuttal) of the Council's assessment of progress by the contractor.

The contractors submit monthly reports to Council which is their opportunity to provide feedback on issues that create problems for them in delivery of the service. Council can consider these issues and determine whether they are covered by the existing specification or if an adjustment to the specification is required.

Feedback is provided to contractors on their performance via written reports, regular face to face and site meetings and notices issued under the terms of the contract. If service standards are not met and a contractor fails to address the issues, Council has a range of options. These include withholding payments, options to rectify defects at contractor's cost, termination of contract and removal of individuals from performing work under the contract. Each contract

also has a review process (at the end of the first, fourth and seventh years) where Council can terminate the contract or take up an option to renew it.

However, in the view of Council, the most important aspect of contract administration is a professional and open relationship with the contractors.

Assessment of Outsourced Project

Mosman Council estimates that contracting in the early 1990s achieved savings of approximately 20 per cent across the board compared with in-house supply. These included the following savings in:

- Weed spraying 8%
- Grass cutting 16%
- Bushland management 25%
- Tree Pruning 35%

The savings achieved by moving from a reactive service regime to a planned maintenance approach meant that more public areas could be maintained and to a higher standard.

There were further minor savings in the second round of tendering in the mid/late 90s and Council continued to improve its management of the process. Contract specifications in this second round of contracts did not alter significantly and savings were smaller (only in the order of 1% – 2%). There was a creeping increase in costs due to the reliance on the consumer price index for annual increases.

However, several of Council's outsourced services in the third generation of contracts are provided at significantly lower cost than in the second generation contracts. The current Street Tree Management Contract is delivering a higher level of service than the previous contract at an estimated cost saving of \$18 000 (19%) per annum in the first year, \$26 000 (26%) in the second year and \$38 000 (39%) in the third year. The higher level of service has also greatly reduced complaints/enquiries from the public (by about 80%) with a corresponding reduction in staff time dealing with these matters.

The new Parks Management Contract let in 2004 combines five previous separate contracts and resulted in estimated savings of \$66000 (20%) per annum, totaling \$330 000 over the life of the contract. The specification also requires higher levels of service in some areas.

Because Council no longer employs blue collar workers to undertake these tasks, there has been a significant reduction in workers compensation claims and insurance premiums. It is difficult to quantify the savings because insurance premiums are influenced by many factors. However, in 1991 Council's workers compensation insurance premium fell from \$131 000 in 1991 to \$90 000 in 1993, when several services were outsourced.

The third generation of Parks and Gardens contracts also provides considerably higher levels of service than the original contracts in the 1990's. This has been achieved largely through progressive improvements implemented each time the contracts have come up for renewal. The biggest improvement came in the most recent round of contract renewals where

specifications were altered considerably from very prescriptive “how and when” type specifications to “what” the required outcome is. Contractors have more flexibility in scheduling of required work, work methods to be used, and materials and equipment which allows them to deliver the same, or often an improved level of service for a better price.

The cost savings have been used to increase the scope of services. For example, in the early 1990s Council was maintaining 12 separate bushland areas with a total area of 19.8 hectares. The funding was insufficient to maintain these areas in their current condition and not sufficient to make real improvements.

In 2000/01 Council reviewed its bushland management program and developed a new approach. The then bushland management contracts were structured around the available budget. In the tendering process contractors were often advised of the budget and asked to submit a proposal based on the staff hours they could provide for this budget. The new approach established the key performance indicators and built these into a specification that required specific outcomes/improvements in each bushland area. Council also provided additional funding to allow all of the major bushland areas in the municipality to be included in the contracts. Council now has all 28.5 hectares of bushland in the area under contract.

There were many problems associated with downsizing the organisation in the early 1990s, including determining maintenance programs and educating officers in contract management and administration. Additionally, Mosman worked under the ethos that the expectation is the specification. Although Council demanded that contractors adhere to the specification, it enabled Council to press for higher standards when items were not specified.

Overall, Council considers that contracting of services has been a considerable success. A market place approach to the delivery of works and services has led to better planning and co-ordination and makes it harder for elected members to become involved in operational issues. If issues arise, they are prioritised into established programs at the appropriate point. Considerable savings have been achieved, a work depot disposed of, and the local community now enjoys much higher levels of service than in the 1980’s and 1990’s.

5 Outsourcing Maintenance of Physical Infrastructure in the Mornington Peninsula, Victoria

The Mornington Peninsula Shire is an area of 720 square kilometres and 130 000 people located approximately 75 kilometres south-east of the Melbourne CBD.

In 1995 Mornington Peninsula Council resolved to substantially increase the scope of outsourced works and in 1997 Council entered a contract with Transfield Services, a major private company, to manage the maintenance of roads, buildings and open spaces in the community. To implement this, Council had to restructure its workforce into purchasing and providing departments. This contract with an extension ran through to 2001 and produced small savings for Council. The savings were smaller than expected because the tender specifications were drawn up quickly and revisions were required as work went on.

Drawing on this experience, in 2000 Council started a new two-year program involving detailed new specifications of works for contractors, consultations with the community about service standards, and a thorough expression of interest and tendering program. Late in 2003,

Council let out five contracts for cleansing services, parks and roadsides, furniture and signs, building maintenance and road maintenance. There is a detailed review and monitoring program for each contract. Council reports that these contracts have produced high quality services, significant cost savings, and no significant disputes with contractors. Council expects to build on the established processes.

Establishing Outsourced Services in the Mornington Peninsula

Following the 1994 *Local Government Act* in Victoria, Mornington Peninsula Council reviewed the out-sourcing potential for each major council service. Council already contracted out some services such as waste collection. The choice of additional possible contracted services depended principally on the deliverability of the required legislative outcome and the possibility of significant savings. Council decided to outsource the maintenance of all physical infrastructure services in the Shire because this was a substantial service unit and most services could be specified in terms of measurable outcomes. Specifically, Council would tender for the management of roads, buildings and open spaces.

Starting in 1995, Council spent a year in developing the tender documents and the tendering process. To facilitate this process, the Council restructured its staff organisation, separating out the purchaser and provider functions. Council created a contract management unit within the Corporate Support group to oversee the contract (purchasing) process. On the other hand, it created an in-house team within the engineering division to bid to undertake the work.

In early 1997, Council signed a three-year agreement with Transfield Services for the maintenance of roads, building and open spaces. All of these services were performed previously in-house. The cost of the services amounted to approximately \$12 million per annum. In December 1999, the Shire resolved to extend the contract for all works with Transfield Services for a further two-year period.

In 2000, Council started a major new contracting initiative (Sustainable Infrastructure Maintenance Services, SIMS). This was based on a more comprehensive consultation and specification process taking well over a year. In all there would now be five separate large contracts for cleaning (including drainage), parks and roadsides, furniture and signs, buildings, and roads (see more details below). This process and timing of SIMS took the following form:

- Initial community consultation (July to September 2000)
- Community workshops (July 2000 to March 2001)
- Establishing service standards (December 2000)
- Expressions of interest (August to December 2001)
- Tender specification (March to July 2002)
- Tender period and evaluation (August to December 2002)
- Final selection of tenderer (December 2002)

The selection process was thorough and lengthy. There was open advertising for Expressions of Interest and a long initial list of possible tenderers was filtered on competencies and company credentials and values. A first short list of firms was developed and nominees of the firms were interviewed for two hours. Council then developed a second and shorter list and held detailed interviews with the proposed contract manager of the candidate companies.

Following the selection of firms for the five tenders, Council officers held a pre-start Quality Relationship Management workshop over two days with each successful tenderer including a final combined workshop detailing integration issues and transition measures.

Key Features of Outsourced Services

From the start the aim was to contract out all routine maintenance activities and some minor cyclic maintenance activities of all asset groups. The specifications for the 1997 contract with Transfield were based on a combination of in-house operational plans where they existed and Vicroads maintenance standards along with other corporate documents that were originally administrative guidelines and position description documents.

The first stage contract with Transfield included the following main elements

- *Road maintenance*
Road, roadside and path maintenance, drainage maintenance, car park maintenance, roadside furniture and signage maintenance, street sweeping.
- *Open space maintenance*
Open space maintenance, foreshore maintenance, tree maintenance, cemeteries.
- *Buildings maintenance*
Inspection and routine maintenance of buildings.

As noted, in the first round an in-house bid was submitted but was not successful. The engineering staff involved were transferred to new entities or retired. A few remained as field supervisors with a role change.

The SIMS process that started in 2000 built on the existing contract package, added specification documents provided by the original contract provider, and used Aus-Spec as the specification reference framework. Council determined the intervention standards and response standards through a workshop process with residents, who were asked such questions as the levels of potholing, rutting, roughness etc that would be tolerated and the preferred response time having regard to current standards and to the costs of other standards.

The SIMS contract included the following main services:

- *Cleansing*
All drainage infrastructure; litter collection from commercial areas and public open space, barbecues, and public toilets; boat ramp and beach cleaning.
- *Parks and roadsides*
All road verges on the local road network, all playing fields, passive recreation areas and fire management services.
- *Furniture and signs*
All signage roads, parks etc., all road and park furniture, steps, walkways, ramps and structures.
- *Buildings*
All public building routine and cyclic maintenance including major nominated council building cleaning.
- *Roads*
Routine maintenance services on local road assets, shoulders, drainage infrastructure repairs.

Contracts were based on a lump sum price for routine maintenance activities. This lump sum was indexed against the consumer price (trades) index, which is applied quarterly. Also there is an annual review of growth impacts. The growth factor is set nominally at 3 per cent but is adjusted annually.

Council bears the external risk factors, for example price increases in major consumables (such as bitumen and crushed rock). The contractor bears any operating cost increases within the review period. Also, nominally at least, the contractor bears the risks associated with not achieving required service quality.

There are numerous comprehensive and detailed schedules and specifications in place to measure service standards along with threshold and trigger points, intervention standards and an audit program. Examples of trigger points for road maintenance are the extent of cracking in pavement and the extent and severity of potholing or rutting or failures. Another example of a trigger is the number of items of litter per square metre within one week of cleansing.

The following is an example of activity specification for traffic island maintenance.

- *Activity definition (what work is included?)*
Inspection and maintenance of all concrete kerbed islands including all traffic calming devices located on the carriageway and in car parks, including those with hard or paved infill areas. Repair of any damaged kerbing and removal of any defects that could constitute a safety hazard to road users and pedestrians. The Cleansing Contractor sweeps the medians and collects litter. The Parks and Roadsides Contractor controls weeds and vegetation on traffic islands and medians.
- *Performance distress and defects (what does Council look for?)*
Damaged kerbing or median noses, interrupted longitudinal drainage flow, tripping hazards in hard paved areas.
- *Performance criteria (why does Council require it)*
The aim is to provide a safe refuge for pedestrians crossing the road. To ensure that the traffic islands continue to regulate and guide traffic movements without constituting a safety hazard to road users.
- *Performance standards*
Infill area must be compact and free of depressions or mounds. Kerbing is to be continuous with no loose or broken sections and formed such that longitudinal drainage flow is not impeded.

To ensure service standards, Council holds biannual senior management group meetings to oversee strategic issues. Council has a team of contract surveillance officers for each of the five service contracts. There are quarterly meetings with contract managers and quarterly, monthly and weekly inspections as specified. A Relationship Management Agreement sits over the contract to ensure sustainable retention of agreed behavioural values and standards. The contracts specify a mediation process and use of independent mediation panel as a final resort. However, mediation has not been required to date.

Assessment of the Outsourced Services

Council reports that the out-sourced projects are well accepted. There are high performance standards, quality of service, and accountabilities. There is strong ownership of outcomes. The outcome depends on the quality of the specification and staff resources used by both Council and the contractor. There are no moves to reverse this strategy.

For the 1997 to 2000 contract, based on the difference between the quote by the successful bidder (Transfield) and the quote by the in-house team, Council expected to save \$5 million per annum. These savings were not achieved fully because, following reviews of the tender scope and adjustments of unit rates, the expected savings were taken up in addressing gaps in service specification.

These gaps arose partly because of the speed with which the contracts were specified initially. Also, on governance grounds, the contract staff preparing the documents was not allowed to discuss the issues with the engineering unit who would compete for the work. Consequently the contract staff did not fully understand the nature and extent of the service requirements and tasks. Probity and procedural correctness presented obstacles to full understanding of the requirements. Nor was there any community input with regard to service improvements.

The subsequent SIMS process addressed these weaknesses. Council took more time (two years instead of one) to develop the contracts. Also Council engaged the community comprehensively through forums, workshops and questionnaires. The Council was intimately involved in the consultation and scoping process so that it “owned” agreed service standards and intervention levels.

The second round of contracts, which started in 2003, brought in further cost savings. Council estimates that there is a further effective saving of \$5 million per annum compared to the first round arrangements. Moreover, Council reports that few problems have been encountered in the current out-sourcing arrangements and that none have been unresolved.

6 Outsourcing the NSW Government Cleaning Service

The NSW Government established the Government Cleaning Service (GCS) in 1915 for the dual purpose of cleaning schools and providing assistance for war widows who were not adequately covered by the existing social security system. The labour force was largely female, older and from non-English speaking backgrounds. Its clients were mainly government agencies such as the Department of Education, colleges of further education, police and court houses, which were required to use the GCS under a tied agreement.

In the late 1980s, the NSW Government established a Commercial Services Group within government to provide common services to government agencies, to improve quality, and to reduce costs in order to compete against the private sector. The GCS was part of this group, but although it paid neither sales tax nor notional corporate tax, the agency’s costs before 1989 far exceeded its revenue. Over the following three years, the GCS achieved efficiency gains of 40 per cent through the removal of restrictive work practices and voluntary redundancies under an agreement with the Federated Miscellaneous Workers Union (FMWU). The work force was reduced from 12 500 to 7500 cleaners.

Subsequently the government resolved to outsource the service and it divided the state into five geographic zones. Following an exhaustive tender process, cleaning services zones were awarded to three contractors. As described below, the outcome has been a significant decrease in the cost of cleaning without loss of quality.

Establishing the Outsourced Project

As the tied service agreement was due to lapse on 30 June 1992, the Government extended it for a further two years and engaged consultants to review options. The FMWU was not invited to participate in this process and, anticipating that the tied arrangement would end in June 1994, the Union investigated the viability of an in-house bid.

The consultants presented the following options to Government:

1. Maintain existing GCS structure until completion of the tied arrangement in June 1994 and continue to maintain in-house staff to allow it to compete against the private sector, estimated cost \$296m;
2. Bring GCS into line with industry standards in regard to pricing and productivity while maintaining public ownership, estimated costs \$94m to \$120m;
3. Sell GCS as an ongoing concern with cleaning sites tied until June 1994, estimated costs \$105m to \$123m; and
4. Sell GCS under the condition that cleaners and their entitlements be transferred to the purchaser. Cleaning services would be provided by the purchaser for five years. Estimated costs \$130m.

In July 1993 Government announced that option 4 ('sale with conditions') was its preferred option. It cited independent analysis which estimated that savings of 20 per cent and productivity improvements of 15 per cent would be possible through contract cleaning. Although option two was financially attractive, the Government perceived the risks of not achieving the reforms and timely efficiency gains under public ownership were significant. More importantly, the Government did not want to be involved in the cleaning business.

The FMWU tried to reverse this decision and fought it in the industrial, legal and political arenas. It was concerned for the jobs of the 7500 cleaners and argued that the standard of hygiene in public schools would fall if contract cleaners were allowed to reduce cleaning hours.

The Government advertised the tender in July 1993. Overseas firms and large service companies without prior cleaning experience were able to tender if they could show that they could obtain the necessary expertise. Tenderers had to agree that transferred staff were entitled to accrued leave, preserved superannuation entitlements, and a guarantee of employment for 18 months on a comparable basis to their previous employment. Cleaning staff were not offered redeployment or redundancies as transferring them to the successful tenderers was seen as essential for contractors to have sufficient cleaners.

The tender process restructured the GCS into five independent regional business units, each covering a geographical zone in New South Wales. The 'sale' of each zone consisted of the sale of GCS plant and equipment at a predetermined price; the transfer of employment liabilities; and a five year contract for cleaning.

At the close of tender, 12 expressions of interest were received. Of these, ten satisfied the pre-qualification of scale and financial capacity. Ultimately seven tenders were received. The in-house group did not obtain adequate financial backing and withdrew.

The tender process was lengthy and thorough and involved use of independent consultants. The Government, in order to avoid creating a monopoly and to foster competition, indicated that it was not prepared to allocate more than two zones to one contractor but recognised that allocating neighboring zones could yield significant operational efficiencies.

Each tender was assessed against six criteria, one related directly to cleaning costs, the other five related to performance and commercial risk. The tender evaluation panel prepared three final options for awarding cleaning zones, costing \$402m, \$403m and \$405m respectively. Since the difference in price between the options was marginal, other indicators were used to determine the final outcome. In any case, by year three, government would save \$60 million per annum (approximately 30 per cent) by contracting out cleaning services. The contracts were awarded in December 1993.

Key Features of the Outsourced Cleaning Services

Each winning tenderer demonstrated good human resource policies and practices and the former GCS cleaners were offered employment beyond the minimum mandatory requirements.

Under the conditions of the tender, the contract cleaning industry could introduce its own work methods. In order to increase productivity, contractors modified cleaners work practices. While employed by the GCS, each person was responsible for cleaning a specified area. Under the contract arrangement, cleaners were working in teams each with specified tasks (eg dusting). Team members could change tasks weekly to add variety and to enable those on rehabilitation to perform lighter duties. Productivity improvements were also achieved through using new equipment and removing restrictive work practices.

Although the FMWU accepted that the introduction of contractor work practices to former GCS staff increased productivity, the union argued that contractors were making cleaners work harder, rather than smarter. Subsequently the FMWU argued in the Industrial Relations Commission that cleaners were not involved in considering options for their future, were not offered redeployment or redundancy, and their employment conditions were significantly different from those at the GCS. The Judge hearing the case concluded that, as the GCS made the decision to terminate employment and that this decision was not related to work performance, former GCS staff were due some compensation. This resulted in Government paying some \$25 million for redundancies.

An independent cleaning inspection program was introduced to assess and document cleaning standards, identify systematic problems and monitor user satisfaction with the cleaning service. Random inspections took place and a complaint investigation and follow up service was created. Each site was inspected without the presence of either the site or the cleaning contractor's representative. Where unsatisfactory cleaning was observed, copies of the inspection report were sent to the cleaning firm and the client. The client was contacted within 14 days to find out whether remedial actions had taken place.

The NSW Teachers Federation (TF) surveyed all government schools in the State about the quality of the contracted out cleaning service. In February 1994 the TF criticised the performance of the contractors, citing dissatisfaction amongst school principals about the time allocated for cleaning and the numbers of cleaners. The decline in service was seen as putting students' health at risk. The complaint focused on the numbers of hours cleaned rather than the quality of the cleaning.

The Government subsequently carried out its own review of standards. It found little evidence of reduction in cleaning standards, but provided an additional \$20m per annum for the cleaning of schools.

Assessment of Outsourced project

With annual operating costs of \$180 million before contracting, there were significant potential savings through outsourcing. On the other hand, as GCS was a major employer in the State, satisfactory resolutions of staff redeployment had to be achieved.

Increased productivity was achieved through introduction of new equipment, cleaning in teams, and removal of restrictive work practices. However, as noted, the FMWU argue that increased productivity was achieved by harder work and changed working conditions.

Although the original estimated savings of \$60 million per annum by the third year were not achieved, partly for industrial reasons, significant ongoing cost savings have been made. There appears to be no evidence that the quality of cleaning has diminished.

However, the Industrial Relations Commission's judgment had significant implications for future reform and may reduce the financial savings from contracting arrangements. Also, building employment guarantees into out-sourcing contracts reduces the potential for resource efficiencies and savings. It was reported recently in the Sydney press that school cleaners went on strike until the NSW Government agreed to written guarantees of employment under new contracts.

7 Outsourcing of Land Valuation Services in New South Wales

The NSW Valuer-General (V-G) is responsible for the valuation of all land in New South Wales each year on behalf of the State government. Currently this amounts to about 2.25 million valuations. The V-G issues all valuations to the Office of State Revenue for land tax purposes and to local councils for rating purposes.

In 1994, as part of wider public sector reforms, the Government reviewed the Office of the V-G with the intent to make it more commercial. In 1996, the Government introduced legislation to authorize competitive tendering. In 1997, it split the V-G's Office into two new bodies, the State Valuation Office (SVO) to carry out mass valuations (the provider) and the Valuer-General's Department (the regulator) to control the statewide valuation records and to manage outsourced valuation contracts.

The SVO won all but one of the first set of tenders for valuation services. However there are now eight contractors providing valuations, with the SVO providing close to 50 per cent of valuations. One-third of land valuation services for the State are tendered annually.

Although it took some years to create a competitive environment, outsourcing of valuation services has resulted in significant productivity gains, enabling more extensive services to be provided. In addition, with the change in culture, various other services are now being contracted. However, so far there have been no significant savings in expenditure or reduction in costs to consumers.

Establishing Outsourced Valuation Services

The Office of the V-G is a statutory body formed under the authority of the *Valuation and Land Act* to carry out a range of statutory duties. These include the management and contracting out of mass valuation services, the maintenance of the valuation roll (data base), dealing with objections and appeals and making valuations under a number of Acts.

When Government decided to outsource valuation services and to separate the regulator from the provider, it established a new government organization (the SVO) to tender for the impending competitive valuation bid. The first tenders were called in November 1996 and in March 1997 the contract for providing land valuations for most of NSW was awarded to the newly created SVO, a business unit of the then Department of Land and Water Conservation. Government awarded a private contractor valuation services for one area in the Hunter Region. Not all valuation contracts were contested.

At the same time, in order to produce efficiencies, traditional valuation methods were replaced by mass valuation techniques. This major change in valuation method required grouping of properties that react to market forces in a similar way and updating values by a market-based factor that is used as a multiplier of the prior land value. Traditional valuation methods, or handcrafting, are also used when appropriate.

In the 1996 call for tenders, the objectives of contracting valuation services were listed as:

- To lower costs to valuation users,
- To provide opportunities for developing new mass valuation methodologies, and
- To maximize opportunities of employment for existing V-G Department/State Valuation Office staff to provide valuation services.

In 1998 further contracts for a number of Sydney local government areas were contested and a private firm won the contract for Sydney East. After this initial tender process the SVO held the contracts covering every contracted area in the State except Sydney East and Outer Hunter and provided about 90 per cent of all valuations.

There were several reasons why the private sector won so few initial contracts:

- the SVO, which was staffed with former employees of the Valuer-General's Department, had experience in carrying out mass valuations;
- the evaluation criteria included a preference for contractors who would take on existing staff; and

- the responsible Minister stated that there would be no job losses from contracting out.

Because of significant public concerns about land valuations flowing from changes to land tax laws, and the impact that valuations have on individual rating and taxing liabilities, the NSW Premier (in 1999) called for an inquiry into the operation of the *Valuation of Land Act 1916*. The terms of reference for the inquiry, the Walton Inquiry, included a reference to assess: *‘the efficacy of the reforms introduced in 1997 under which valuation services are provided through a mix of contested contracts and uncontested contracts’*.

The Inquiry concluded that it was too soon to judge the efficacy of the competitive tendering process as too many other changes had been introduced over the same short period. These included the split of the SVO from the V-G’s Office, a change in valuation method, and the introduction of a new tax (the Premium Property Tax) at a time when land values were rising significantly.

The Walton Inquiry also noted that the competitive tendering process, which searched ‘for new valuation methodologies to reduce cost by minimizing “expensive handcrafting” but that did not allow for testing ... was not wise’. It further observed that the process of competitive tendering required systematic quality control measures and contract managers who were focused on managing contracts rather than on the valuation process.

Key Features of the Outsourced Services

There are now eight contractors providing land valuation services. However the SVO still provides some 50 per cent of land valuations. Previously all contracts were for fixed periods of three years in metropolitan areas and four years in regional areas, however the current request for tenders is for a three year period, with an option to extend for up to two years (two one year periods). This change in the contracting process has been implemented in response to industry concerns that establishment costs could not be amortised over initial contract periods and were a significant disincentive to enter the market for the services.

Of the tender selection criteria, one-third relate to price and the other two-thirds to suitability of staff, the valuation methodology proposed, experience, ability to take on the work and quality assurance. If a tenderer is a government business, it must comply with the State’s policy on competitive neutrality: bids must be comparable to the private sector and adjusted for effects of taxation exemptions.

The contractor is required to make accurate and complete valuations on behalf of the Valuer-General and may be required also to assist the V-G in the determination of objections from third parties and with appeals.

The services provided are to achieve the objectives of the V-G, namely:

- a) the competitive and commercial supply of valuations to the public including lowering the cost of services to end users;
- b) to make accurate and complete valuations; and
- c) to provide a high level of probity and quality control to support the continuing use of mass valuation as a tax base of the NSW government.

The contract details the standards to be achieved by the contractor, reporting requirements, and the valuation procedures to be followed. The V-G provides a procedures manual explaining the mass valuation system and the reporting and approval requirements. The manual specifies that contract management is to be based on the concepts of partnership, transparency, consistency of process and creating positive outcomes.

The contractor must provide valuation recommendations that comply with the requirements of the Act and undertake the quality control processes specified in the procedures manual. These include statistical tests and market analyses designed to measure the accuracy and quality of recommended valuations. The contractor bears the risk of meeting deadlines and any operational cost increases within the contract period. The contractor also bears the risk of not meeting service standards and reporting requirements contained in the detailed schedules of the contract. The V-G uses a scorecard designed to evaluate objectively the contractor's performance. However, the V-G bears the ultimate responsibility for quality of valuations.

Assessment of Outsourced Services

The Chief Valuer reports that outsourcing of the valuation function is now accepted and that valuations will be provided in-house only on a competitive basis through the SVO. The Walton inquiry found there would be no gain from reversing the reforms because the high costs of separating funder and provider, setting up systems, and contracting processes are now sunk costs.

The V-G's Office has improved tender specification and quality control procedures and has increased the skills of its contract managers. With increased skills available in the private sector, tendering has become competitive within the metropolitan area and it is likely to become so throughout NSW. The V-G now contracts for other services such as preparing reports on objections.

One of the main reasons for separating the roles of purchaser and provider was to reduce costs to users of data, primarily the Office of State Revenue and local councils. However, although productivity has increased, savings have not been achieved. There appear to be several reasons for not achieving anticipated savings:

- all valuations are now carried out to a full valuation standard, which was not previously required. This has increased workload;
- a backlog in valuations has been eliminated and all valuations are provided on time;
- start up costs were high;
- there have been significant salary increases; and
- increased workload due to the numbers of objections received each year. (This may be exacerbated in the coming years due to further changes to the land tax regime).

8 Residential Aged Care Services

In Australia, the Commonwealth Government is responsible for residential aged care services (nursing home and hostel care). All residential care services are outsourced to the not-for-profit sector (65%), local and state government (10%), and private sector entities (25%). The

Australian Government pays a subsidy to providers based on the care needs of its residents. Contributions based on ability to pay are also sought from residents.

The high market share of the not-for-profit sector reflects their competitive low costs, based partly on supportive donations and the use of volunteers as well as less restrictive work practices. Also not-for-profit agencies are often perceived as caring organizations. On the other hand, they may be small agencies with limited management skills. Also they may have discriminatory admission policies.

To ensure that the capital requirements of the industry are adequate, residents requiring low care and those needing extra high services pay an accommodation bond to providers. Others pay a weekly fee which is means tested. The Government pays a resident supplement on behalf of residents who cannot afford the contribution themselves.

The Australian Government regulates the quantity, quality, location and price of residential services. The *Aged Care Act 1997* (the Act) provides the regulatory framework for delivery of aged care services. The aim is to ensure equity of access and quality of care, to protect residents from exploitation, and to safeguard the significant levels of government funding.

The quality of care is monitored by the Government's Aged Care Standards and Accreditation Agency through an accreditation process. If accreditation is not passed, the licence is revoked and can be sold.

Although the Act introduced greater flexibility to residential care, a recent review (Hogan, 2004) found that Government should consider replacing the current needs-based planning arrangements with market-based solutions and that there might be a need for a contracting agency to negotiate prices and conditions for residents on behalf of the Government.

The Outsourcing Process

The Australian Department of Health and Ageing selects licensees for provision of residential care places through open tender. Initially, in 1997, the Department granted provisional accreditation to providers for two years as this was deemed to be sufficient time to achieve the prescribed standards or to leave the industry. Since 1999, licenses are granted in perpetuity, subject to regulatory requirements, but can be revoked for failure to perform.

A common framework based on the provisions of the Act relating to *Quality of Care Principles 1997* is used to assess and rank applications. The provisions identify a range of criteria in the assessment process, such as the ability of applicants to provide continuity and appropriate levels of care; the expertise and experience of management and staff; provision of care for people with special needs; and past conduct as a provider of aged care services. The Department may also request that financial information be independently verified and may consider information available through the Aged Care Standards and Accreditation Agency.

Tenders are selected on the basis of a written application and no interviews are held. Success depends on the Department's perception of the provider. The Department keeps a scorecard of compliance with prescribed standards and the completeness and accuracy of statistical and financial returns.

Applications for capital grants are assessed on a competitive basis. The matters considered include the need for capital works to meet essential building standards, such as fire and occupational health and safety, the range of services available in a particular region and the demonstrated lack of capacity to obtain funds elsewhere.

Key Features

Aged Care Assessment Teams (ACATs) act as gatekeepers to subsidised aged care services. ACATs ensure that people obtaining services for the first time receive the right level of care and that access to subsidy is based on objective determination of care needs.

The monitoring of aged care homes under the *Aged Care Act 1997* is a responsibility of both the Aged Care Standards and Accreditation Agency (the Agency) and the Department of Health and Ageing (the Department). The Agency has been set up for the purpose of accreditation of Commonwealth funded residential aged care services. Its functions include managing the accreditation process; promoting high quality care and helping industry to improve service quality by identifying best practice and providing information, education and training. It assesses and strategically manages services towards achieving accreditation.

The Department must ensure that homes meet their other obligations under the Act and imposes sanctions where approved providers have breached their responsibilities. These arrangements are designed to provide residents and their families with the assurance that they are receiving quality care and that their user rights are respected.

Accreditation is for three years, there are annual visits, support contacts and desk audits. If a service fails accreditation review, the licence is revoked and can be sold.

Accreditation is based on the achievement of four standards that are detailed in the *Quality of Care Principles 1997*. These are:

1. management systems, staffing and organisational development;
2. health and personal care;
3. resident lifestyle;
4. physical environment and safe systems.

There is a clear statement of the principle used to guide the assessment of each standard. There are 44 expected outcome indicators for the four standards. For example, Standard 2: *Health and personal care*, and three of the outcome indicators, are set out below:

Principle: Residents' physical and mental health will be promoted and achieved at the optimum level in partnership between each resident, or his or her representative, and the health care team.

Matter Indicator
Clinical Care

Expected Outcome
Residents receive appropriate clinical care

Specialized nursing care needs	Residents' specialized nursing care needs are identified and met by appropriately qualified nursing staff.
Other health and related services	Residents are referred to appropriate health specialists in accordance with the resident's needs and preferences.

The Agency may carry out a review audit on site if believes, for example, that there is non compliance with the standards or there has been a change of ownership or key personnel. The auditors assess the quality of care by reviewing documents; interviewing staff, residents, relatives and others (such as visiting doctors, pharmacists); and observing the environment and practices of the home. Within 14 days of receiving the audit report and considering any submission from the provider, the Agency may decide not to revoke the accreditation, vary the period of accreditation, or revoke accreditation. However, the Agency is not bound to follow the recommendations of the review team.

Where a home does not comply with the Standards, the Agency maintains close supervision over it to ensure that improvements are implemented and residents are protected. The Agency encourages regular self-assessment.

The *Quality of Care Principals* in the Act set out a structured approach to managing quality and place the ultimate responsibility for the quality of performance in each facility on the professional staff and management.

Assessment

The *Aged Care Act 1997* introduced greater flexibility to residential care, supported higher standards of care and accommodation through accreditation and certification and improved quality of care. These measures also resulted in some rationalization of providers.

The current tightly regulated place allocation system and the monitoring requirements benefit residents. They ensure that the quality of care is generally high.

However the regulated system is expensive to administer. It reduces competition between providers and entry to the industry is difficult. Capital requirements and the availability of trained staff are barriers to entry for new providers. The current system is dominated by the relationship between government and providers and consumers have restricted choices. Prices are fixed and, largely because of the needs based assessment, bed occupancy rates are high in the industry (96%).

Hogan (2004) found that the residential aged care sector required structural reform to become more efficient and to ensure its long-term financial sustainability. The review recommended more flexible planning and allocation arrangements for residential care places, streamlining the administration of the Resident Classification Scale to increase efficiency, and more government support for the education and training of aged care nurses and care workers.

To increase choice for consumers and to shift the focus on bed-allocation to a more competitive system, the report canvasses the need for establishing a contracting agency that

negotiates prices and conditions for residents on behalf of the Government and an auction system for the allocation of places to providers. Government is currently considering these recommendations.

9 Health Care Services in Port Macquarie Base Hospital

Port Macquarie is located on the NSW coast about 400 kilometres north of Sydney. The town services the Hastings Region, which has a catchment of 7000 square kilometres and population of about 60 000 people. Within the town, the Port Macquarie Base Hospital has been managed by a private company, Health Care of Australia (HCOA), under contract with the NSW government since the hospital opened in November 1994. The private provision of services was part of a wider agreement between the NSW Government and a private consortium to build, own and operate the hospital. In this paper we focus on the private provision of services and related arrangements.

The private provision of public hospital services at PMBH was an early case in Australia in which a private firm was responsible for providing all services at a public hospital, not just some services such as cleaning or pathology. Since then, despite the costs noted below, there have been several similar projects including Latrobe Regional and Royal Women's Hospital in Victoria, Noosa and Robina in Queensland, and Modbury Hospital in South Australia.

There are limited public data on the arrangements for PMBH. In this paper we draw heavily on the 1996 report by the NSW Auditor-General¹ as well as on our knowledge of the arrangements from media and other reports. Doubtless there have been detailed changes in arrangements since 1996, but the key issues appear unchanged.

Overall, it appears that there were few significant benefits in the out-sourcing arrangements for PMBH. The NSW Government apparently paid a high price for the service without a significant increase in the quality of service or a reduction in the risk to government.

Establishing Services at PMBH

The operating contract was part of a broader build, own and operating contract between the NSW Health Department and five private companies, involving the private owner (Port Macquarie Base Hospital Pty. Ltd, PMBH P/L), two finance companies, a construction company, and HCOA. This contract included construction of a new hospital of 161 beds in Port Macquarie between 1992 and 1994. The contract allowed for two main annual payment streams. One was an 'availability' charge, which would enable the private firms to recover construction, finance and other costs associated with building the hospital. The second was a 20-year 'service' charge to HCOA that would cover the operating costs of the hospital. The hospital is contracted to treat 80 per cent public patients and 20 per cent private patients. At the end of 20 years, PMBH P/L has the right to sell the hospital.

The reasons for establishing the project were partly political and partly financial. Successive NSW governments had promised a new hospital to the local community but failed to deliver possibly because it was not a marginal seat in the NSW parliament. However, the Government claimed that its \$300 million per annum for capital health works was fully committed to other projects. Producing the hospital by private finance had the short-term attraction that it did not take funds away from these projects.

¹ NSW Audit Office, 1996, *The Auditor General's Report for 1996*, Volume 1, Appendix 4.

The contract was established by a competitive tender. In October 1990, the NSW Government approved the calling of expressions of interest from the private sector. In September 1991, the Government invited four groups to tender. Three tenders were received and evaluated by the end of the year. In February 1992, the Government authorised the Department of Health to proceed towards finalising a Services Agreement with the preferred tender group. The contract was finally signed in December 1992. As is typical in this process, most of it is competitive. However, in the final stage there is protracted negotiation between the government and the preferred tenderer, from which the government cannot easily withdraw and in which competitive pressures are reduced.

Key Features of Services at PMBH

Under the Services Agreement with the NSW Department of Health, HCOA agrees to provide services for public patients presenting themselves to the hospital. Performance guarantees are built into the agreement, which specify that no person requiring urgent or essential treatment will be denied appropriate care.

The Department of Health sets the number of individual services to be provided annually, which has regard to a range of factors including changes in demographics and in other demand factors. It also specifies the quality level for each type of service at the expression of interest stage. According to the NSW Audit office (1996), the quality levels specified were generally greater than those applicable to the public hospital that it replaced.

The Department of Health pays a 'service' charge to the operator for the treatment of public patients. Most of the budgeted service charge is calculated on a set fee per service. This fee was set equal to the top cover, private insurance rebate. In addition, the NSW Audit Office (1996) reported that payments for non-inpatient services were set initially on a fixed budget basis. The budgeted annual service charge in any year is not to be less than the total service charge in the previous year.

HCOA also negotiates additions. After the signing of the contract, the Department of Health agreed to add \$1 million to the service fees to allow for treatment of Department of Veteran's Affairs patients that were not identified in the negotiations before signing of the Agreement. Further, under threat of litigation, HCOA successfully claimed an extra \$3 million from the Department in 1997 to cover the cost of providing for medical patients (Collyer, 1997).

In terms of the allocation of risk, the Department of Health bears the risks related to changes in taxation and legislation, litigation during operation, and termination. It also bears the risk of poor performance because it would be very difficult to terminate the contract with HCOA. Significantly, the Department is required to consult with both PMBH P/L and HCOA before planning any new health facility in the region.

The private operator bears the risk for use of the hospital up to a point (given that the annual service charge cannot fall), maintenance and repairs, outgoings of the hospital, insurance, and disputes between the parties. However, HCOA owns and operates the main private hospital in the town and so has a monopoly position with private patients.

In terms of monitoring standards, a Contract manager of the Department monitors the provision of services at the Hospital and the Department receives regular reports from HCOA

on performance. Also, HCOA is accredited with relevant bodies as specified in the contract. However, the NSW Audit Office (1996) was unable to verify whether these controls on standards were effective in practice.

Assessment of the Out-sourced Services

Assessing the efficacy of these arrangements is complicated by the variety of services being provided and by the lack of public data and benchmarking. However, Government almost certainly paid a premium for financing the hospital by private finance. Chung (2003) estimates that, even with a high 10 per cent discount rate, the present value of the 20 annual availability charges is \$67 million compared with the actual capital outlay of \$52 million.

It appears also that operating expenditure was significantly higher than in publicly-run hospitals at least in the early years. Because of secrecy provisions of the Services Agreement, the NSW Government does not release data on the service charge for PMBH. The NSW Hansard (29/05/1996) showed that recurrent funding for PMBH was \$28 million for the year. Chung (2003) estimated that this was \$6 million more than the average for seven similar regional hospitals namely Albury, Coffs Harbour, Dubbo, Lismore, Orange, Tamworth and Wagga Wagga.

The evidence on clinical quality of service is less clear. The NSW Hansard (29/05/1996) reports that, in 1996, PMBH had a good record with few unplanned returns to the operating theatre or to the hospital as well as few post-operative embolisms and contaminated wounds. On the other hand, Chung (2003) reports that, from 1998 to 2002, waiting times and the number of patients with waiting times greater than a year were comparatively high.

Without information on the contract details we cannot tell whether there are ongoing incentives to control operating costs or to improve service quality. Given the length of term of the Service Agreement and the way in which it was bundled together with the provision of infrastructure, there must be concern that the benefits of out-sourcing were not fully achieved.

As noted the NSW Government bears a significant amount of risk. This is perhaps inevitable where the quantum of services cannot be specified precisely in the contract. The risk is exacerbated by political inequality between the parties. Government has to maintain continuous health services. It can litigate if a service is unsatisfactory but it cannot walk out of an agreement. This is not true for a private firm. When Australian Health Care started to make large losses from the Latrobe Regional Hospital, it first litigated for more funds and then in October 2000 abandoned the contract.

Overall, it is hard to find significant benefits in the outsourcing arrangements for the PMBH. It appears that the NSW Government paid a high price for the service without a significant increase in the quality of service or a reduction in the risk to government

10 Outsourcing the Melbourne Metropolitan Ambulance Service

In the early 1990s, the Victorian Government decided to outsource a large number of the state-run ambulance services in Melbourne. However, whatever the potential merits of outsourcing such services may be, the process was highly flawed. Contracts were poorly

specified and, worse, they were often awarded to favoured parties without competition or due process. In this case study, we draw on the report of the Victorian Auditor-General's Office (1997) to describe a contracting out process that was seriously flawed and the subsequent corrective measures taken within the Metropolitan Ambulance Service (the Service) to improve outsourcing practices.

Outsourced services

Between 1993 and 1995 the state-run Melbourne Metropolitan Ambulance Service outsourced several major contracts for services. These included:

- Engaging consulting firms to manage the tendering for and subsequent management of several contracts.
- A new computerized communications system for \$7.5 million over 4 years;
- The operation of new financial and management information systems at a cost of approximately \$15 million over 4 years;
- The management and maintenance of ambulances and other vehicles for approximately \$2 million per annum, and
- Non-emergency ambulance services at an estimated cost of \$6 million per annum.

Poor Practices and their Consequences

In 1996-97 a performance audit by the Victorian Auditor General revealed serious deficiencies in the Service's outsourcing program. These were attributed to poor management practices and corrupt activity that would have been avoided if proper procedures had been followed.

The Audit noted that the manner in which the contracts were managed enabled consultancies '*to reap significant financial benefits without challenge.*' and resulted in poor advice being provided, a poor level of service and in failure to achieve the estimated \$20 million in savings anticipated from outsourcing.

Management of the outsourcing was characterized by inadequate documentation and a total disregard for the Government's outsourcing guidelines.

The deficiencies continued for some time and had a seriously adverse impact on the operations of the Service.

Highly dubious practices included:

- Appointment, without tenders being called, of a private firm which had previous commercial associations with the chief executive officer;
- Serious deficiencies in the development and implementation of its new communication system. These included using systems specifications which contained major shortcomings; the absence of documentary evidence to substantiate the short-listing of potential suppliers; and the inability to produce critical information to support the evaluation of tenders;
- The failure to observe acceptable standards for the engagement of two consulting firms, including irregularities in the tender process; failure to formalise agreements specifying

the consultants roles and responsibilities; and lack of evidence that the technical competency of these firms had been investigated;

- Total delegation of responsibility to the two consultants without assessment of their performance;
- The existence of a conflicts of interest in the tendering process for delivery of non-emergency services; and the absence of a cost-benefit analysis to support the decision to enter into long-term contracts
- Payment of significant sums over approved budgets without evaluation of the basis of such claims.

Corrective Management Measures

Following the performance audit, the Service's new chief executive initiated a range of actions aimed at improving the Service's contract management practices. These included:

- the recruitment of experienced contract administrators;
- development of policies and procedures for all aspects of contract management;
- the introduction of performance criteria in all contracts; and
- a formal system of delegations.

In addition, the Department of Human Services introduced more stringent accountability arrangements for the Service, including the requirement that all tenders greater than \$100,000 be approved by the Department's accredited purchasing unit.

The Service was also requested to establish an audit committee and to meet regularly with the Department for the purpose of reviewing financial and operational performance.

Conclusions

This case study demonstrates the importance of good governance and due process for contracting out of services and how significant the consequences of poor management and control of an outsourcing program can be. These included failure to achieve the overall objective to achieve savings of \$20 million and a reduction in the quality of services. Importantly it draws attention to the need for management to retain control of any outsourcing program. However, it should also be acknowledged that the incompetence and corruption of the management became transparent eventually through the failure of outsourcing. In the absence of outsourcing, the same poor management qualities may have continued hidden but with equally poor outcomes.

11 Conclusions

International evidence (Bailey, 2002) and Australian evidence (Domberger and Hall, 1996) suggests that outsourcing of government services to raise public sector productivity has been successful on the whole. In a review of early contracting experience in New South Wales and Victoria, Domberger and Hall (1996) found that competitive contracting out of state government services produced annual savings in the order of 20 per cent of previous expenditure. However, it is hard to tell whether these savings have been maintained since then

as current governments in the two states are not actively pursuing contracting and are not reporting on the subject.

In this survey we found that Mosman and Mornington Peninsula Councils achieved substantial cost savings by contracting out a wide range of infrastructure maintenance services and improved services by improving specifications and monitoring. By outsourcing, the NSW Government has made major savings in property cleaning services and improved the coverage of valuation services. We also found that extensive monitoring of residential aged care services ensured a good quality of care generally. However, in this case costs and prices are high, there is limited competition, and places are limited.

Contracting out often requires significant structural reform of an organization, especially when an agency has long experience of in-house provision. Successful contracting out also requires a great deal of work in drawing up appropriate specifications, which should be performance-based where possible, in the tender process, and in the monitoring of the ongoing contracts. Experience in contracting out also improves performance and outcomes. Where governments have been reluctant to restructure, notably within the NSW Government, or in a hurry to develop contracting procedures (a common problem), the benefits of contracting out have been much smaller.

In more extreme cases, contracting out can produce expensive outcomes or major service failures. Examples include the lack of scrutiny of the contract with Port Macquarie Base Hospital and management's failure to maintain control of the process of contracting out various parts of the Melbourne Ambulance Service.

In NSW and Victoria, the Governments currently focus on shared service arrangements within the public sector, state-wide procurement contracts, and the protection of public sector employment. Where the private sector is involved, the emphasis is on service partnerships. Partnering requires both parties to own and develop a common agenda – a sharing of the risks and rewards that is commensurate with the contribution made by each party. However, it is not clear that the policy rhetoric of partnering is a real substitute for the hard decisions of allocating work or resources. It seems likely that, in one way or another, outsourcing will remain an important economic and social issue.

Appendix NSW Government Principles for Outsourcing

When the NSW Government started a program of competitive tenders for public services in 1993, it adopted the following important principles (NSW Premier's Department, 1993):

1. Robust assessment for retaining or contracting activities

All activities should be progressively assessed to determine the approach that will contribute most to the efficient and proper achievement of the Government's objectives.

2. Quality and equity in the provision of contracted services

There should be clear accountable standards for service provision that nevertheless recognise special needs of different groups which should be incorporated in service contracts.

3. Consultation with staff

There should be full consultation with staff at the planning and execution stages. This does not imply employee involvement in decision making, access to commercially sensitive material, or a veto power for staff.

4. Safety and equity in the workplace

The government is committed to promoting and maintaining safety and equity in workplaces. Contractors must scrupulously follow their statutory responsibilities.

5. Clarity of roles and accountabilities

The government must clearly specify:

- The objectives of the service or activity;
- Each party's obligations;
- The form, volume and quality of the service; and
- The monitoring and enforcement arrangements.

6. Facilitation of innovation

Government should specify outcome requirements rather than methods for providing services. This allows tenderers to respond flexibly and innovatively to service provision requirements.

7. Fair and effective competition

The principle of fair and effective competition requires:

- facilitating effective competition: This includes informing the market place of contracting requirements; defining the task in performance terms; effective monitoring of actual performance; and ensuring that the contractual and operating conditions facilitate a change over of contractors when appropriate.
- ensuring competitive neutrality especially between in-house teams and outside contractors.
- ensuring proper processes that are fair and open to scrutiny.

8. Full risk assessment and efficient risk allocation

The full range of risks is to be identified and assessed and allocated to the party most able to influence and control specific risks.

9 Effective performance monitoring and assessment of contracts

Effective monitoring and assessment of contracts is crucial for successful contracting, whether it is in-house or external.

10 Limited scope for contracting between government organizations

Public sector agencies should focus on their core role and not market services which are supplied by the private sector in competitive markets.

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