



PUBLIC MANAGEMENT

OCCASIONAL PAPERS

No. 20

CONTRACTING OUT GOVERNMENT SERVICES

Best Practice Guidelines
and Case Studies

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**CONTRACTING OUT
GOVERNMENT SERVICES:
BEST PRACTICE GUIDELINES
AND CASE STUDIES**

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FOREWORD

Contracting out government services is one of the principal market-type mechanisms applied in OECD Member countries. Its use is increasing in virtually all Member countries as the evidence is fairly clear that contracting out can lead to efficiency gains, while maintaining or increasing service quality levels.

Senior Budget Officials, meeting under the auspices of the OECD's Public Management Committee (PUMA), requested the OECD Secretariat to undertake a study of contracting out practices in Member countries in order to identify the key success factors for achieving the benefits of contracting out. The Secretariat was assisted by a panel of experts in this study. As part of their work, panel members prepared case studies of specific activities that had been contracted out in their respective countries.

The Best Practice Guidelines were prepared by Jon Blondal of the OECD Public Management Service, who also edited the Case Studies. Additional input was provided by David Shand. Technical assistance was provided by Jocelyne Feuillet-Allard and Judy Zinnemann.

The Guidelines were reviewed and endorsed at the 1996 annual meeting of Senior Budget Officials and were subsequently approved at the Autumn 1996 meeting of the Public Management Committee.

It should be emphasised that the purpose of the Guidelines is not to identify which activities should be contracted out, but rather to identify best practices for evaluating whether government services should be contracted out and how the process can best be managed once the decision to contract out has been made.

This report is published on the responsibility of the Secretary-General of the OECD. The views expressed in the case studies are those of the authors and do not commit or necessarily reflect those of governments of OECD countries.

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BEST PRACTICE GUIDELINES FOR CONTRACTING OUT GOVERNMENT SERVICES

SECURE TOP MANAGEMENT INVOLVEMENT AND ENCOURAGE RE-ENGINEERING

- Contracting out should be integrated with the overall corporate strategy of the organisation. It requires the active leadership of top management if it is to achieve its full potential. The ownership and oversight of the contracting out exercise should therefore rest with the very top of the organisation.
- Contracting out should not involve a mechanistic consideration of contracting out existing tasks or processes. Rather, it should be used as an opportunity to re-evaluate both the rationale for existing tasks and the processes used to carry them out. These re-engineering benefits can only be reaped with top management involvement.
- Contracting out can lead to tensions within organisations. There may also be resistance to contracting out by some in the organisation. Active top management involvement is essential in preventing, or resolving, these internal impediments to contracting out.

When the City of Indianapolis decided to contract out the operations of its international airport, the Mayor took personal leadership of the project. It was one of the many projects where he had decided to apply the principles of competition to the provision of government services. Under the direct management of its board of directors, the Indianapolis Airports Authority then began the process of soliciting proposals to run the airport. This high-level commitment is one of the key factors responsible for the success of the project.

From United States Case Study

FOCUS ON STAFF ISSUES

- It should be recognised that contracting out is not only a financial and performance issue; it is also a people issue. It is essential to demonstrate a high degree of sensitivity in this area.
- Staff are inevitably concerned by contracting out. These concerns are caused in large part by the uncertainty that the contracting out exercise can create for them. While the process requires proper analysis, it must proceed rapidly in order to minimise any period of uncertainty for staff.
- It is of primary importance to consult staff immediately when an activity is being considered for contracting out; to deal with them honestly and frankly; and to keep them informed at every step of the way, both individually and as a group. As some staff may feel uneasy about asking questions, a confidential box (or similar) should be established where staff can drop questions anonymously with the answers then being posted for all to see.
- Similarly, the relevant trade unions should be consulted immediately when an activity is being considered for contracting out and kept up-to-date on developments.

When the Inland Revenue Department contracted out its information technology function, it immediately recognised staff worries about their future, and adopted a number of approaches to keeping them informed and responding to their concerns including: establishing a confidential telephone inquiry line, issuing newsletters and information bulletins, providing question-and-answer booklets and one-on-one meetings with individual staff. Consultations were opened with the trade unions at an early date as well. The Inland Revenue requests regular reports from the contractor on the progress of its former staff. These show that the staff is enjoying better career prospects at one of the world's leading information technology firms than they did previously working in the information technology department at the Inland Revenue.

From United Kingdom Case Study

SPECIFY SERVICE REQUIREMENTS IN TERMS OF OUTCOMES OR OUTPUTS

- Service requirements should be specified in terms of outcomes or outputs, not inputs. This means specifying *what* the activity is, not *how* the activity is to be performed. Operational flexibility is essential for the contractor to be innovative in performing the activity, and thereby securing efficiency gains. These outcomes or outputs should be specified as fully as possible, and include appropriate service quality measures.
- Consideration should be given to the applicability of incentive payments in the contract, either by structuring payments in such a way that they are contingent on the achievement of certain levels of service, or by offering bonus payments for achievement of service levels above a pre-defined baseline.

When Australia decided to contract out its case management services for the unemployed, the contracts were specified in terms of finding a job (or full-time education) for the unemployed. That was the desired outcome, and the contracts were framed around that. This was backed up by the payment schedule to the contractor. Fees are paid in two parts: an initial fee after the case manager and the client have developed an agreed "return to work" strategy, and a second fee based on achieving a successful outcome. The outcome fees are paid after the client has completed 13 consecutive weeks in employment or full-time education. This aims to create an incentive for case management organisations to attract clients and successfully place them in employment or training.

From Australian Case Study

MONITOR PERFORMANCE AND FOSTER CO-OPERATIVE RELATIONSHIPS

- Contracting out an activity does not diminish, in any way, the responsibility of the organisation for the performance of that service. This is especially relevant when that service is being provided to a third party.
- The organisation should regularly and formally monitor the performance of the contractor to ensure that the performance standards stated in the contract are fulfilled. When performance information originates from the contractor, it should be audited to ensure its accuracy.
- Although contracting out involves a formal contractual relationship, both parties need to recognise their mutual dependence and thus their mutual interest in developing a co-operative relationship rather than an adversarial relationship.
- The contract should incorporate provisions regarding contractor non-performance, dispute resolution mechanisms and the smooth hand-over of the activity to another contractor.

When the National Hospital in Copenhagen contracted out its building cleaning services, a system of performance monitoring was put in place. The hospital established a group of controllers to ensure that the work performed by the contractor was in accordance with the provisions of the contract. Unannounced quality checks are made 40 times per month. No such independent reviews had previously been conducted.

From Danish Case Study

When the Turkish Ministry of Finance contracted out its catering operations, it ensured that they were regularly monitored against the output-based quantity and quality standards stated in the contract. If they are not in conformity with the terms of the contract, the contractor is warned and fined for the first two violations. If the violation is repeated for a third time, the contract is terminated and the contractor's guarantee fee is not returned. The Ministry of Finance has never had to resort to these enforcement mechanisms.

From Turkish Case Study

ENSURE VALID COMPARISONS

- It is important when considering proposals for contracting out that all alternatives, which may include continued in-house provision, be comprehensively evaluated. This involves considering both the costs and outcomes or outputs, including comparative quality. All risks should also be systematically assessed. This includes the risk of dismantling in-house capabilities and possible dependence on a single supplier.
- A thorough costing of the present activity should be conducted and used as a benchmark for evaluating contracting out proposals. This involves identifying all costs related to the activity that is to be contracted out. These include not only the direct costs of the activity, but also its share in overhead costs and such non-cash costs as depreciation and cost of capital. The treatment of the present activity for taxation purposes also needs to be taken into account.
- If the present activity can be restructured in such a way as to offer improved performance, then this should be similarly costed and used as the benchmark for evaluating contracting out proposals.
- If contracting out an activity will incur a liability for severance payments, then this should be identified as a separate item recognising the one-off nature of such payments.

When the New Zealand Audit Office contracted out many of its audit functions, careful attention was paid to determining the cost of its services for comparison with private sector providers. The financial management reforms undertaken in New Zealand in recent years were of great assistance in this respect. All costs are reported on full accrual basis, thus reflecting depreciation charges; and include a capital charge to reflect the cost of capital employed. This enabled the reported cost of producing audit services by the public sector to be directly compared with the price charged by private sector providers.

From New Zealand Case Study

EVALUATING IN-HOUSE BIDS

- An in-house bid occurs when the staff presently performing an activity bids against an outside contractor for an activity being considered for contracting out.
- In-house staff are often in the best position to identify opportunities for work process improvements. Their bid should be judged on the basis of these improvements.
- In-house bids should in all respects be treated the same as outside bids. Special care needs to be taken to ensure that the costing of the bid is complete, *i.e.* that it incorporates all items of cost faced by private sector contractors. The costing should be reviewed by an independent organisation to verify its accuracy. In-house bidders should also fulfil any accreditation and certification requirements imposed on an outside bidder.
- A winning in-house bid should be awarded to the staff on the basis of a formal document that obligates the staff to meet the terms of their bid. The performance of in-house staff should be monitored using the same processes and criteria used for outside contractors.
- The criteria used for deciding whether to permit an in-house bid should be clear and specific.

When the Dutch Tax and Customs Administration decided to contract out its printing services, it emphasised extensive consultations with all stakeholders. Involving all parties in the process at an early stage led to a balanced solution that was widely accepted. Staff members participated in the working group established to develop further the contracting out proposal. This working group recommended that no decisions be taken until a detailed Social Plan was developed for dealing with each affected staff member. All staff were either offered new positions with the contractor, reassigned to other positions within the organisation or offered outplacement training and related services. Given this Social Plan, the unions agreed with the decision to contract out the printing services.

From Dutch Case Study

FOSTER COMPETITIVE MARKETS

- Competitive supplier markets are key to achieving the benefits of contracting out. The government should foster competitive markets by recognising that its contracting out practices can play a major role in the development of markets for the relevant services.
- This relates especially to the scope and duration of contracts. At either extreme, contracts may be so small and short that they do not stimulate interest, or so large and lengthy that only the largest suppliers can participate. Consideration should therefore be given to bundling various services into attractive “packages” that can be contracted out as a single activity, or, conversely, splitting an activity among more than one contractor in order to foster competition. A judgement has to be made each time, but it should explicitly take account of its competitive impact.
- Avoiding over-specification in contracts is also important for fostering competitive markets. If the objective is specified, rather than the operational aspects of an activity, the market may be encouraged to develop its own proposals and solutions.
- Contracting out is part of the procurement function. It should be recognised that participating in the bidding process involves substantial time and resources on the part of the bidders. To the extent that this process can be simplified and shortened, a greater number of valid bidders are likely to participate.

When the Icelandic government decided to contract out residential treatment homes for children with behavioural and emotional problems, it was unknown whether there were any potential contractors willing to provide these services. The government was, however, determined to see if it could extend its competitive tendering policies to core social functions such as this. The government publicised this widely and took out advertisements in leading newspapers soliciting interest from the private sector. The response was overwhelming. A competitive private sector market has now been established where none existed before, and almost all residential treatment homes have now been competitively contracted out.

From Icelandic Case Study

DEVELOP AND MAINTAIN THE NECESSARY SKILLS

- Effective contract management requires a new set of skills for many government organisations. Recruitment and staff training policies need to take account of this.
- Organisations that contract out activities need to maintain their knowledge of the market and their technical knowledge of the activity. This is imperative in order to be able to communicate with the contractor on equal terms, and to be in a position to effectively tender the activity again. This is especially relevant in the case of contracting out complex activities.
- It can be considered inappropriate to assign responsibility for the contract management function to staff members formerly responsible for in-house production, especially if they were part of an unsuccessful in-house bid.
- It should be recognised that contracting out involves a learning process, with knowledge gained through the contract management phase enabling subsequent tendering of the activity to be carried out more effectively.

When Mexico started contracting out its network of national highways through toll-based private finance initiatives, it encountered difficulties. The volume of traffic on the highways was less than estimated, the quality of the highways constructed was higher than that actually required, and the length of the contracts was too short. Other problems were identified as well. These problems are viewed as “areas of opportunity”, and have been studied in depth by those responsible for the management of the contracts. Subsequent tendering will incorporate the lessons learned.

From Mexican Case Study

CONTRACTING OUT CASE MANAGEMENT SERVICES FOR THE UNEMPLOYED IN AUSTRALIA

by

Lyn Maddock, Simon Corden, and Timothy Hunt, Industry Commission

I. INTRODUCTION

In its May 1994 White Paper on employment and growth, *Working Nation* (Keating 1994), the Australian government announced it would introduce an element of competition to the delivery of labour market assistance – the community and private sectors would be used to provide a proportion of case management services to unemployed people. In a refocus of the activities of the responsible department, case management services were to be provided to the long-term unemployed and those short term unemployed identified as being at high risk of becoming long term unemployed (the clients).¹

The 1994 Employment Services Act established the basis of the institutional framework. The Employment Services Regulatory Authority (ESRA) was formed to regulate arrangements for the introduction of competition; promote its introduction; accredit and contract private, community and other public sector case managers; and administer their payments. It began operating on an interim basis in mid-1994. The Act also established within the Department of Employment, Education and Training a separate organisation, Employment Assistance Australia (EAA) to be the public, and major, provider of case management services for unemployed people.

The government is phasing in competitive arrangements and has established the proportions of clients to be managed by EAA and by contracted case managers. The targeted proportion for contractors was 10 per cent of clients in 1994-95, increasing to 20 per cent (up to 100 000) in 1995-96. It was anticipated that this figure might be increased to around 30-40 per cent in subsequent years if evaluation showed the capacity and performance of contracted providers to be adequate. Clients have some choice of provider within these constraints.

Direct competition, in the immediate future, will therefore be limited to the 20 per cent of clients to be shared by contracted providers. In the longer term, ESRA considers it possible that the market share of all players could be determined by the flow of clients choosing case managers in the marketplace, although the government has yet to decide upon this (ESRA, 1995a, pp. 1-2).

The total budgeted outlay on case management for 1995-96 is just over \$251 million. Of this, over \$68 million (about 27 per cent) will fund the contracted case management scheme through ESRA, with the balance allocated to EAA. Contracts to provide case management services were written with 252 community, government and private sector organisations, with a total of around 800 case managers employed.² In 1994-95, EAA had the equivalent of around 2 000 full-time case managers.

The first referrals of clients to contracted providers occurred in late March 1995, on the basis of 12 month contracts. By December 1995, 19.4 per cent of the client group were receiving case management services from contracted providers (Table 1). A second round of tender evaluation is currently under way.

Because case management of the long-term unemployed was a new programme in 1993-94, comparisons with previous service delivery, staffing and expenditure levels cannot be made.

Table 1. **Contracted case management commencements and market share 1995-96 Financial Year (to end December 1995)**

	Cumulative commencements with contractors	Per cent of year-to-date commencements in case management	Contractors percentage share of all clients in case management
July	12 721	29.0	15.6
August	21 486	26.0	17.3
September	27 724	27.5	17.7
October	31 858	24.0	18.2
November	38 408	24.0	18.9
December	43 643	23.7	19.4

Source: ESRA, 1996.

II. GOVERNMENT POLICY ON CONTRACTING OUT

In recent years, there has been a growing interest in the use of competitive tendering and contracting by all levels of government in Australia. governments have been increasingly willing to expose their operations to market competition. As the use of competitive tendering and contracting has expanded, governments and agencies have sought to supplement general purchasing policies and guidelines with policies and guidelines specific to contracting.

Contracting has extended to areas sometimes considered the exclusive province of government providers (*e.g.* prisons, welfare services and policy analysis). A range of social welfare, training, development and education services have been contracted at all government levels. Labour market services have been contracted at both federal and state government levels.

In 1994-95, the amount of contracted government expenditure in Australia was estimated at around \$8 billion (15 per cent of total current expenditure) at the federal government level, \$3.3 billion (4 per cent) at state and territory level, and \$2 billion at local government level (20 per cent) (IC, 1995).

III. IMPLEMENTATION ISSUES

Determining the feasibility of contracting out

Assessment of the feasibility of contracting out case management services largely relied on government experience in related areas which enabled an "in principle decision" to be made by the government, rather than a formal feasibility study. A working party of government officials then examined how to implement such a scheme. The Department of Employment, Education and Training had made considerable use of external providers, contracting over \$300 million worth of services in 1993-94, more than \$140 million of which were labour market programmes (IC, 1995). External providers had provided case management-type services under a smaller programme that assisted very long-term unemployed (the Contracted Placements programme) while case management had been used within other areas of the public sector including by the Commonwealth Rehabilitation Service.

Many of the community and private sector agencies providing these programmes had indicated interest in, and had some capacity to, case manage their clients (Keating, 1994, p. 129). Contracting out of the service sought to tap the skills and expertise of these providers.

The government took the view that the primary constraint on this activity being performed entirely by contracted providers was the ILO Convention 88 requirement that there be universal access to a *free, public* employment service. The government has met this requirement by obliging EAA to be the provider of last resort in areas where it has not been possible to attract non-government providers. Strategies to attract non-government providers to these areas are being considered.

The market for case management

There are a variety of ways in which the desired outcomes of case management could be achieved, reflecting both the diverse needs of clients and the variety of skills and methodologies offered by potential contractors. The decision to contract out case management services encouraged, as anticipated, a large number of enterprises and individuals from a range of related areas to establish operations to provide this service, with more than 600 organisations initially gaining accreditation. Of these, more than 400 submitted tenders in the first round of tendering; the total capacity was thus-sought twice the market being made available. These organisations came from a number of related areas including:

- private sector employment agencies;
- community groups that help people on a one-to-one basis to deal with the social security system and to find work;
- providers of occupational rehabilitation services for injured workers;
- training organisations including community groups, for-profit enterprises and government agencies; and
- private sector case managers in the Contracted Placements programme.

At this early stage, the market is immature rather than “effective” with both competition and the institutional framework evolving. External providers compete through the tendering process for allocations of client capacity based on a fixed fee structure. Accredited providers specify the number of clients they wish to manage in particular locations. Once allocated capacity, they market their services to the client group to attract individuals (although all clients are obliged to participate in case management). Individual contractors can apply for additional capacity where they have demonstrated the ability to successfully manage their current case load. However, because of constraints on total market share of the contracted sector, ESRA can only provide additional places where it considers other contractors will be unable to attract their allocated case load.

Costing of services

While the government did not set up direct competition between EAA and contracted providers, the potential for benchmark competition between the two groups, as well as their linked funding arrangements, focused attention on the costing of EAA. The results of an annual internal cost attribution study conducted by the Department will affect the contracting out exercise in three ways. First, the government has stated that the average cost of external provision should not exceed that of EAA. Second, a scheduled evaluation of EAA and the contracting of external providers would be expected to assess the value for money of the two alternative methods of service delivery, and this will depend, among other things, on the assessments of the costs of EAA. Third, as EAA’s share of the case management market is reduced, its funding will decline, and the funds available for external provision increase.

The *Guidelines for Costing Government Activities*, released by the Department of Finance in July 1991, provide broad guidance on costs that should be included (for example, taxes paid by private providers and a return on capital), but are not prescriptive about issues such as apportioning overheads. The purpose of the cost attribution study is to identify and attribute the running costs across the Department’s sub-programmes. The Department of Employment, Education and Training considered the guideline’s framework not entirely appropriate for a study on which to base a cost attribution of the Department’s cash appropriation, and consequently the study differs from the guidelines in some respects. The study provided direct and indirect costs on a programme and sub-programme basis, including the cost of operating EAA, for reporting purposes for departmental financial statements and the annual report. As part of the auditing of these statements, the Australian National Audit Office examined the cost attribution methodology, as has the Department of Finance. Direct and indirect costs, such as salary, administrative expenses, property operating costs and superannuation, were included. No allowance was made for tax equivalent payments. The Department recognised “that the

estimated costs do not reflect the full cost of EAA operations as accrual costs (except for superannuation) were not calculated since these are not included in the Department's cash appropriation."

The costing and funding arrangements also raise a number of difficult issues concerning the parameters of the service that is produced and thus funded. EAA's costing and funding is calculated by costing the level of inputs per client, whereas the fees paid to contractors are based in part on achieving outcomes (that is, a success fee for clients gaining employment or other paid outcome). Because of the lack of a single agreed definition of quality, measures of output or process measures, such as hours of counselling per client per year, are not defined for either EAA or contractors.

Competitive neutrality

Ensuring competitive neutrality between EAA and contracted providers is a significant issue with a number of dimensions. ESRA is responsible for monitoring all case managers (including EAA), examining, among other things, referral of clients to case managers and availability of client choice of case manager. An evaluation of competitive arrangements, independent of both the Department and ESRA, is to be undertaken by June 1997.

It is necessary to ensure that assessment and allocation of clients does not favour any provider. EAA is co-located with Commonwealth Employment Service (CES) local offices and shares staff in some locations and other resources, but is set up as a separate body for the purpose of client identification and internal costing. CES staff (not EAA's) undertake the initial screening and classification of clients. Where there are a number of case management organisations, clients are offered a choice of their preferred provider, including EAA. To assist this choice, the client is provided with a one-page information sheet about each of the providers in the area. These sheets are compiled by the providers, with those of the contracted providers cleared through ESRA. If clients do not exercise a choice, or if their chosen case manager has no vacancies at the time, they will be referred to a case manager by the CES. Case managers must accept all referrals made to them to guard against providers attempting to maximise their returns by rejecting those clients in a given fee group likely to be less profitable (ESRA, 1995a, p. 5).

Other issues

Contracted case management was introduced during a period when a major reorganisation of the public employment service occurred to streamline administration and improve local delivery networks. Industrial relations issues directly associated with contracting seem to have largely concerned additional workloads placed on CES staff as a result of the introduction of case management, rather than its external provision. Resources were provided and workload reduction measures implemented to offset the increased workload in the CES. The peak union body, the ACTU, supported the introduction of contracted case management and encouraged unions to establish themselves as providers by becoming case managers (ACTU, 1995, p. 1).

Benchmark competition through contracting out some of this activity may have a profound effect on EAA over time, as external providers are funded by a transfer of resources from Departmental running costs.

The introduction of external providers may further affect public sector managers on two levels. First, because the payments to external providers are in part linked to the classification of clients by the CES, there are greater pressures on CES managers to improve the precision of the classification system. There is also a need for CES management to ensure that both the internal (EAA) and external providers (those contracted by ESRA) are treated equally. Second, there may be greater pressures on performance if the introduction of competition improves the available outcome and cost benchmarks for judging the performance of EAA.

IV. CONTRACT ARRANGEMENTS

In assessing the suitability and risks of competitive tendering and contracting for case management, ESRA needed to design a contract and monitoring process to address issues that were specific to the service, to the market and to the agency. Some challenges in contract design in this area were that:

- the future needs of individual clients could not readily be predicted;
- there was no standard measure of quality, because the service depends on combining a number of elements of a service in different ways for different users;
- there was uncertainty as to which potential solutions offered by different providers would be most successful;
- a stable relationship between the contractor and the long-term unemployed client was important;
- the provider market was underdeveloped, with few having experience, and consequently with competitive tendering and contracting of this service; and,
- the contracting agency, ESRA, similarly was learning as it went along.

These factors affected contract design and monitoring, specification, contract type and duration, tender model, and evaluation.

To address these particular service and market characteristics, ESRA chose to rely on a mixture of performance specification (that is, based on outputs) and design specification (that is, based on minimum levels of inputs or the process).

Fee structure

A contractor's revenue is determined by fee levels, which are based on four classification levels of clients, and by the proportion of clients achieving successful outcomes (see Table 2).

Job seekers have a wide range of strengths and weaknesses in terms of their work experience, qualifications, education, English language skills and disabilities. ESRA recognised that more disadvantaged clients would require, on average, greater support (ESRA, 1995a, p. 2). To reflect this heterogeneity amongst the clients (and in the absence of setting a specific fee for each client), ESRA devised a schedule whereby the fee paid for the case management of a client varies according to his or her Client Classification Level (CCL), as determined by the CES. The classification of clients into CCLs, together with the scaling of fees, determines the initial and success fees a case manager receives.³

As an initial measure, classification was based primarily on duration of unemployment until a more sophisticated method could be devised. This initial approach delivered a greater proportion of clients into the higher classification levels and fee categories than was anticipated when the fee structure was determined. On 3 July 1995, a new system was introduced by which the client classifications were calculated automatically during the referral process to a case manager by the CES, based on a questionnaire filled out by each client. This new method focused on the combinations of employment strengths (for example, vocational skills and labour market attachment) and personal barriers (for example,

Table 2. **Contracted case management fee structure**

Client classification level	Initial fee for case management activity agreement	Outcome fee		
		Unsubsidised employment	Other suitable outcome	Other event which terminates case management
1 (easier)	\$150	\$200	\$150	Nil
2	\$300	\$400	\$250	Nil
3	\$600	\$900	\$500	Nil
4 (harder)	\$2 000	\$1 500	\$1 000	Nil

Source: ESRA, 1995a, p. 3.

disabilities and language barriers) that each client possessed. Duration of unemployment was eliminated as a criterion. This new classification method generated a classification profile closer to that originally intended, but its introduction caused an adverse reaction from contracted case managers, who regarded many of the classifications as too low. A review of the classification process has now been undertaken, and a revised questionnaire has recently been trialed. Case managers may, in any event, seek a review of a client's classification level if additional information of relevance to the classification subsequently comes to light.

Fees are paid in two parts: an initial fee paid after the case manager and the client have developed an agreed "return-to-work" strategy, and a second fee based on achieving a successful outcome. The outcome fees are paid after the client has completed 13 consecutive weeks in employment or full-time education. This aims to create an incentive for case management organisations to attract clients and successfully place them in employment or training.

Evaluation of tenders was based on quality rather than price and, particularly in the first round, on quality of inputs. As data on the performance of providers becomes available, this will be taken into account. Price is not considered in current tendering decisions, but may become a factor in future tendering when a clearer understanding of "quality" case management has been developed. Even then, ESRA does not anticipate that price will be of primary importance.

The ability to deliver quality services has been a crucial element of the tender evaluation, which is largely based on the expected quality of service provision and the viability of an organisation's business plans. Rather than adopting a prescriptive approach, ESRA sought a combination of skills and experience suitable for case management practice.

Pre-qualification or accreditation

A form of pre-qualification was used to reduce the risk of a provider failing to deliver the minimum quality of service required – all tendering organisations were first accredited by ESRA (and must maintain accreditation).

Organisations may apply for general or specialist accreditation. Specialist accreditation recognises the ability to provide services tailored to the needs of one or more specialist groups, including Aboriginal and Torres Strait Islander people, people with disabilities, people from non-English-speaking backgrounds, young people, and mature age people, or the ability to provide services to clients in particular industries or occupations (ESRA, 1995a, p. 3).

Applications for accreditation are assessed against nine criteria:

- adequate infrastructure;
- financial and institutional stability;
- adequate insurance cover;
- general experience;
- management ability;
- expertise;
- suitable personnel;
- standards of premises; and
- ability to conform with ESRA's rules of conduct in relation to clients (ESRA, 1995a, p. 3).

Because of the difficulty in defining the total service, only some dimensions of quality are explicitly defined in the contract. Case managers are required to provide services in accordance with the Employment Services Act 1994 and ESRA provider guidelines, including compliance with the Rules of Conduct. These rules cover service ethics and standards, standards of premises and facilities, advertising, and financial and resource management. Only case managers specifically approved by ESRA can be used (ESRA, 1995c, p. 1990). EAA case managers do not require accreditation, but are required to conform with legislation relevant to the public service, including Australian public services regulations and rules of conduct.

Performance indicators

ESRA has developed a set of performance indicators to evaluate case managers. These include the proportion of cases that result in successful outcomes, the proportion of unsubsidised employment outcomes, the number of complaints lodged by clients, and the use of labour market programmes. Contractors and EAA will be able to compare their relative performance in several of these categories.

Some data on the performance of case managers is collected on the Department of Employment, Education and Training's central database. ESRA has access to an increasing range of aggregated data on client characteristics and outcomes, although this is not as flexible and as detailed as it would like. Only limited performance data is publicly available to date (see Tables 3 and 4).

Performance indicators have been developed to evaluate the overall performance of the case management system, and these will subsequently be fed back into the tender process. The most important of these is successful outcomes, while others include the proportion of clients who are offered a choice among case managers, the proportion of cases managed by contractors, and the number of new organisations that apply for tendering.

Table 3. **Cumulative commencements with contracted case managers and outcomes, March 1995 – January 1996**

	Commencements	All outcomes ¹	All outcomes as a percentage of commencements
June 1995	30 087	1 411	4.7
July 1995	42 808	3 664	6.6
August 1995	51 555	6 761	13.1
September 1995	57 811	8 785	15.2
October 1995	61 945	13 136	21.2
November 1995	68 495	18 176	26.5
December 1995	73 730	21 893	29.7
January 1996	79 195	26 563	33.5

1. "All outcomes" includes job seekers placed in employment, education or training for which ESRA will pay an outcome fee, and those who may exit case management for non-employment or education based reasons such as withdrawal, loss of eligibility etc.

Source: ESRA, 1996.

Table 4. **Contracted case manager performance by state and territory to 31 December 1995**

State or territory	Number of outlets	Commencements (March to December 1995)	Positive outcomes ¹	Clients in post placement support ²	Total of A and B ³	Total of A and B as per cent of commencements
New South Wales	181	23 062	1 797	2 211	4 008	17.4
Victoria	182	26 128	2 285	2 540	4 825	18.5
Queensland	113	15 412	1 241	1 718	2 959	19.2
South Australia	51	6 633	433	620	1 053	15.9
Western Australia	50	5 111	359	497	856	16.7
Tasmania	21	2 458	172	305	477	19.4
Northern Territory	6	803	38	70	108	13.4
Australian Capital Territory	5	366	15	27	42	11.5
Total	609	79 973	6 340	7 988	14 328	17.9

1. "Positive outcome" – a placement in employment, education or training for which ESRA will pay an outcome fee.

2. "Post-placement support" – a placement in employment, education and training for which ESRA will pay an outcome fee if and when it lasts for 13 consecutive weeks.

3. Note that this total does not include job seekers who may exit case management for non-employment or education based reasons such as withdrawal, loss of eligibility etc. (in contrast to Table 3 above).

Source: ESRA, 1996.

Contract size and duration

Contract size has been chosen to facilitate the participation of as many providers as possible to offset the uncertainty about likely success factors and the inexperience of providers. Contracts specify the maximum number of clients that may be managed by a contractor for the contract period, and at any given time. ESRA has indicative referral levels on which to base these numbers. However, these are flexible, and ESRA has revised upwards the maximum case loads. In December 1995, the maximum number of clients per case manager was 75 at any one time (ESRA, 1995c, p. 1999). This ratio has been increased on request where case managers have demonstrated the ability to successfully place more clients than initially allocated.

Contracts were initially let for 12 months. The provision of case management services may extend beyond this period, depending on the date of referral and the period necessary to obtain an outcome (ESRA, 1995a, p. 5). Contracts state that case managers will take clients for the specified period. However, the contractor remains responsible for a client for 12 months after the date of referral. Hence, even after the contract expires, the organisation must manage its remaining clients even if it does not bid for, or is not awarded, another contract. This can result in a gradual dwindling of the case load.

ESRA has stated its intention to move to a longer contract period in the current round (ESRA 1995c, p. 1987).⁴ The move to introduce longer contracts reflects the desire to produce a more stable environment for business planning, encouraging contractors to undertake investment (including recruitment and training of staff) and practice improvement. ESRA considers that longer contracts also have the advantage of ensuring that a more stable and continuous service is provided to clients (ESRA 1995c, p. 1987).

Given the importance of stable contractor/client relationships, the duties of parties where contractors cease operations have been defined although not included in the initial contract.⁵ If a case management organisation goes out of business, clients are transferred back to the CES, where they are referred to a new case manager.

Other issues

Competitively tendering case management, according to ESRA, involves "... a move away from a centralised, public provision of assistance with strict reliance on uniform guidelines to a more flexible arrangement where private and community [contracted] case managers will have a degree of discretion. Case managers will assess the particular needs of individual clients. Case managers will be encouraged in the longer term to be innovative..." (ESRA, 1995a, p. 7). It is too early to say whether this has been the result, as only one contract round has been completed to date.

The broad framework for case management was set up by the Employment Services Act 1994, while details of how competition would be introduced, including the tendering and contract framework, were developed after wide-ranging consultation. In the first round of tendering and accreditation, ESRA consulted with interested parties across Australia about ESRA's role and the introduction of competition to case management services (ESRA, 1995a, p. 3). ESRA also regularly contacts contractors and holds a range of formal and informal consultations with stakeholders, including clients. Providers are monitored to reduce the risk of contractor failure and to gather more information on the factors underlying success and failure.

In the interest of developing a competitive case management market, special provisions were available to assist small business to participate in the bidding process. ESRA can provide advances on fees to not-for-profit organisations, in addition to providing some part of the fee up front under the general pricing system (ESRA, 1995c, pp. 1980-81).

With regard to the relative effectiveness of EAA and contractors, the Department of Employment, Education and Training and ESRA have agreed upon a joint strategy for the evaluation of case management. An interim report is to be released for the 1996-97 budget and a final report for the 1998-99 budget. An independent evaluation of competitive arrangements is also to be completed by the end of June 1997.

To evaluate the programme in general, a three year longitudinal survey is also being undertaken to evaluate whether clients are just being turned over or are remaining in longer term employment (ESRA, 1995c, p. 1985).

V. OVERALL ASSESSMENT AND LESSONS LEARNED

The results of contracting out case management services for unemployed people could be assessed in either of two ways. First, how the process adopted compares to best practice. Second, whether contracting out this activity has achieved greater value for money than maintaining monopoly public provision.

This case study does not seek to address the second question. Less than 12 months after the introduction of contracted case managers, it is too early for a quantitative assessment of the performance of the contracted providers versus EAA. Moreover, the appropriate performance indicators are not self-evident. Performance indicators for providers could, among others, include:

- cost per client in case management;
- cost per individual client achieving a “successful” outcome; and
- for a given cost, the client satisfaction with elements of the service.

An assessment of the broader decision to contract out could seek to assess, while adjusting for other factors, the:

- cost to achieve a given decrease in benefit payments;
- cost to achieve a given decline in long-term unemployment; and
- cost to achieve a decline in overall unemployment.

At this early stage an assessment of the contracting out process is a more tractable problem. The Industry Commission’s (IC, 1995) report *Competitive Tendering and Contracting by Public Sector Agencies* examined contracting across a broad range of jurisdictions, markets and industries, and formulated recommendations as to what it considered best practice. While the discussion below focuses on a few key elements of best practice, identified in Box 1 below, others have been discussed earlier.

Specifying and monitoring the quality of the service to be supplied is a more difficult problem where client needs vary widely, and it may only be possible to specify the minimum level of service in a useful way [element a].

One part of the solution has been to allow clients to choose among providers by awarding a relatively large number of small contracts in each local employment area. In contrast to the approach whereby one set of specifications is formulated for a single large contract, this approach permits clients, by their choices of providers, to induce providers to improve quality in various dimensions. This relies on clients having the information necessary to make informed choices.

It also relies on clients having a real choice by ensuring that total potential supply exceeds demand. In the current institutional framework, competition between contractors is strongest capacity is allocated by ESRA. Although the pricing structure provides a strong incentive to providers to produce a good service, there is only limited capacity for them to compete for clients: that is, a contractor requires ESRA’s approval to increase its share of the market at a competitor’s expense, and it is therefore possible that meaningful choice will not always be available to clients.

A second element addressing the difficulty that process cannot be used to define quality (for example, hours of counselling per client) was to structure the fees to reward performance (in this case by having payments related to outcomes, including clients gaining employment) [elements c and f].

A third element was to rely on accreditation, in part based on demonstrated expertise in related areas (a form of multi-stage tendering) to ensure minimum levels of service [element f].

Box 1. A Framework for assessing the process of contracting out

In their approach to tendering, agencies should:

- a) specify the service in clear, accurate and easy-to-follow terms;
- b) consult both the intended clients (or their representatives) and potential providers in preparing the specifications and other aspects of the tender documentation (such as draft Requests For Proposal, Requests For Tender and contracts);
- c) adopt performance specifications wherever possible;
- d) use industry-wide standard forms of tender documentation (including contracts) and standardised tender processes where possible;
- e) select a type of contract appropriate to the characteristics of the service and nature of the market;
- f) include an appropriate mix of incentives and penalties when specifying the service contract;
- g) consider incorporating non-court dispute resolution procedures into service contracts;
- h) identify the risks involved in any contractual arrangement and allocate these risks to the party best able to manage them;
- i) use multi-stage tendering whenever feasible and shortlist as quickly as possible;
- j) allow adequate time for bid preparation and between tender stages, taking into account the scope and difficulty of the information requested from tenderers;
- k) seek no more than the information required at each tendering stage;
- l) publish tender evaluation schedules as early as possible, and adhere to them;
- m) identify transition costs (including redundancy costs) and indicate in the tender documentation how they will be assessed at the tender evaluation phase;
- n) specify the selection criteria to be used in the tender evaluation and rank them in order of importance in the tender documentation;
- o) keep tenderers informed about the general progress of the tender process;
- p) advise unsuccessful bidders in writing as soon as they are eliminated from the evaluation process and debrief them on request; and
- q) consider employing, for major projects, an external audit of the costing of any in-house bid, an independent auditor on the evaluation panel and a probity audit of the tendering process overall.

Source: Industry Commission, 1995. Draft report recommendation 23.

The relatively small size and short length of the contracts reflected the characteristics of both the service and the market. With the high social cost borne by clients in case management if they are forced to change providers as a consequence of a contract failure, the contracting agency was very aware of the need to limit the impact of any one contractor failing. Quality parameters are both ill-defined and potentially hard to measure, and the market undeveloped, with providers unable to demonstrate that they have delivered this service in the past. The contracting agency therefore sought to ensure that it contracted with a large number of providers with diverse backgrounds and experience, in part to ensure that it has a diverse information base on which to refine its contractor selection in the future. ESRA also sought to foster development of regional competition in an environment where there were few organisations bidding across a large number of regions. Outcome measures, as they become available, will be a key component for determining quality.

However, both these choices could impose costs if continued as the market develops in the longer term. The resulting relatively small size of contractors may limit the development of extensive local employment networks and the realisation of other economics of scale or scope, without creating greater regional competition.⁶ In addition, the short duration of the contract with each contractor (and hence the ongoing insecurity of their involvement) would seem to work against investment by contractors in the development of local employment networks. Access to such networks is, however, seen as impor-

tant in generating successful outcomes for clients. In the future as the market matures, larger contracts that permit providers to exploit any economies of scale or scope, and longer contracts that reduce the uncertainty faced by providers could be appropriate [element e].

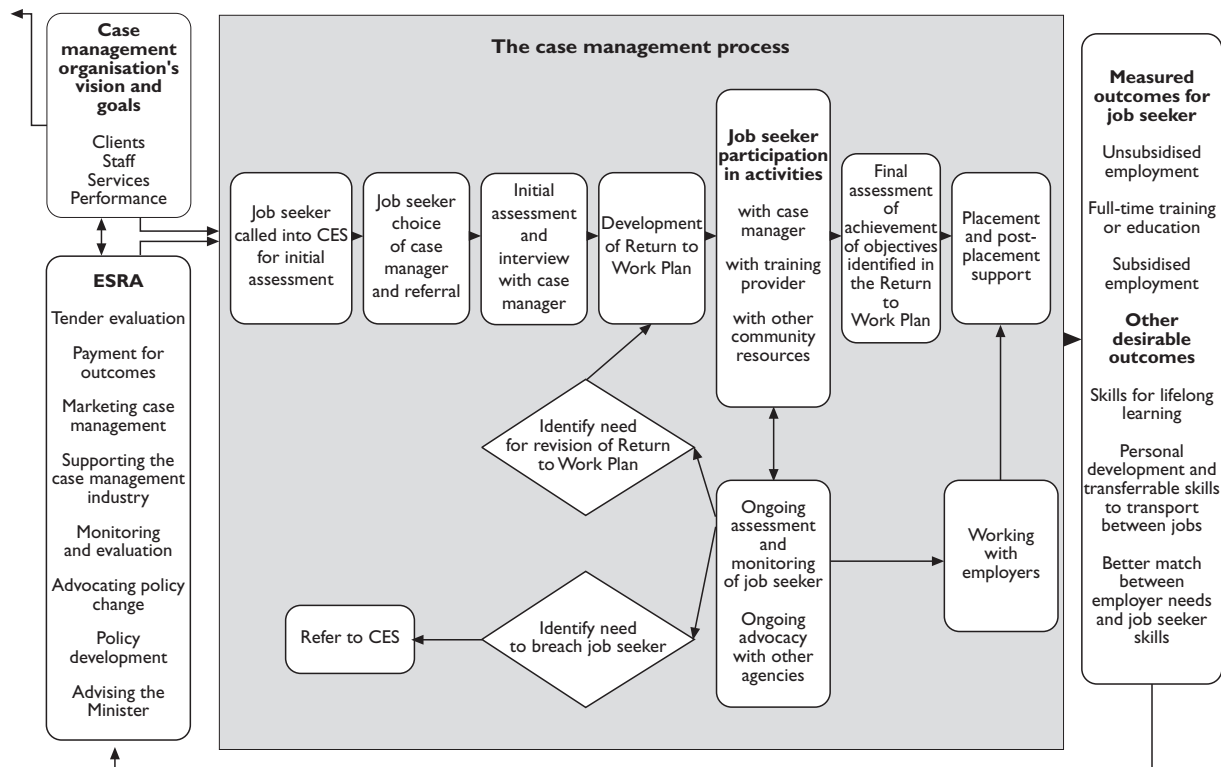
Governments face a trade-off between seeking to maintain flexibility to refine and otherwise change policy on the one hand, and the cost of increasing uncertainty in terms of the risk premium that contracted providers will require to induce them to undertake investment.

In this case, an important source of risk for the contractors and contracting agency was that the proportions of clients allocated to each category could change as the allocation process was refined. While contracted providers would benefit from refinements in the precision with which clients are allocated to the four fee categories, variations in the proportions of clients in each category (with the resulting effect on likely revenues of individual providers) are more problematic. The impact of any change in the allocation process was only on contractors and the contracting agency – EAA being budget funded. It is unclear why the contracting agency should not control the parameters of that process and bear the risk associated with change [element h].

Achieving a competitive neutral environment is a complex task. External audits of in-house bids can reduce concerns among contracted providers that the public provider may be favoured when assessing price [element q]. While in this case EAA does not compete directly in the short term with contracted providers, it is possible that, in the longer term, the market shares of both EAA and contracted providers will be more market-driven. This makes it more important that the costing of EAA be both robust (that is, it includes the correct costs) and transparent (that is, it is seen to be robust).

While EAA does not participate in the tendering process and thus probity concerns do not arise, EAA and contracted providers do compete for clients. One of ESRA's functions is to monitor the ability

◆ Figure 1. *The case management industry under Working Nation*



of the government's employment service (which screens and evaluates clients, and provides those eligible for case management with information on the available case managers) to meet its responsibilities to EAA and contracted providers.

There have been transitional problems (particularly related to changes in the client classification processes and perceptions of competitive advantage referred to above), and these may have been reduced if more time had been available for design and testing. On the other hand, there do not appear to have been any major breakdowns in the system, and processes have been flexible enough to enable design changes to be introduced iteratively.

For the Commonwealth government of Australia, contracting out of case management services for the unemployed is a bold experiment in an alternative method of service delivery. It is too early to assess its successes but there are positive signs in the development of the supply side of the market and in the structure of incentives for the contractors to provide a quality service. There are some areas for improvement as discussed above in the design of the scheme, but overall it fits well with best practice in contracting out.

NOTES

1. Case management, in this context, involves the job seeker working on a one-to-one basis with a case manager to prepare and implement a return-to-work programme which could include counselling, training, job search assistance and support tailored to the individual's needs (Figure 1 outlines the case management process). A form of case management was increasingly utilised in the early 1990s to assist jobseekers from special groups, such as sole parent pensioners or people with disabilities, and extended significantly under the initiatives introduced by *Working Nation*. Prior to this, the long-term unemployed were assisted under general programmes.
2. The actual full-time equivalent number of case managers is fewer than 800, as many case managers work part-time.
3. Under its budget funding arrangements, EAA is neither rewarded for taking on a higher proportion of clients who are difficult to place, nor penalised if its client mix is skewed towards individuals who are easier to place.
4. However, the allocation of further contracts was suspended until after the federal election (2 March 1996).
5. ESRA is inserting penalty clauses for default in the second round of contracts.
6. If the same five organisations were awarded tenders to operate in each local market, the market would not necessarily be any more or less competitive (as the market develops and more organisations begin operating across a large number of markets) than if the five organisations in each market only operated in that market.

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CONTRACTING OUT BUILDING CLEANING SERVICES AT THE NATIONAL HOSPITAL OF DENMARK

by

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I. INTRODUCTION

The largest contracting out exercise at the National Hospital was carried out in 1992. Prior to 1992, competitive tendering and contracting out had been a very controversial issue at the hospital. In 1990, the National Hospital had invited tenders for 5 per cent of their building cleaning services, which resulted in a work stoppage among the staff of the building cleaning services.

Before contracting out the building cleaning services in 1992, the number of persons employed was approximately 475, corresponding to 286 full-time employees. The expenditure on building cleaning at the National Hospital was just below 60 million Danish kroner (DKK). Absenteeism due to sickness was rather high when the staff was employed by the National Hospital.

The hospital had also contracted out laundry and canteen operations with no problems. In the case of the laundry, the reason could be that the laundry was physically located outside the hospital.

II. GOVERNMENT POLICY ON CONTRACTING OUT (MARKET TESTING)

Denmark has a long tradition of contracting out public activities, particularly various public works.

In the latter half of the 1980s, the government took various initiatives to promote contracting out with the purpose of creating more competition in the production of public services. The objective of contracting out was to ensure that the production of public services was organised and carried out in the most effective way.

The opinion of the previous conservative government was that more public services could be contracted out. In 1992, the Ministry of Finance issued a circular committing all state institutions to invite tenders for all activities that could be carried out by external suppliers.

The Social Democratic Party, upon assuming office, also showed a positive attitude to contracting out and confirmed this policy in a new circular issued in 1994. According to the government, contracting out, is not an aim in itself. The aim of contracting out is to achieve through competition the highest possible effectiveness in the management of public services.

In particular:

- Government institutions should be more cost conscious.
- Management was instructed to market-test government services.
- Management should be conscious about achieving quality as well as low prices.
- Staff of the organisations themselves should be allowed to make an in-house bid for an activity. Conditions and procedures were stipulated in order to ensure fair competition between public and private provision of the activity, especially relating to cost calculations.
- Staff who would be affected by contracting out an activity should be involved in the contracting out process.

- The contracting out documentation should make provisions for the problems that could arise for the staff when their collective bargaining agreements with the public employer terminated.

Furthermore, the government attaches great importance to the following premises:

- public services must be carried out in an overall economically advantageous manner;
- contracting out should be integrated with the public institutions general management and planning activities;
- contracting out has to be arranged so as to encourage co-operation between the public sector and the private sector;
- contracting out must make necessary consideration for staff, including the need for training activities.

In the Ministry of Finance's circular, the process of contracting out applies equally to tenders subject to European Union procurement regulations.

The municipalities and regional authorities normally follow the rules in the circular, but they are not obligated to do so.

Contracting out has, to date, primarily been in the field of support services. There does not appear to be political will to contract out other functions.

In the period 1992-94, expenditure on external production of public services rose from 15.7 per cent to 17.3 per cent of the *total operating costs* of state institutions.

The average extent of contracting out *capital works* for all ministries is approximately 75 per cent, but for many ministries it is nearly 100 per cent.

III. THE CASE OF THE NATIONAL HOSPITAL

In 1991, no contracting out of building cleaning services took place at the National Hospital.

The National Hospital conducted an analysis of all the support service functions at the hospital. It was the management's opinion that all the support service functions could in principle be contracted out.

The hospital management attached great importance to co-operation with the staff. In co-operation with staff representatives, an "analysis model" for evaluating support service activities at the National Hospital was developed.

The analysis model had two main components:

- contracting out should result in savings of at least 10 per cent for each activity;
- a description of each activity which included the following:
 - What types of support service functions were required?
 - In what quantity were they required?
 - What level of quality was required?
 - At what cost was the service produced?

The model included criteria for evaluating whether the service was suitable for contracting out. If there were no conclusive arguments against contracting out, the service had to be put forward for tender.

The evaluation of the building cleaning services was made in co-operation with private consultants. A report was prepared indicating that cost reductions of 15 per cent could be realized through contracting out, and that this activity was suitable for contracting out.

The hospital primarily used the cost calculation rules stipulated in the Ministry of Finance's Costing Circular. The rules include the following:

1. Before the external tenders are received, the institution calculates the costs of performing the activity. The calculation is based on:
 - direct costs (salary, materials, etc.);
 - indirect costs included in the budget (share of management and administration);
 - indirect costs not included in the budget (depreciation and return of investments).
2. After the external tenders are received, the costs for the institution of managing the contract is calculated and added to the tender of the external contractor.

Denmark has a very competitive private sector market for building cleaning activities. The largest companies have world-wide branches. There are also medium sized and small companies. The contracting out policy provides market opportunities for small companies and strengthen the larger companies in their efforts to compete abroad.

A bid from the in-house team was permitted. The cost calculation rules ensured that competition was on an equal footing with providers from the private sector.

The basis for protecting the staff in case of contracting out is the European Union directive of 14 February 1977 (77/187/EU), the so-called transfer directive. According to the directive, the collective bargaining agreements with the staff must remain unchanged until their validity period expires.

The contract requires that the collective bargaining agreements for the staff be unchanged for the entire contract period. This includes individual salary supplements. This goes further than the EU directive requires. The contracted company negotiated the agreement for dismissals and for reassignment of employment contracts.

Contracting out by itself cannot imply dismissal of the staff. This does not mean that the winning company is committed to employing all the transferred employees if there are technical or organisational reasons that result in changes to the number of persons needed for the job.

As part of the overall agreement in Parliament concerning the Budget Bill for 1993, it was decided that the hospital had to rationalise its support services. Provisions for redundancy payments were made part of the total appropriation for the hospital for the next 4 years.

As mentioned, staff representatives participated in the process of contracting out.

Before the winning bidder took over the building cleaning activity, it held a series of information meetings for the employees. The company informed the staff about its concept and about its plans for taking over the cleaning of the hospital.

The company dismissed 146 employees, who were offered other available jobs in the group of companies. The company offered 5 million DKK in severance pay, which was refused by the employees. When the company started operations, there was a work stoppage which lasted for 3 days. The conditions at the National Hospital were discussed in the Parliament.

IV. CONTRACT ARRANGEMENTS

The contract is very detailed. There are standards for each room to be cleaned; standards for the frequency of cleaning the walls, the floors, the equipment, etc. There has to be an overall building cleaning once a year. Quality control tests are executed even if there were no quality control tests stipulated in the contract. This was agreed to during the contract period.

The flexibility of the contractor is low. All changes have to be approved by management of the hospital.

There was no provision in the contract for sanctions for non-performance.

Bidders were selected during a prequalification process. The external bidders were all large companies. The hospital and its consultants examined the companies accounts for the last three years. To ensure the technical capacities of the companies, the hospital asked for references.

After the prequalification test, there were two external tenders and an in-house bid. The highest bid was the in-house bid of 58.7 million DKK. Next came a bid of 41.6 million DKK. The lowest bid was of 33.4 million DKK. The lowest bid was accepted, even if it was surprisingly lower than the other bids.

The bids were evaluated by the board of directors of the hospital together with a group of representatives of middle management and employees and an outside consultancy company.

At the beginning of the contract period, the managers at the hospital realised that the quality was too low. The two parties agreed to introduce quality control checks and the possibility of sanctions for non-performance. The hospital controllers would make unannounced quality checks 40 times per month.

The duration of the contract is 4 years.

V. OVERALL ASSESSMENT AND LESSONS LEARNED

Was it a success?

The hospital considers contracting out to be a good tool for making services as effective as possible.

From a financial point of view, it was clearly a success, with savings of 100 million DKK over 4 years.

Quality standards have improved. From January to October 1995, quality has been reported at near 100 per cent.

The contract company has announced that staff absences due to sickness, which for many years were very high, have declined from about 22 per cent in March 1995 to about 5 per cent now.

Main lessons learned and key success factors

It has been possible to reduce costs without lowering quality.

The better the preparation of the contract documentation, the better the contract is.

It is important that the organisation contracting out the services prepare the contracting out documentation itself, so the knowledge will be placed within the organisation.

It is very important to go through the contracting out exercise in co-operation with staff representatives and to keep the staff informed of every step in the process.

CONTRACTING OUT RESIDENTIAL TREATMENT HOMES FOR CHILDREN WITH BEHAVIOURAL AND EMOTIONAL PROBLEMS IN ICELAND

by

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I. INTRODUCTION

Protection and concern for the welfare of children is one of the basic elements in a modern welfare society. According to the Protection of Children Act 1992, children with behavioural and emotional problems have the right to receive appropriate treatment in specific facilities if necessary, with the aim of a return to a normal life with their families. The Child Protection Agency is responsible for the implementation, supervision and monitoring of the services. The number of institutions in this field has increased rapidly in recent years. So, too, has the cost of running those institutions.

Until recently, all residential treatment homes were run by the government. Now, private organisations or other parties are authorised to set up such services if the project has been approved by the Child Protection Agency. The government is obligated to ensure the availability of specialised homes and institutions for children when other remedies have not proved effective. This refers to homes and institutions providing specialised treatment, such as treatment for alcohol and drug abuse, placement due to suspected criminal offences, delinquency and other serious behavioural problems.

II. GOVERNMENT POLICY ON CONTRACTING OUT

Since 1991, successive governments in Iceland have emphasised policies on privatisation and contracting out. The contracting out policy is part of the government's wider Competitive Tendering Initiative.

According to the Competitive Tendering Initiative, the general rule for all government procurement, whether it relates to goods, services or works, is to the effect that competitive tendering be practised. The Competitive Tendering Initiative applies to all ministries, agencies and concerns being the property of the government. Freehold establishments and associations receiving the majority of their income from the government shall also abide by the provisions of the Initiative. The same applies to joint projects that are majority financed by the government. Open tenders shall be practised unless special circumstances dictate an alternative arrangement. In the case of insufficient number of bidders to ensure effective competition, other means shall be sought, such as co-operative tenders or negotiations.

In Iceland, there is a long tradition of competitive tendering for the purchase of goods and public works. Contracting out services and activities previously performed by the government has generally not been practised. The benefits of contracting out is being promoted within the public sector. It is viewed as an effective tool for controlling government expenditure.

Some support services have previously been contracted out, for example building cleaning and canteens. The service described in this case study was among the first core public services to be contracted out in Iceland.

III. IMPLEMENTATION ISSUES

The operation of residential treatment homes has been expensive and difficult to manage. Budgets were typically overrun and all corrective measures typically failed. The homes were located around the country, and a central office in Reykjavík, managed, *inter alia*, the financial side of the operation. The staff at each location managed the professional operation, which consisted mainly of psychologists, social workers and teachers. They were competent professionally but the cost of running the homes was increasing rapidly without the services improving at the same rate.

In 1993, a non-profit organisation, Save the Children, announced that it would buy a farm and donate it to the government for a new residential treatment home for children. The money being used had been collected in a highly publicised fund-raising campaign that all radio and television stations had participated in. There was a need for a treatment home for a number of children in the 7- to 12-year-old age group that were practically homeless due to the inability of their parents to provide them with satisfactory care. As these children were experiencing emotional and behavioural problems, a foster home was not sufficient, and placement in a residential treatment home was necessary.

The idea of having the new home privately run was initiated by the Ministry of Social Affairs. It was introduced to Save the Children and others involved and was well received from the onset. All concerned were willing to consider the possibility of having it privately run.

A working group within the Ministry of Social Affairs was created to explore this idea further. The group determined the feasibility of contracting out this activity, calculated the current cost of performing the activity in-house and defined the requirements that the contractor had to meet. The Ministry of Social Affairs had a particular contractor in mind, and the group had talks with him and Save the Children. Both were willing to explore this possibility further. The potential contractor met the educational requirements and possessed the professional experience suitable for the task.

At that time, privately run residential treatment homes for children did not typically exist, with two exceptions. First, a residential home for delinquent youth had been privately operated since the early 1980s. However, no formal contract had ever been made, although the government had for more than a decade financed the operation. Second, a contract had been made with professional foster parents living on a farm concerning two children who had committed serious crimes but were too young to be punitively responsible. Thus, contracting out activities within this sector had not generally been practised. It was therefore unknown whether there were any potential contractors willing to participate in a contracting out exercise. The decision to contract out this activity would definitely foster a private sector market, if such a market were at all possible to establish.

There were concerns about the special qualifications required of the contractor. Requirements had to be specified concerning education, experience, therapy programmes, etc. Since this was the first contracting out of services in this sector, there was great political interest in a successful outcome. The task could not be handed to just anybody. An open tender was therefore not really viable.

The working group reached an agreement with Save the Children: they would own the treatment home facilities and the government would pay them a fixed amount annually. Negotiations with the potential contractor stalled; he and the buyer had different expectations about the task in question, especially about the price to be paid for the service. It was decided to discontinue the talks and look for other possible contractors.

Instead of inviting bids, advertisements were placed in leading newspapers, asking all parties interested in running a home of this type to sign up, describing their qualifications. The working group then ranked them. Many very good potential contractors applied. Negotiations commenced with the one ranked first. After a short time, a contract was signed. The contractor had all the qualifications that were needed. Prior to negotiations, the working group had listed all the basic requirements and standards that had to be met.

In June 1995, the Child Protection Agency was established. Its main objective is to co-ordinate and strengthen child protection services. It is responsible for the day-to-day administration of child protection activities and running all residential treatment homes financed by the government. With the

favourable results of the Save the Children home, the policy of contracting out residential treatment homes previously run by the government was strengthened. The Agency was to act as the buyer of the services and thus be able to concentrate on its main responsibilities as the co-ordinator and supervisor of child protection services instead of being tied-up in running homes.

Now, most residential treatment homes for children in Iceland have been contracted out or are in the process of being contracted out. First the more simple ones were contracted out, then the more complicated homes. Where possible, contracts have been made with the former management of each home. Basically, the reason for this approach is to take advantage of the experience of the former management. Furthermore, it contributes to the stability of the operation of the homes, which is extremely important given the nature of the services.

All agreements made have had similar contents. The main topics covered in the contracts are as follows:

- *Location.* The homes must be located where the service is needed and away from any possible distractive factors. Parents and other relatives must also be able to visit the children, since it is often part of the treatment to have the family involved.
- *Number of children.* The agreements states the number of children that can be located at each home. A typical home can have up to 6 children at a time.
- *Placement decisions.* The Child Protection Agency usually selects the children that are to be treated and allocates vacancies in consultation with the contractor.
- *Standard of housing and other facilities.* The children's environment has to be like that of an ordinary home. In some cases, the government provides the facilities for the home; in other cases, the contractor does.
- *Staff requirements, e.g. number of staff members per child.* At some homes the children need 24-hour surveillance.
- *Staff training and education.* Some of the homes have to provide basic education as if it were a school within the public school system. Those home need to have certified teachers.
- *Emotional relationship with the children.* Among the problems facing each child is often the lack of love and care from adults and the absence of warm-hearted and friendly relations. The staff has therefore to strive for emotional bonding with each child if possible. Usually, it is required that some of the staff live at the home with the children.
- *Psychological services* for the children are typically provided by outside specialists and not the contractor. It was considered appropriate that such specialised services were provided according to each child's needs. The amount of psychological therapy varies and is therefore difficult to include in a fixed contract.
- The *operation of the contractor* is supervised by the Child Protection Agency and an appointed psychologist.
- A *therapy plan* must be developed for every child and approved by the Child Protection Agency.
- A *fixed amount* is paid for the services covered in the agreement, and is divided into salaries and other costs. The amount is indexed according to the official inflation assumptions contained in the government's budget. The payment is paid in advance every three months.
- The contractor must send the Child Protection Agency an annual *financial statement* approved by a certified public accountant.
- The *duration* of contracts varies; the minimum is two years with an extension clause. Shorter agreements are made when the government owns the facilities being used.

IV. OVERALL ASSESSMENT AND LESSONS LEARNED

Contracting out residential treatment homes is viewed as a success. The main benefits have been:

Flexibility

- The pattern of demand for treatment can change over time. Contracting out makes it possible to react quickly to these changes, and therefore to be more responsive to changing needs.
- In case the buyer is not satisfied with the services provided, it is possible to cancel the contract and seek a new contractor.

Control of cost

- Budget overruns are a commonplace problem within the public sector, and this was certainly the case with the residential treatment homes. This problem does not exist today. The contractor is responsible for providing the required services for fixed prices.
- The cost of operating the residential treatment homes has decreased by 20 per cent on a comparable basis, as the contractors run the services more efficiently.
- Overhead costs have been reduced, as the head office had previously managed the payments of bills, accounting, etc.
- The benefits of decreasing the number of government employees are important, as there are many hidden wage-related costs to government employment, *i.e.* pension rights, training expenses, etc.

Consistency in quality of services

- Higher standards of quality. The “buyer” has defined his requirements and expectations and stated them in an agreement with the “seller”. Services of the contractor are to be consistent with the contract. Previously, the experts in the field, all working for the State, were constantly defining and re-defining service requirements and also delivering the service. Now they define the service standards and the contractor delivers the service.
- Separation of service and supervision. Previously these different tasks were performed by colleagues within the same organisation. In that kind of situation, the level of tolerance is higher than in a buyer/seller relationship.
- There are few negative aspects. The most noticeable one, which in fact was foreseen from the outset, is that the contractor typically has the option to veto a placement if he can argue that the placement is in conflict with the interest of the other children in the home.
- It is timely to suggest contracting out when a new organisation is being established. People are more willing to “experiment” with unestablished organisations than with settled institutions.
- The contractor can lower costs in many different ways that the government cannot. Those ways have no effect on the quality of service.

CONTRACTING OUT HIGHWAY DEVELOPMENT AND OPERATIONS IN MEXICO

by

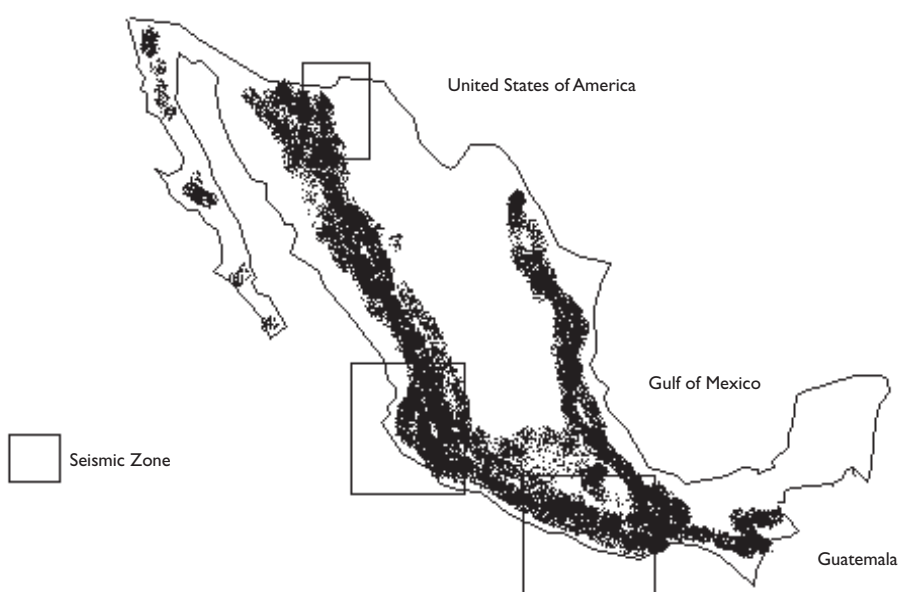
Roberto Barrera, Ministry of Finance

I. BACKGROUND

Mexico's territory extends over 1.9 million square kilometres, with two mountain ranges covering a large part of its territory. Located in a region of intense seismic activity, its coastlines border two oceans. Its neighbour to the north is the wealthiest country in the world. Mexico is a land of contrasts and works hard toward its development.

What is the sense of putting together all these different characteristics among the many that a country might have? For a road builder, the answer is simple: this profile defines a good part of the considerations to be taken into account in developing the system of roads and highways that serves the population. A system that connects the larger cities, that facilitates the transportation of merchandise for domestic and foreign trade, that unites ports and border areas at the same time provides access to the most remote areas, in the middle of a mountain range, in the desert or in the heart of the jungle. A system that serves the tourist who wishes to take a vacation on a beach, or the farmer who wishes to sell his products on the market – a system that withstands long rainy seasons or the devastating effects of earthquakes. Figure 1 is a map of Mexico indicating the major mountain ranges and seismic areas in the country.

◆ Figure 1. *Map of the Mexican United States*



In Mexico, the network of roads and highways covers more than 306 000 km (1995) and this includes 200 144 km of rural roads, 56 271 km of state highways, 43 259 km of toll-free highways managed by the federal government and 6 342 km of toll roads (see Table 1).

Over the last 25 years, the total extension of the road network has quadrupled; rural roads have shown explosive growth, federal highways and toll-free state highways have doubled, and, although with a considerably lower extension, toll roads have grown more than six-fold, from 968 km in 1970 to 6 342 km. in 1995. Figure 2 shows the breakdown and comparative growth of the different elements of the network for the 1970-1995 period.

Despite the magnitude of these figures, prior to 1990, Mexico had very few high-specification roads (four-lane highways, high speed, etc.).¹ For this reason, and in view of the demand for this type of roads, the government implemented a construction programme of concessioned toll roads, through which private individuals could participate in the construction and operation of this type of project.

Prior to 1987, the federal government, through the Ministry of Communications and Transportation (the MCT), was solely responsible for the design, construction, operation and maintenance of federal highways in Mexico. To help in its work, the MCT would contract private consulting services or obtain support from construction companies to build highways and provide maintenance for the network. *Caminos y Puentes Federales de Ingresos* (Federal Toll Roads and Bridges), a division of the MCT, was in charge of the operation and maintenance of the few toll roads that there were.

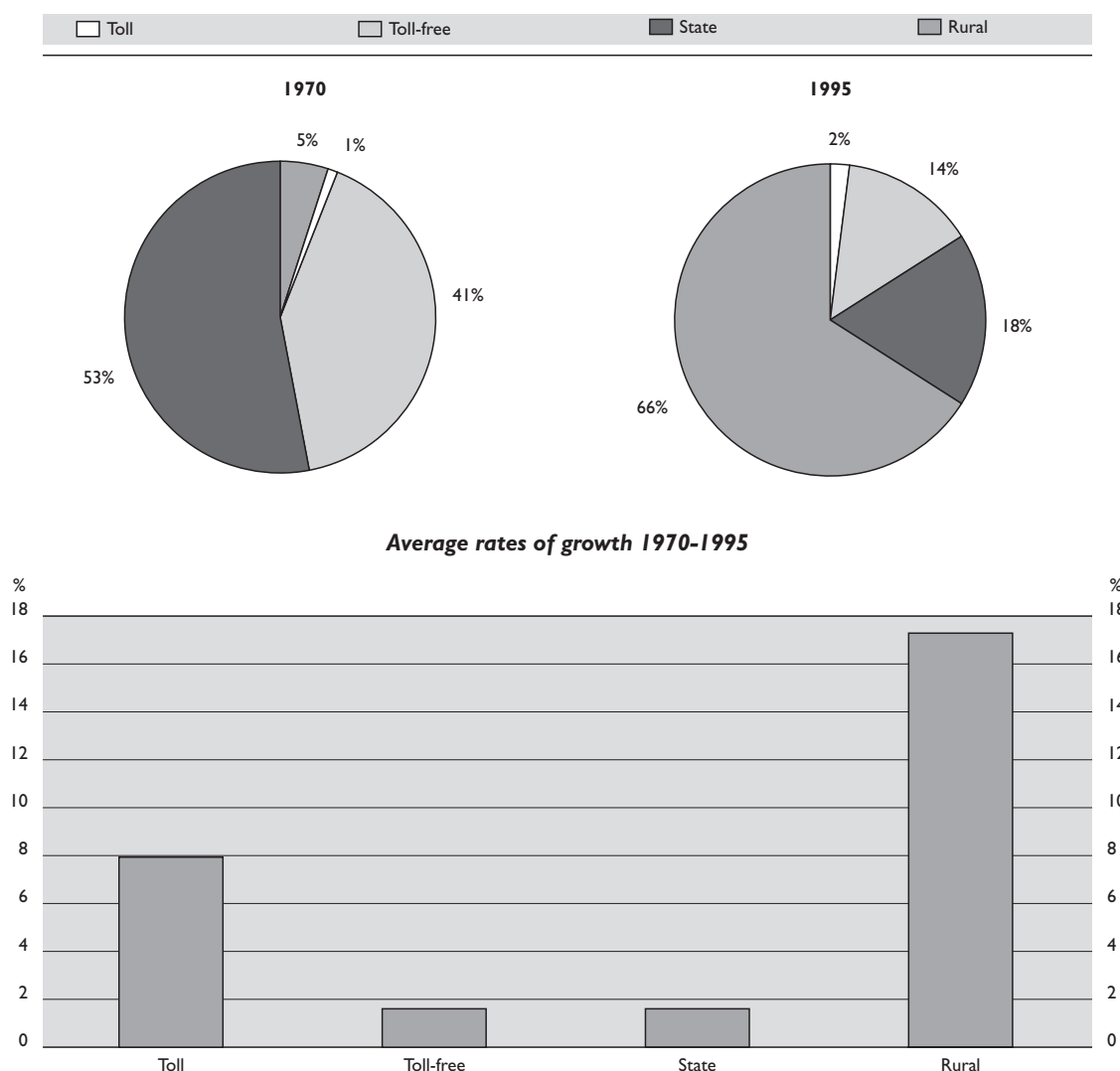
The development needs of the country and the public sector's budget restrictions led the Mexican government, starting in 1987, to summon a large number of investors to participate in the construction and operation of the new toll roads, as well as in other infrastructure projects. This case deals with the Mexican experience in the concession of toll roads to individuals, specifically with regard to the National Program of Concessioned Toll Roads (NPCT).

Table 1. **Development of the National Highway Network**
(Length in km)

	Toll	Toll-free	State	Rural	Total
1970	968	29 358	37 514	3 680	71 520
1971	968	30 063	38 717	4 304	74 052
1972	968	33 328	40 676	49 419	124 391
1973	1 036	36 095	43 543	76 032	156 706
1974	1 036	37 272	48 769	88 312	175 389
1975	1 028	38 292	50 591	96 307	186 218
1976	1 028	40 508	50 597	101 157	193 290
1977	1 007	40 657	52 409	104 987	199 060
1978	932	41 562	50 763	114 404	207 661
1979	932	41 949	51 522	116 843	211 246
1980	932	42 521	52 496	116 677	212 626
1981	932	43 408	52 692	116 206	213 238
1982	932	43 661	53 076	116 033	213 702
1983	932	44 211	54 574	116 754	216 471
1984	953	44 612	55 420	120 018	221 003
1985	923	44 359	56 295	122 648	224 225
1986	939	44 722	58 429	126 901	230 991
1987	939	45 204	59 622	127 574	233 339
1988	1 106	45 664	60 020	128 243	235 033
1989	1 231	45 705	60 488	129 633	237 057
1990	1 761	45 743	61 108	130 623	239 235
1991	2 662	45 823	61 108	132 369	241 962
1992	3 470	45 808	61 736	132 482	243 496
1993	4 668	45 286	61 998	133 231	245 183
1994	6 288	42 832	56 149	197 992	303 261
1995 ¹	6 342	43 259	56 271	200 144	306 016

1. Estimated.

Source: Ministry of Communications and Transportation.

◆ Figure 2. *Breakdown and growth rates of the national highway network*

Source: Ministry of Communications and Transportation.

II. GOVERNMENT POLICY REGARDING CONTRACTING OUT

For the purpose of fulfilling a triple objective: 1) to contribute to the efficiency of the overall economy, 2) to achieve healthier public finances and 3) to improve the quality of goods and services provided to society, the government of Mexico began an ambitious programme of divestiture of government-owned entities including the privatisation of a large number of companies. In 1934, Mexico had 15 state-owned entities; in 1982 the number had grown to 1 155. After a rigorous streamlining process, at the end of 1995, the number of state-owned entities had dropped to 204. Among the companies privatised during the process were: telephone companies, banks, sugar mills, steel plants, fertiliser plants, airlines, etc. Recently, the privatisation process has centred on two areas: the energy sector and the communications and transportation sector. On the matter of energy, it is important to note that investment is now open to individuals in gas distribution, and petrochemical plants and

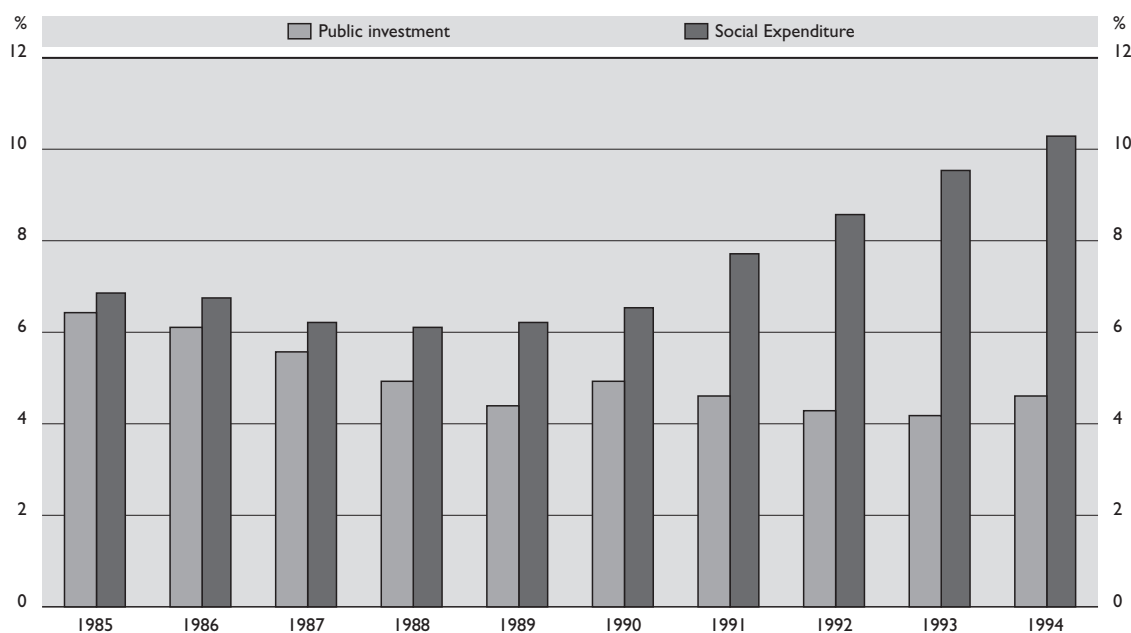
complexes have been privatised; in the area of communications and transportation, seaports are being privatised, telephone service concessions are now open to new participants, and the programme includes the auction of the radioelectric spectrum, the sale of satellites, the privatisation of the railroad system and of the major airports.

The privatisation process in Mexico can be viewed as a type of contracting out, where, in order to obtain the desired benefits, the government has decided to give up ownership of some entity and/or has determined to open up to competition some monopolistic situations. Despite this privatisation, the Mexican government continues to monitor the economy and to maintain exclusivity in some strategic areas, such as in crude oil, social security, transmission and distribution of electricity. Other activities, for social and political reasons and supported by the legal framework, are open only to Mexicans; such is the case of the construction, operation and maintenance of roads and highways.

Examples of successful contracting out in areas where the government maintains ownership are: power generating plants, substations, transmission lines, petrochemical processes, oil refineries, etc., in which the Build, Operate and Transfer (BOT) or Build, Lease and Transfer (BLT) schemes have been adopted. The need for these schemes is increasing as a result of growth imposed by the country's development. For example, on the matter of electric power generation, Mexico has an installed capacity of 33 037 MW (1995), which has grown more than 6 per cent annually during the last 10 years. To maintain this rhythm it is necessary to invest at least US\$2.5 billion a year on power generation projects alone, without taking into account the pressures created for transmission and distribution. The growing need of resources for the development of infrastructure projects has also led to changes in the legal framework so that the government can utilise these financial schemes with greater flexibility.²

The policy of privatisation has permitted the Mexican government to raise its level of social spending (as a share of GDP) and, at the same time, reduce investment expenses by transferring a part of this responsibility to private investors. Figure 3 shows the evolution of social spending and investment expenses during the 1985-1994 period.

◆ Figure 3. **Public investment and social expenditure in Mexico**
As a Percentage of GDP



On the matter of infrastructure (roads, ports, airports, railroads, water and sewage services and electricity), it is estimated that an investment of more than US\$100 billion is needed over the next ten years.³ With this background, the 1995-2000 National Development Plan points out the need to encourage private participation in the development of infrastructure works through schemes that will allow adequate profitability, with the support, even, of public resources at a “zero rate”, that is, for which no financial benefit is expected. The National Program of Concessioned Toll Roads (NPCT) is considered under this framework.

III. NPCT – STRATEGY AND IMPLEMENTATION ASPECTS

Toward 1987, the need was set forth to extend the Federal Network of Highways and Roads, through better roads that would connect the capital, Mexico City, with the main ports and border areas, and new routes that would connect the Pacific ports with those of the Atlantic. The reason was not that these routes did not exist, but that new options were being sought, with better planning and stricter specifications, that would facilitate traffic. The scarcity of budgeted resources for these purposes, which had been directed mostly to the development of rural roads,⁴ made it necessary to bring in private investment in order to achieve these objectives. At that time, the idea was conceived that private individuals could participate through concessions, and could therefore build, operate, maintain and exploit the new highways, with the nation retaining ownership of the roads.

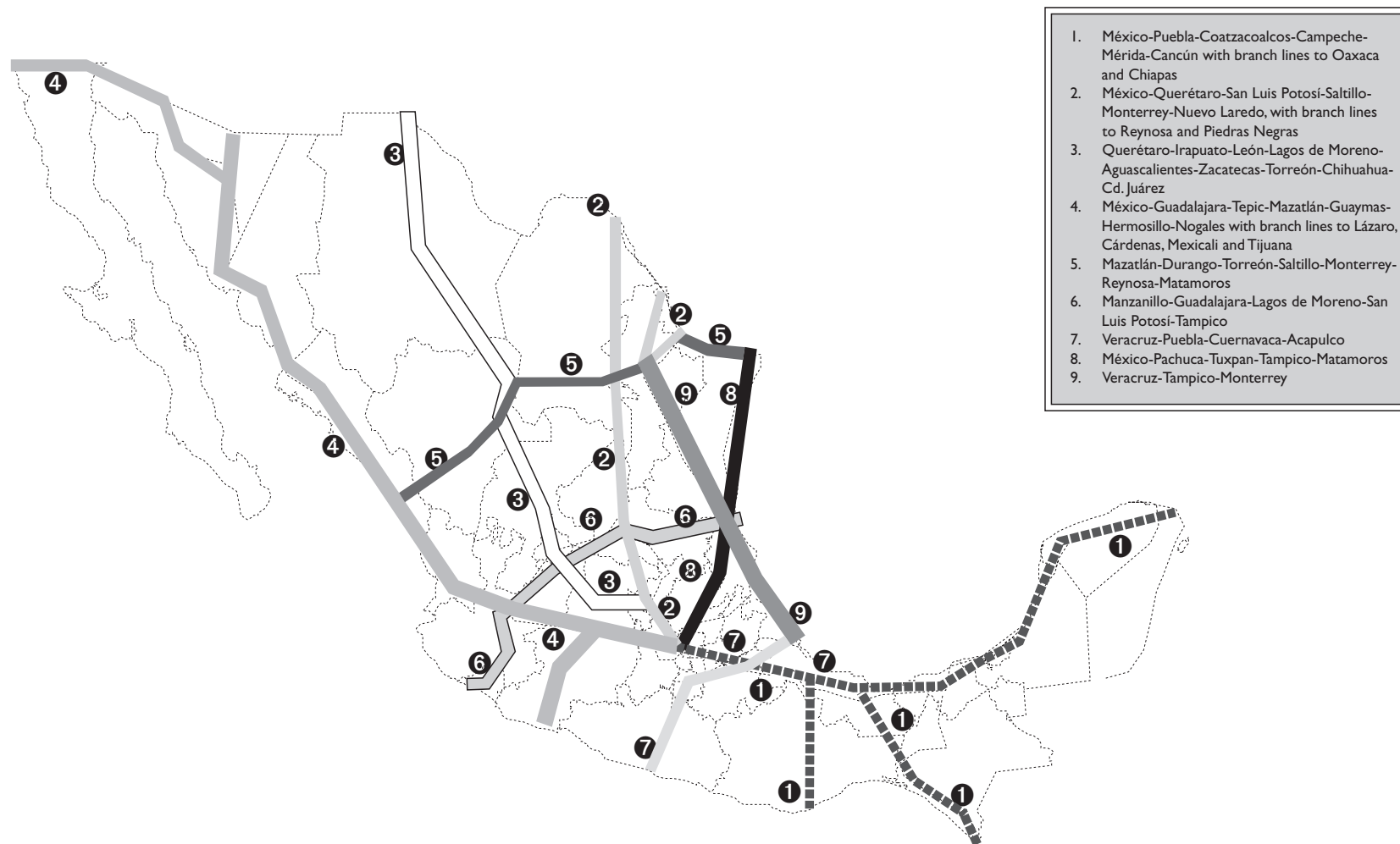
It was decided that nine main axes would be the spinal column of the concessioned road system:

1. **Mexico City-Ciudad Hidalgo/Cancún**, which would link the City of Mexico with the Southern states on the border with Guatemala. One of the branches would reach the tip of the Yucatan peninsula.
2. **Mexico City-Nuevo Laredo**, leading toward the north, this highway would link Mexico City and Monterrey, and continue on to the border with Texas (Laredo) in the US, with branches leading to other border areas (Brownsville and Eagle Pass).
3. **Mexico City-Ciudad Juarez**, which would connect Mexico City with the main cities in the central part of the country, and would run toward the northeast to the US border in the state of Texas (El Paso).
4. **Mexico City-Nogales**, which would link Mexico City with the major cities in the western part of the country allowing access to some border cities in the states of Arizona and California in the US.
5. **Mazatlán-Matamoros**, which would cross the country from the west to the northeast and would connect a Pacific port (Manzanillo) with the border area on the Northern Gulf (Matamoros).
6. **Manzanillo-Tampico**, which would cross the country from west to east, but through the central part, connecting two major ports.
7. **Tuxpan-Acapulco**, with the same end as the two previous axes, would connect the Pacific area with the Atlantic, but at a lower latitude (more toward the south).
8. **Mexico City-Matamoros**, which would connect two ports on the Gulf with Mexico City.
9. **Veracruz-Monterrey**, which would link Mexico's main port with the most important industrial city.

Figure 4 shows the location of the main highway axes.

Once the axes were defined, the amount of investment required was estimated in a preliminary fashion, thereby confirming the need of inviting private investors to develop and operate the projects. With this intention, the Ministry of Communications and Transportation (MCT) designed an overall concession scheme that would allow the participation of private investment, and submitted the plan to the President of Mexico for a decision. In the meantime, construction companies and the major banks were consulted regarding their interest in participating in these projects, either as concessionaires or financiers; their response was very enthusiastic. The President of Mexico approved the NPCT as an

◆ Figure 4. *Main national axes of the toll road network*



Source: Ministry of Communications and Transportation.

Table 2. **National Program of Highways 1989-1994**

	Length in km
Concessioned	
Private	3 485
Banobras	237
States governments	1 626
Total concessioned	5 348
Non concessioned	
Federal toll-free	731
State toll	316
State toll-free	112
Capufe	122
MCT	340
Total non concessioned	1 621
Total	6 969

Source: Ministry of Communications and Transportation.

integral part of the National Highway Program 1989-1994, which, in addition, included other non-concessioned projects. Table 2 itemises some characteristics of the Highway Program.

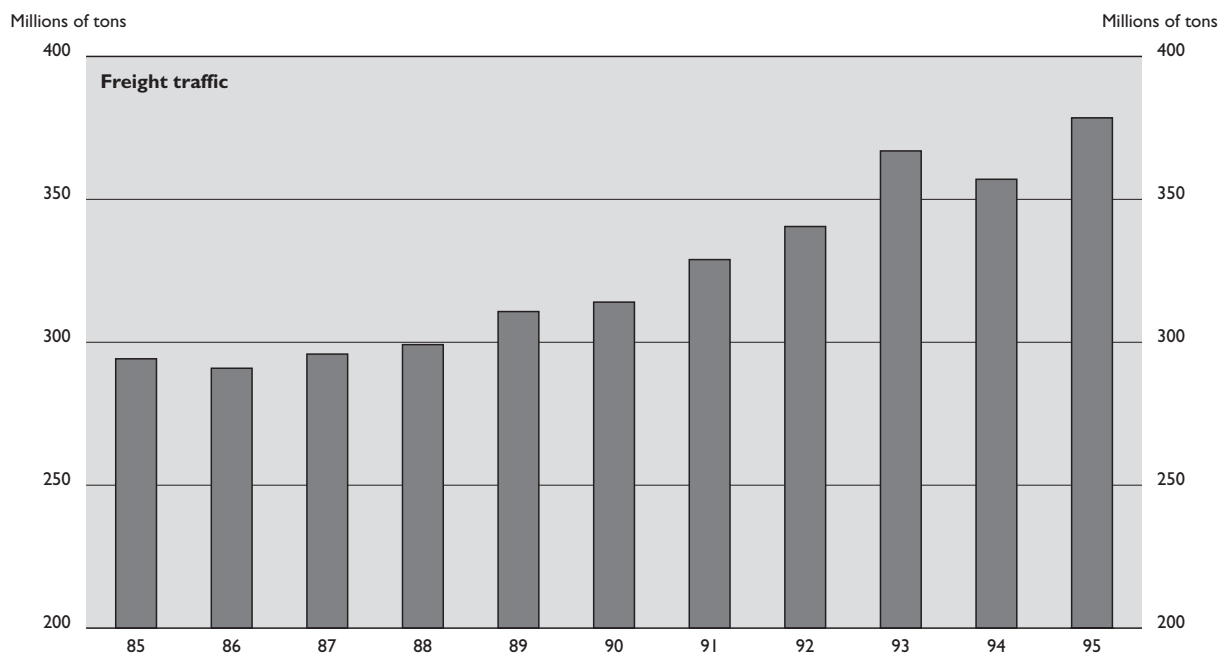
Once the strategy was approved, each axis was divided into sections, and for each section detailed engineering studies were made: traffic estimates, socio-economic impact on the areas, environmental studies, etc. To carry out these studies, bids were summoned and, finally, the Ministry of Communications and Transportation (MCT) decided what companies would be awarded the work. The Law on Acquisitions and Public Works and its bylaws stipulate that any work, study or project that exceeds US\$100 000 must be open to bidding and that, under certain conditions, the summons to bid may be by restricted invitation. The same Law prevents those granted the design of a project to participate in its construction.

Additionally, the services of legal experts were contracted to help define the terms of the summons for bids and the general conditions of the bidding process. Internally, changes were made to the legal framework: the old law on the subject, the Law on General Communication Channels (1993), was complemented with a new law on the subject, the Law on Roads, Bridges and Federal Auto Transport (1993), which reinforces the concepts of the concession and of the participation of Mexican private investment in the design, construction, operation and management of highways. The Law does not provide for foreign participation in toll road concessions.⁵

Once the first concessions were defined, out of precaution and because they were the first projects, these were assigned to development banks (property of the federal government) and to some State governments. The first concessions awarded to private individuals were granted in 1989 through an open public bidding process in which, depending on the project, the winner was whoever required the lowest concession term (after establishing a toll rate for use of the road).⁶

The summons notice and general conditions for the bidding process included, among other documents, detailed engineering studies, the project of the concession title, appraisal studies, etc.; the maintenance standards required by the MCT were also set forth. The summons or invitation to bid was sent to those interested in being awarded the concession, and this included everything from construction to maintenance of the project throughout the term granted. That is, whoever was awarded the construction also had the right to operate the project for the term of the concession, receive the income from its operation and carry out maintenance work, whether major or minor. Competition was introduced for the overall project, but not in each of the main activities.

The private companies that were awarded the contracts were mostly construction companies that, either on their own or with other investors, were able to take advantage of the opportunities offered.⁷ The most important concessions were granted to the following companies: *Ingenieros Civiles Asociados, S.A.*

◆ Figure 5. *Evolution of freight movement in Mexico*

Source: Ministry of Communications and Transportation.

(ICA), *Grupo Mexicano de Desarrollo, S.A.* (GMD) and *Triturados y Basálticos, S.A.* (TRIBASA), which, because of the success and the magnitude of the operations, were able to list their stock on the Mexican Stock Exchange and to issue securities on the international markets.

The government agency responsible for granting the concessions was the MCT (Ministry of Communications and Transportation). As set forth in the summons for bids and in the general conditions for the bidding process, the MCT directly exercised, with the support of companies, the supervision of the work and, once operations were initiated, the supervision of its proper functioning.

The granting of the concessions and setting up the operation of the projects caused a favourable impact on the economy in addition to the advantages of the improvement in the traffic, since the projects involved an overall investment of more than US\$15 billion, which flowed into the economy in general. Figure 5 shows the evolution of cargo or freight movement during the 1982-1994 period, in which an upturn can be seen starting in 1991 to a great extent influenced by the start-up of operations of the new toll roads.

IV. THE NPCT – CONTRACTUAL ASPECTS

The General Conditions of the Bidding Process for a concessioned toll road, which groups together the elements of a summons to bid and the general conditions for the bidding process, are divided into nine chapters:

1. General Guidelines;
2. Basic Requirements for Bidders;
3. Technical Proposal of the Project;
4. Schedule of Activities;
5. Financial Feasibility Studies;
6. Evaluation of Proposals;

7. Procedures;
8. Presentation of Documents;
9. Calendar and Protocol.

A brief description of the contents of each chapter follows.⁸

1. **General Guidelines.** These contain the objectives of the summons to bid, the specifications for the highway section, the duration of the concession and some limitations regarding the responsibility of the MCT.
2. **Basic Requirements for Bidders.** These indicate the nationality requirements of the bidders; it is noted that foreign participation will be limited to 49 per cent of the capital stock of the bidder; the minimum capital amount that the participants should have, as well as some characteristics that serve to validate the technical and financial capacity of the bidders.
3. **Technical Proposal of the Project.** The basic components included in the appendices of the general conditions are summarised; the bidders are asked to deliver detailed budgets, to include the location of the toll gates and the improvements proposed for the projects; some guidelines are provided that should be followed during the execution of the work.
4. **Schedule of Activities.** Bidders are asked to provide a schedule of activities for construction, another for setting up the operation, another for maintenance, etc.; a maximum term is set for the conclusion of the project and another for the start of construction work if the contract awarded.
5. **Financial Feasibility Study.** Bidders are asked to provide cash flow projections for the project, together with basic assumptions; they are also asked to indicate the expected Internal Rate of Return.
6. **Evaluation of Proposals.** This chapter defines who will evaluate the proposals and how they will be evaluated; the conditions for selection in case of a tie are also indicated.
7. **Procedures.** This indicates the obligations and responsibilities of the MCT and the concessionaire, the authorisations to be given by the government, the rights of the concessionaire, the sanctions and the supervision to be carried out during the various phases and activities.
8. **Presentation of Documents.** This specifies the documents that should accompany the proposal and the formats to be used.
9. **Calendar and Protocol.** This indicates the dates for delivery of proposals and for notification of the decision, and the protocols to be followed in both cases.

Appendices. The Concession Title is the legal instrument signed by the MCT and the concessionaire, granting the respective rights and obligations inherent to the construction, operation, use and maintenance of the toll roads. In addition to the title, the appendices include the executive project, the different formats that should be followed to provide information to the MCT, the maintenance standards, etc.

It is common for concessions to be granted through a trust, which incorporates the concession rights and in which both the government and the concessionaires participate. This has a double purpose; 1) to permit a better financial and administrative control of resources, and 2) to facilitate the possible adhesion of new partners to the concession or changes among them. The trust allows for the issue of trust certificates, which can be the subject of a public offering on the securities markets, or perfectly limits the rights in the case of bank financing with the projects as guarantee. Both financial procedures, that of issuing securities instruments on the market, or that of obtaining financing through banks, imply additional supervision mechanisms for the project on the part of the financial intermediaries. The trust certificates, through which revenues are securitized, facilitate greater participation by foreign investors, as has happened in a good number of toll roads concessioned to private companies and in another operated by the federal government.

The General Conditions for Bidding are published in Mexico's Official Gazette of the Federation (*Diario Oficial de la Federación*).

V. GENERAL EVALUATION AND LESSONS LEARNED

Taking into account the triple objectives that Mexico seeks in its efforts to privatise and contract out (economic efficiency, healthy public finances and higher-quality goods and services) and the objectives of the NPCT, there have been some successes and some failures.

In terms of economic efficiency, the country now has more than 5 100 km of new toll roads in operation which will provide great benefits sooner or later. Nevertheless, it is recognised that resources were allocated poorly, were greater than they should have been and were applied before they were necessary.⁹ As for the health of public finances, there was, in fact, a greater participation of private investment, which meant that fewer fiscal resources had to be used. However, the urgency of using certain supports has resulted in a high cost for the fiscal resources used. With reference to the quality of the goods and services, the new toll roads are better designed, but often their specifications are superior to what is needed. For example, in those roads where freight traffic is more important, the predominant characteristics correspond more to automobiles.

The NPCT required an investment 29 per cent higher, in real terms, than that agreed upon in the concession titles; the construction periods were 55 per cent longer than those agreed; vehicle traffic, more than two years after most of the projects began to operate, is 37 per cent lower than planned; the tolls are 30 per cent lower, in real terms; the participation of the public sector (including that of the development bank) in the capital stock, which was to have been minimal, is now 40 per cent of the total, and the concession terms have had to be extended for most of the projects so that private investors may have a greater opportunity of recovering their investment.

The Mexican economic crisis of 1995 aggravated the situation of the concessioned toll roads. The drop in domestic demand affected traffic on the toll roads; the rise in interest rates increased the financial burden of the projects. This led the government to implement a plan of emergency supports with a value of more than US\$2.2 billion (1995). These supports limited the transfer of the problem to the financial system,¹⁰ which was already affected by other variables and the performance of other sectors of the economy.¹¹

In a critical manner, and with the object of improving the continued advance of the NPCT, some areas of opportunity¹² have been identified, for example:

1. **Design of the toll roads.** Ensure that the specifications should correspond better to the type of vehicle and to more conservative traffic estimates.
2. **Terms of the concessions.** Extend the concessioned periods to terms whereby it will be more feasible to recover the investment (the Law stipulates that the maximum term will be 30 years, although the term can be renewed).
3. **Efficiency in the projects.** Introduce competition in each of the phases: construction, operation, exploitation and maintenance; this would be feasible if construction is separated from the concession and if the new concessionaires had to bid on the operation and maintenance of the project.
4. **Elimination of the commercial and operating guarantees by the government.** In some of the concession titles, the government guaranteed a minimum of traffic on the toll roads and the obligation to extend the term of the concession until a certain rate of return was obtained on the investment.
5. **Financial structure of the concessionaires.** Excessive optimism regarding the estimates and the lack of an adequate financial structure (high leverage) caused a considerable number of concessions to enter into situations of insolvency when income was reduced, expenses increased and there was insufficient capital to face the situation. Construction of most of the concessions was financed with short-term bank resources; the concessionaires (which at the same time were construction companies) contributed their capital as part of their profit margin for construction, which meant that, for some years, the only fresh resources that entered into the project were those derived from the loans. Added to this, the financing terms were extremely short: at the beginning of 1995, the average bank loan term was 6 years, while the life of the concessions was, on average, closer to 20 years.

NOTES

1. In 1990, Mexico had 0.9 km of toll roads for every 1 000 km² of territory, or 20.7 km for every million inhabitants; these statistics contrast with those of Germany, 30.1 km. and 136 km respectively, and are quite similar to the levels for Greece: 1 km and 19 km. In 1995, the same road density data for Mexico changed to 2.9 km for every 1 000 km² and 62.3 km for every million inhabitants.
2. Changes to the Law on Budget, Accounting and Public Expenditure.
3. The Aspen Forum on Infrastructure.
4. The development of rural roads has allowed access of all the regions of the country to better opportunities, economic as well as social.
5. The Law on Roads, Bridges and Federal Auto Transport stipulates that toll road concessions will be granted to Mexicans or Mexican companies. In this respect, the Law on Foreign Investment indicates that the share of foreign investment in these companies may be, at the most, 49 per cent of the capital stock, and this percentage could be higher with specific authorisation of the Foreign Investment Commission. Starting in 1999, there will be no limit to foreign participation in concessionaire companies.
6. The criterion to determine the winning bidder has been maintained, with the exception of one case in which the concession was granted according to the highest amount offered to the government, after the term of the concession and the rates were defined.
7. The construction companies had comparative advantages that permitted them to win the bidding process. The advantages were based on the fact that most of the investment budget was destined for the construction of toll roads, and, even when the construction companies were not awarded the bid, it was materially impossible not to contract their services.
8. Before starting with each chapter, the general conditions contain a section where the bidding process is identified, its legal basis and the basic terminology to be used in the rest of the document.
9. The argument for anticipated investment is supported by the fact that there is very little traffic on the toll roads and that once they began to operate it was seen that the period of maturation would be longer than was originally foreseen.
10. The banking system and the securities market had provided, through financing, 52 per cent of the total investment required for the toll roads, which, as of November 1994, was US\$7.8 billion.
11. The support programme also included a series of fiscal benefits for transport carriers in order to promote the use of the toll roads. Additionally, in 23 of the 51 concessions, the concessionaires offered reductions of up to 40 per cent of the rates. It was agreed to extend these fiscal benefits and rate reductions until the end of 1996.
12. Identification of these areas of opportunity have resulted from a work group created within the federal government to agree to actions of the different ministries involved in solving the problem of the toll roads.

CONTRACTING OUT PRINTING SERVICES AT THE DUTCH TAX AND CUSTOMS ADMINISTRATION

by

Jan Schild, Ministry of Finance

I. INTRODUCTION

This is a case study of contracting out the printing services¹ at the Dutch Tax and Customs Administration.² The main reason for selecting this case is that it is a relatively topical case. Moreover, the availability of documentation about this case is an advantage. The starting year of this case study is 1989. A great deal of attention is given to the decision-making process and preparations for it.

The structure of this case study is as follows: Section II contains general information about the Dutch Tax and Customs Administration, the printing services and the contracting out policy in general. In Section III, the decision-making process, research methods, evaluation, policy proposals and decisions, and consultation with the unions are considered. Section IV concerns the follow-up of the contracting out decision, especially the bidding process; the monitoring of the execution of the contracts; and the effects of contracting out. In Section V, some conclusions are drawn.

II. GENERAL

The tax and customs administration and its printing services

The Tax and Customs Administration (from now on called Tax Administration) is part of the Ministry of Finance. The Tax Administration is responsible for levying and collecting taxes, auditing bookkeeping systems and investigating fraud. The Tax Administration is also responsible for levying and collecting social contributions. In the Netherlands, the Tax Administration is the special responsibility of a State Secretary.

Some years ago, the Tax Administration was fundamentally restructured. The organisation of the Tax Administration is now based on different categories of taxpayers (*e.g.* individual taxpayers, small and medium-sized companies, and large concerns). Before that, the organisational basis was the type of tax (*e.g.* wage tax, income tax, corporate tax, value added tax). Other organisational developments were decentralisation, ongoing computerisation and the introduction of a company logo. Nowadays, we can say the Tax Administration is more responsive and more client-oriented.

Table 1. **Key figures of the Tax Administration**

	1989	1994
Total collected (million HFL)	178 906.4	225 270.4
Taxes	(120 370.8)	(152 475.3)
Social security charges	(58 535.6)	(72 795.1)
Expenditure on personnel and material (million HFL)	2 273.5	2 952.4
Number of employees (FTEs)	31 552.0	28 967.0

Source: Ministry of Finance.

The outline of the Tax Administration (see the Organisation Chart) is now as follows:

- a central staff at the Ministry of Finance in The Hague (general fiscal affairs, planning, finance and control, etc.);
- the target-group directorates nationwide (private taxpayers, enterprises, etc.) with the regional and the local units;
- the supporting units (automation centre, training, etc.).

The local printing services were located at the local units and the supporting units. The central printing service was (and is) located at Apeldoorn, as a unit of the Automation Centre. In 1989, there were more regional and local units than now.

The local printing services mainly produced simple printing (A4 format, no colour). The machinery (offset and photocopy) was in line with these requirements. The central printing service had more facilities than the local printing services.

Relatively little use was made of the central printing service by the local units. The strength of the local printing services was that they could produce quickly and were very flexible in meeting specific demands of their clients.

Besides, the local printing services were free of charge for the clients. The central staff at the Ministry in The Hague and the supporting units (*e.g.* Training, and the Fiscal Information and Inquiry Service) were the major outside customers. The central printing service charged only the cost of paper.

In Table 2, some key figures are given about the printing services of the Tax Administration in 1989 and 1994, and about printing and copying costs in 1989 and 1994. These years are chosen because they are the years before and after the decision to close down the local printing services. The effects of this decision can be seen in this table. Other factors that influence development between 1989 and 1994 are mentioned in the notes to the table.

◆ **Organisation chart 1995**

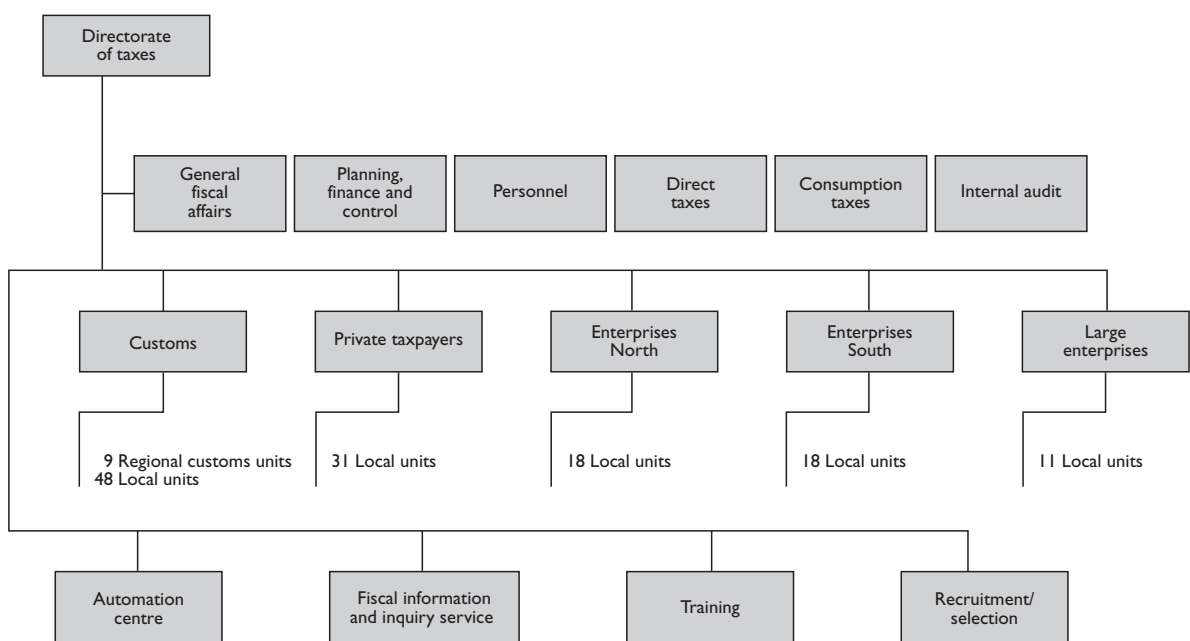


Table 2. **Key figures of printing services at the Tax Administration**

	1989	1994
Number of printing services	25.0	2.0 ¹
Number of employees, local printing services (FTEs)	33.0	1.0
Copies, local printing services (million) ²	66.9	35.4
Number of employees, central printing service (FTEs)	29.0	21.0
Copies, central printing service (million) ³	46.3	28.6 ⁴
Printing, binding and paper (million HFL) ⁵	25.9	32.2
Copying costs (million HFL) ⁶	5.0	6.2

1. These are the central printing service at Apeldoorn and one local printing service at Heerlen.

2. Both printing (offset) and high-volume photocopying. The high-volume photocopying in 1994 is of course not in local printing services. In 1994 the offset printing in the local printing service at Heerlen was 1.8 mln. p.

3. Both printing (offset) and high-volume photocopying.

4. For a fair comparison it should be kept in mind that in 1989 the production was made in A4 format, but nowadays is mainly produced in A3 format. Furthermore, nowadays more (supporting) colours are used, in which case the pages pass through the machinery at least twice.

5. This is the budget for all printed matter that the Tax Administration is contracting out. The costs for the type of printing that is the subject of our case (A4, no colour, mainly photocopying) are assessed for 1994 at 1.3 mln (1989: 0).

6. This is the budget for "in-house" copying costs.

Source: Ministry of Finance.

Contracting out policy

Given the principle that the public sector should not do things that can be done just as well or better by the private sector, the Cabinet decided in 1986 that the printing services of the central government should only have a strategic minimum capacity for confidential printing and (limited) urgent orders. The printing services were then seen as an auxiliary function.

The Cabinet decided that commercial printing and publishing activities had to be contracted out, if possible, not later than 1990.

This was expected to reduce the public sector, stimulate the private sector and reduce government expenditure.

III. THE DECISION-MAKING PROCESS

In this case study, the description of the decision-making process is for analytical reasons divided into separate sections covering the procedure, research methods, evaluation, policy proposals and decisions, and consultation with the unions.

Procedure

In preparing for the execution of the 1986 Cabinet decision mentioned above, some researchers of the central staff were asked to make an exploratory study of the current situation, the future printing needs of the Tax Administration (offset and photocopying) and the necessary capacity to meet this demand. In December 1989, the researchers presented their report, "Exploratory Study: printing services at the Tax and Customs Administration", henceforth referred to as the Exploratory Study.

The Board of Directors of the Tax Administration discussed this Exploratory Study in 1990 and agreed largely with its proposals. Subsequently, a working group was formed to develop an implementation scheme.

The Chairmanship and secretariat of the working group came from the central staff of the Tax Administration. Staff members of the local units were also involved (such as representatives of the local printing services and of the central printing service).

The Board of Directors agreed with the proposed implementation scheme of the working group and submitted it, according to legal rules, with a "Social Plan" (a scheme to offset the personnel

consequences) to the Special Committee (*de Bijzondere Commissie Belastingdienst*). The Special Committee was the consultative body with the unions. The Special Committee agreed with the decision of the Board of Directors and with the accompanying Social Plan.

Research methods

The Exploratory Study contained information about the (future) printing needs of the Tax Administration (offset and photocopying) and the capacity to meet this demand. The researchers took into account the expected consequences of the restructuring, the ongoing computerisation and the introduction of the logo.³ The researchers also calculated the average (total) costs per page for each printing service.⁴

In order to obtain broad information and proper insight, the researchers conducted an inquiry into the units of the Tax Administration. They also interviewed experts. They used elaborate questionnaires dealing with both the supply side and the demand side.

Concerning the *demand side*, the questions were (divided in subquestions) as follows:

- For what and to what degree are you now using the local and central printing services?
- Where do you place your printing and copying orders?
- Why do you place printing orders at the local or central printing services? (suggested motives were cost, quick delivery, service, quality and confidentiality).

Concerning the *supply side*, questions were asked about the local printing services, the central printing service at Apeldoorn and external printers. Attention was paid to available capacity, facilities, cost prices, quality standards, delivery time, etc.

The working group did additional research into the clients of the printing services and into the possibilities for cost price calculation. For this additional research, the working group selected five printing services considered representative for all local printing services. Prices and facilities of private printers were examined as well (primarily through interviews).

Evaluation

Cost comparison is a prominent criteria for contracting out decisions. The researchers and the working group gave much attention to the design and drawing up of the cost calculation. The average (total) cost per page calculated by the researchers ranged in general from HFL 0.05 to well over HFL 0.11 per page.⁵ The cost prices of three small local printing services with only offset machinery were higher.

These results were compared with data from private printers. The average price of a private printer was, including value added tax, roughly HFL. 0.09 per page. Thus, some printing services, especially the bigger ones, were competitive.

In addition to these cost price comparisons, by the researchers and working group mentioned other considerations are:

- In 1989, when the printing services did not charge their clients, there was no incentive for the printing services to make economical use of the printing budget. Both in the Exploratory Study and in the report of the working group, cost calculation and user charging were advised. Only then could the client make a well-founded choice between doing the copying himself, ordering from the local printing service or from the central printing service, or contracting out the order to a private printer.
- Another disadvantage of the situation in 1989 was the lack of detailed information at central level of printing expenditure. Therefore, systematic comparisons among printing services and between printing services and private printers were not possible.
- Concerning quality and service, the delivery time and the flexibility of the local printing services was an advantage. The quality of the work delivered by the local printing services (mainly A4, no

colour) was sufficient for the purpose. The central printing service at Apeldoorn and private printers could provide better quality and could also meet special needs. With regard to the possibilities of the market sector, a further inquiry was made. The capacity of the market sector was sufficient for a quick delivery of high-quality printing at competitive prices. The relevant printers had modern machinery also fit for future developments such as electronic data transmission.

Policy proposals and decisions

The information mentioned above was the basis of both the recommendations in the Exploratory Study and the reconstruction scheme in the report of the working group.

The Exploratory Study recommended maintaining the central printing service at the existing level and to concentrate printing orders at some large regional printing services. The non-competitive local printing services had to be removed. This solution 1) largely met the requirements of the 1986 Cabinet decision and 2) the regional printing services continue to react quickly and flexibly to the needs of the units.

Calculation of average (total) costs per page had indicated that the central printing service was competitive with private printers. Moreover, the central printing service functioned as a strategic facility for the Logistics Division of the Automation Centre: frequent use of the central printing service was made for urgent and limited orders. A condition for maintaining the central printing service was that it should work under market conditions and charge for its costs.

The Board of Directors agreed with the proposal to maintain the central printing service. But with regard to the local printing services, it was decided to remove all offset machinery within a period of two years.

The proposal of the working group formed to develop a reconstruction scheme was:

- Printing services with offset should be removed within two years after the decision by the Board of Directors.
- The closing down of the offset sections would not automatically imply replacement by high-volume photocopying.
- No decision would be taken before a solution is reached for the personnel involved. In exploratory talks, potential contractors appeared willing to offer opportunities to take over employees.
- For each location, private printers would be invited to make offers on the basis of a detailed programme of requirements. Aggregation of demand would result in further savings.
- In larger offices, a sufficient basic facility should be available for limited and urgent orders. This basic facility would have a regional function and the capacity must be appropriate to it. Charging for costs would always be necessary.

The Board of Directors agreed with the proposal of the working group and submitted it with the Social Plan to the Special Committee (the consultative body with the unions).

Consultation with the unions

The proposal to close the printing services had no consequences for the total staff of the Tax Administration. Employees of printing services were mostly clerical staff or were members of supporting units. 24 of the 27 employees involved could be reassigned without difficulty. For the 3 remaining employees (trained graphic designers), it was proposed to develop the necessary outplacement activities at unit level. For these activities, sufficient budget resources should be provided at central level. In exploratory talks, potential contractors appeared willing to offer jobs to skilled offset printers. Negotiations were made easier by the fact that, as a consequence of closing down printing services, the Tax Administration contracted out more printing to private printers.

Given this "Social Plan," the Special Committee agreed with the decision of the Board of Directors to close the local printing services.

IV. FOLLOW-UP

The moment the decision to contract out had been taken, it had to be implemented. This implied the phased closing of local printing services (reassigning employees, removing offset machinery, etc.) and making contracts for printing orders. The phased closing of printing services took more time than intended. In particular, finding a solution for the personnel involved and avoiding unnecessary loss of capital invested took more time than foreseen. At the moment, there is still one local printing service in operation (Heerlen, with 1 employee, see Table 2).

The remainder of this case study deals mainly with the bidding process, the monitoring of the execution of the contracts and the effects of contracting out.

The bidding process

The Tax Administration was already experienced in contracting out printing services. Moreover, serving as a pilot, the printing service of the Training Unit had been closed down and its printing contracted out following the proposed procedure (programme of requirements, etc.).

The bidding process was centrally controlled. The local programmes of requirements formed the point of departure. The units were asked which printers they preferred to make an offer. It turned out that, in general, units preferred existing relations and suppliers in the surrounding area. Personal contact was seen as important for providing, if necessary, a quick and flexible execution of orders.

The selected printers were asked to make an offer on the basis of the local programmes of requirements. The following step was to select a printer in consultation with the units. The local programmes of requirements were the starting point of this selection. Price was also an important criterion, as were confidence in delivery-time, flexibility, service, and the possibility of personal contact. Sometimes these latter factors compensated for acceptable differences in prices.

It was not easy to compare prices. Often the structure of tariffs varied from printer to printer. Different tariffs for different numbers, differences in tariffs for offset and photocopy, differences for facilities such as single-sided or double-sided, different costs for additional services, etc.

The whole process resulted in 1992 in "framework contracts" for three years with two suppliers, namely Multicopy International and Sdu ReproPartners. Precise arrangements were made concerning prices, delivery time, quality and payment. Usual rises in costs may be passed on.

In Multicopy's favour was its large number of branches all over the country; it thus meets the demand for "a supplier in the neighbourhood". As for Sdu ReproPartners, the Tax Administration had a long-standing relationship with them, particularly for special printing.

To adapt the bidding process to the new European Rules (Council Directive 92/50 of 18 June 1992, relating to the co-ordination of procedures for the award of public service contracts), the extension of the period of the framework contracts for one year is being considered.

Monitoring of the execution of contracts

Monitoring of the execution of the contracts is carried out as much as possible by the unit that places and pays for the printing order. Problems are solved, if possible, bilaterally between supplier and client. In addition, there is regular consultation among suppliers, units and central staff to monitor the execution of the contracts and the quality of printing.

On balance, all parties are satisfied with the execution of the contracts. The suppliers consider the Tax Administration a respected client, and try to maintain a good relationship with it. For example: suppliers did not ask to adjust the framework contract (*e.g.* for prices) when the number of copies contracted out fell short of the estimates. In general, problems were solved flexibly.

Effects of contracting out

The most important effects of the (partial) contracting out are as follows:

- Both the Tax Administration and the suppliers considered contracting out to be positive.
- Given the phased approach, the costs of closing the printing services were limited. For example, it was possible to avoid dismissal of employees (with reduced pay). At this moment, two printing services still remain (the central printing service at Apeldoorn with 21 employees and a local printing service at Heerlen with 1 employee, see Table 2).
- The expenses of contracted out printing and copying are charged to the account of the units. This stimulates cost consciousness and allows units to take a well balanced decision on whether to contract out.
- In-house copying has grown faster than foreseen. This is partly due to technical developments. Available photocopiers have become more and more user-friendly.⁶ These developments caused offset to be replaced by photocopying more quickly than foreseen. This implied that the volume contracted out to the market sector fell short of the estimates. This growth of in-house copying is seen worldwide.

The intention was to provide only a basic facility for limited and urgent orders in larger offices. This basic facility should have a regional function and the capacity should be appropriate for it. Costs should always be charged.

These intentions have been only partially realised. There are always confidential notes for which in-house copying is preferable. Moreover, the criteria “limited”, “urgent” and “confidential” tend to be interpreted broadly. The charging remained limited to the cost of paper and the hiring costs of the photocopying machine. The intention was that the central printing service at Apeldoorn should work under market conditions. This, too, has been only partially realised. The total costs have been calculated, and on that basis a price is fixed and invoiced. In this way, information on costs is provided. However, the clients were undercharged since, as a temporary measure due to the existing budgetary constraints, they benefit from a considerable discount.

V. CONCLUSIONS

In general, the following conclusions can be drawn:

- From a purely methodological point of view, the valuation of expected effects is rather complicated. This valuation requires a thorough knowledge and comparison of the “without” situation and the “with” situation. The problem in this case is that the “without” situation changed continuously because of unforeseen technical developments. As mentioned above, available photocopying machines became more and more user-friendly, which induced a continuous substitution of offset by photocopying. Moreover, the “with” situation changed unexpectedly since the full costs of copying were not charged to the clients. So, a fair assessment of the effects is rather difficult.
- The thorough managerial preparation of the decision-making in this case has helped to formulate a well-balanced contracting out decision with sufficient support. As a first step, some researchers of the central staff made an exploratory study of the existing situation and the future printing needs of the Tax Administration (offset and photocopying) and of the capacity to meet this demand (based primarily on an inquiry and interviews). Then, a working group was formed to develop a reconstruction scheme. Printing services staff participated in this working group. Prices and facilities of private printers were thoroughly examined. Finally, the proposal (especially the personnel consequences) were discussed with the unions. It was also an advantage that the Tax Administration had already a lot of experience with contracting out printing. Moreover, a pilot project was started: the printing service of the Training Unit was closed and its printing was contracted out on the basis of the proposed procedures.

- For the copying and printing that was not contracted out, the full costs have not been charted, as was intended. Concerning the central printing service at Apeldoorn, total costs have been calculated and on that basis a price is fixed and invoiced, but a considerable discount is given. And in the case of high-volume copiers at larger offices, charging remains limited to the cost of paper and the hiring costs of the photocopying machine.
- Obviously, in the absence of a detailed planning system, it is difficult to attain a situation functioning fully under market conditions for the in-house printing services.
- Partial contracting out increases the risk of units using “cheaper” internal facilities. Criteria such as “limited”, “urgent” and “confidential” are interpreted broadly. Physical restrictions, as intended in the reconstruction scheme, seem insufficient.
- On the other side, the phased closing of the printing services has advantages. The operations of the central printing service at Apeldoorn and the temporary operations of the local printing service at Heerlen helped units to accept the consequences of contracting out and reduced costs.
- It is expected that printing and photocopying in the Tax Administration will function more and more under market conditions. The local printing service at Heerlen will be closed. Closing the central printing service at Apeldoorn is being considered. And a fuller internal charging of total copying costs is being discussed as part of the discussion about facility management.
- Finally, it should be mentioned that, because of a number of technical reasons, no thorough analysis of the costs involved has been conducted. These technical reasons are:
 - the differences between costs and budget expenses;
 - the expenses for printing and copying are recorded in a number of different budget items (e.g. central budgets and unit budgets), and this differs over the years.

Of course, there are indications that the benefits (including budgetary savings) outweigh the costs. The parties concerned are positive about contracting out, and the contracting out of printing and photocopying in the Tax Administration is continuing.

However, for decisions on contracting out printing services in cases like this, an integral assessment of costs and benefits of the relevant alternatives is necessary.

NOTES

1. For the sake of terminology, the term printing service is used throughout this case study. The concept of printing used in this case study includes also photocopying but excludes printing by printers related to personal computers. Nowadays nearly all this printing in the Tax Administration is high-volume photocopying. In 1989, the first year of this case study, the printing services produced two times more off-set than photocopy.
2. This case study was carried out in co-operation with the Tax and Customs Administration.
3. The conclusion of the researchers was that, through these developments, the need for printing and copying would probably diminish.
4. With some revision, the working group used this calculation scheme for additional research at five representative printing services.
5. The average total costs calculated by the working group for the five representative printing services ranged from HFL 0.07 to HFL 0.10 per page.
6. The present photocopying machines, both high-volume copiers (mostly in larger offices) and low-volume copiers (one or more in each office at an easily accessible place) can perform better technically than machines from 1989 (e.g. double-sided, automatic handling, sorters, stapling, A3 format). Other developments to be mentioned are the possibilities of electronic data transmission from personal computer to printer and a higher quality of printing and copying (e.g. colours).

CONTRACTING OUT THE FUNCTIONS OF THE NEW ZEALAND AUDIT OFFICE

by

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I. INTRODUCTION

Over recent years, the New Zealand public sector has made increasing use of competitive tendering and contracting out as part of the government's wider strategy to achieve further efficiencies in the delivery of public services. From a very broad perspective, government policy in New Zealand is that the Crown should be efficient in its allocation and use of resources. Where it is efficient to purchase goods or services outside the public sector, and there are no other compelling policy reasons for retaining production within the public sector (such as continuity of supply), the government has supported contracting out. Before outlining the case study, this introduction gives a brief overview of the key features of New Zealand's public sector management system that have fostered competitive tendering and contracting out.

The most important point is that the New Zealand public sector management system is characterised by a high degree of managerial freedom. Decentralisation was a key component of the public sector reforms that were implemented in the late 1980s. Briefly, this involved decentralisation of decision-making authority to give chief executives control over acquisition, utilisation, disposal and mix of inputs, including both labour and capital. Ministers, on behalf of the Crown, purchase goods and services (outputs) from departments rather than determine how these goods and services are to be produced.

The freedom to choose whether to produce in-house or contract out has meant that, over the past 10 years, a large number of activities have been contracted out. Initially, contracting was confined to basic activities such as cleaning services. More recently, other activities such as facilities management, debt collection, education, health care, policy advice, accounting and auditing have all been contracted out to some extent. This case study focuses on the experience of the New Zealand Audit Office in contracting out the provision of audit services to government.

The Audit Office example provides several years of experience in contracting out an activity that was once considered to be inherently public sector. The case study outlines the specific risks associated with out-sourcing public sector auditing services and how these were managed. It outlines a situation where, although the chief executive has opted to out-source the delivery of services, he remains ultimately responsible to the government for the delivery of those services.

II. CASE STUDY: THE AUDIT OFFICE

Background

The role and purpose of the Auditor-General is founded upon fundamental constitutional principles. Under New Zealand's system of government, all authority for governmental activity ultimately stems from Parliament. Government agencies are, therefore, accountable to Parliament for their use of resources and powers conferred by Parliament.

As part of its accountability arrangements for executive government, Parliament seeks assurance from an independent source, the Auditor-General, on the performance of the instruments of government. The Auditor-General is appointed by Parliament to be the auditor of nearly all public sector organisations. An audit involves the collection and examination of facts of another party's actions for the purpose of giving an informed opinion of those actions.

The Auditor-General's role is to provide assurance to Parliament that governmental organisations are operating and accounting for their performance, in accordance with Parliament's intentions. To be credible, such assurance must be seen to be independent and competent.

To provide this assurance, the Auditor-General has a legislative mandate that requires a more comprehensive audit than a typical private sector audit. For example, legislative audits include questions regarding the appropriate use of taxpayers' dollars and whether an entity has done anything that they should not have done. The Auditor-General provides assurance to Parliament through reports arising from audits.

The Audit Office consists of two business units – the Office of the Controller and Auditor-General (OAG) and Audit New Zealand. The OAG provides the policy role of the Audit Office. This involves developing auditing policy and strategy, the provision of reports to Parliament and a contract management function to manage the audit tender process. Audit New Zealand is the Audit Office's operational arm. Audit New Zealand is totally devoted to providing auditing services. In a contestable environment, Audit New Zealand competes for audits against other audit service providers (ASPs).

In performing its statutory functions, the Audit Office provides three main functions. First, it provides reports and advice to Parliament on matters of significance arising from audits, or in relation to financial management and accountability in the public sector. Second, the Audit Office has a statutory duty to provide assurance that all funds released from the Crown bank account are for purposes for which there is an appropriation (the "Controller" function). Finally, the Audit Office audits the statements (including financial and non-financial information) of public sector organisations to provide assurance that they fairly reflect actual performance. More than 85 per cent of the Audit Office's budget is applied to the provision of audit services – the third function listed above.

Approach to contracting out

Auditing public sector entities is an example of an activity that was previously considered as inherently public sector. More recently, the legislative responsibilities of the Auditor-General and the powers to delegate those responsibilities has meant that it has become feasible to allow private sector auditors to perform this traditionally governmental role.

The new contracting philosophy was introduced in 1992-93. Although the decentralised management environment gave this initiative added impetus, the Audit Office, like other departments, was facing increasing pressure to demonstrate that it was providing an efficient service and value for money in the audits it conducted.

Determining the cost of Audit New Zealand's services for comparison with private sector providers did not present any initial difficulties to the Audit Office. New Zealand's public sector financial management system requires departments to follow generally accepted accounting practice. In addition, a capital charge regime means departments report the full cost of their outputs – including the costs of capital. This enabled the reported cost of producing audit services by the public sector to be directly compared with the price charged by private sector providers.

As mentioned above, the Auditor-General retains the responsibility for the delivery of audit services. Consistent with this, planning and prioritisation of public sector audits is a role conducted solely by the OAG. The OAG has responsibility for managing the audit plans in the competitive tendering environment.

Tendering process

The Audit Office approached the contracting out issue through the use of competitive tenders. Since the early 1980s, the Audit Office had followed an internal policy of contracting in staff from other audit firms during peak periods. The reasons for this were twofold. First, it was efficient in that it avoided the need for the Audit Office to have a number of under-utilised staff during quiet periods. Second, it allowed the private sector auditors to gain experience with auditing public sector organisations. This policy proved to be valuable as the Audit Office moved to a fully contestable environment.

As a first step in the tendering process, all ASPs must be evaluated and registered by the Office of the Auditor-General before being permitted to participate in the contestable process. ASPs must be able to demonstrate that they have the capacity and capability to perform the type and size of audit they are registering for. The evaluation covers the following areas:

- their methodology, including how they will audit legislative compliance, and non-financial information, and how their audit approach will identify wider mandate issues and fraud;
- their quality assurance and control systems;
- specific representations; and
- where available, details of New Zealand Society of Accountants practice review reports.

An important part of the tender process is that the entity being audited is contacted by senior staff of the Audit Office to obtain their agreement to being included in the competitive tender round. Where they do not agree, the audit continues to be conducted by Audit New Zealand. Experience to date suggests that most entities are generally comfortable with being included in the competitive tender round. The entities view this as a potential way to encourage improvements in audit service quality.

Following this, registered audit service providers are invited to submit an expression of interest in specific tenders. These are evaluated by the Auditor-General and a minimum of three are short-listed. The present auditor is always on the short-list, since, typically, the relationship between an auditor and a client is a long-term relationship. Leaving the present auditor on the short-list allows the auditor to foster this long-term relationship. In order to minimise the Audit Office's dependence on any one firm, no private sector firm is short-listed if it already provides more than 50 per cent of auditing services for a given sector.

The short-listed auditors are invited to send a tender letter to the Audit Office. Before submitting the tender letter, tenderers are given an opportunity to hold due diligence discussions with the entity to be audited. This allows the tenderer to confirm his or her understanding of the entity.

The tender letters are initially screened and comments provided by technical staff and senior staff from the OAG. Comments, which detail the strengths and deficiencies of the tender letter, are provided to the tender evaluation panel. The panel consists of a client representative, an OAG representative and independent person as chair. It considers and ranks the tenders on the basis of the information received. The OAG provides criteria and guidance to assist the panel with the process of evaluation.

Appointments are made by the Auditor-General after consideration of the panel's recommendation. The OAG debriefs each firm on the results, giving them the overall results of the tender round, and the specific comments made on their tenders by the panel. The process is reviewed by an independent consultant, who issues both a short-form and long-form report on the integrity of the process.

For most audits over 2 000 hours, the process is supplemented with an oral presentation by the tenderers to the panel. For those smaller and less complex audits, the entities to be audited are encouraged to manage the process themselves. They short-list and evaluate based on information and detailed guidance provided by the Audit Office. They send a summary and recommendations for the Auditor-General's approval.

The audit contract is for a three-year period with a fixed audit fee. This may be renewed for a further period of three years subject to agreement among the three parties and fee negotiation. The

Auditor-General contracts with the “approved auditor” (AA)² and the audit service provider (the firm). The contract may be voided if the AA changes. The contract consists of four documents:

- the engagement letter;
- the terms and conditions of engagement;
- the tender letter; and
- the OAG audit standards.

Implementation of the tender process

Before the Audit Office moved to a contestable environment, some auditing services were already contracted out. For a number of years, the Auditor-General had used chartered accounting firms to audit state schools – largely because of the sheer number of individual audits involved. The process outlined above evolved with the benefit of the Audit Office’s early experiences with contracting out.

The Office held an initial tender round which enabled it to gauge the state of the market for the provision of audit services. Audit New Zealand was not permitted to tender in this round. The private sector market for performing audit services was well advanced in terms of private sector audits. However, the peculiarities of the public sector and the breadth of the legislative audit meant that private sector providers faced a steep learning curve in coming to terms with public sector audits. For example, private sector auditors generally had no experience auditing service performance as the Auditor-General is required to do.

Recognising that public sector entities cover a wide spectrum of activities, the audit portfolio was initially divided in two:

- Those audits for which the audit service would be contestable comprising approximately 57 per cent (based on hours) of the Auditor-General’s total portfolio. These audits consist of commercial entities (for which the audit is very similar to private sector organisations), and entities with a mixture of social objectives, but which are usually subject to more comprehensive reporting requirements.
- Second, those audits where the audit services were to continue to be provided by Audit New Zealand. These were government departments and related bodies plus territorial and local authorities, which largely rely on taxation revenues and are also subject to comprehensive public accountability arrangements.

The reason for this split was to enable:

- the private sector auditors to have an opportunity to develop greater knowledge of the public sector in general and the unique features of public sector auditing in particular;
- an exchange of knowledge to occur as a result of drawing on a wider pool of auditors, and on private sector knowledge and practices, which would make a positive contribution to the quality of financial management and accountability in the public sector; and
- the entities being audited to have the opportunity to “test the market” for the provision of services.

The audits in the contestable pool were to be progressively tendered out over a three-year period commencing in December 1992. Four tender rounds have been held so far, at the end of which approximately 40 per cent of the Audit Office’s workload of annual audits was contracted out, and a fifth comprising a further 5 per cent is in progress.

The first tender round, consisting of 36 entities ranging in size from large electrical utilities to small trust boards, began on 1 December 1992, and included 8 per cent of the total annual workload by hours. Audit New Zealand was successful with its tender for 13 of these entities. This tender round saw a 26 per cent reduction in audit hours and approximately a 12 per cent decrease in fee. Some discounting of fees occurred. Most of the audits were won by the major chartered accounting (CA) firms, although two smaller CAs were successful in winning two of the smaller audit entities.

The second round consisted of a re-tendering of the schools, which had been out on contract, largely to CA firms, for five years. This was a major logistical exercise, undertaken from July to November 1993.

The audit fees also dropped in relation to these audits; however, as the scope of the audit was reduced (service performance did not require auditing) it is difficult to determine how much of the decrease relates to the reduced scope and how much relates to downward pressure on fees as a result of the tender.

Late in 1993, a further group of bodies was tendered out, comprising all of the newly established Crown Research Institutes (after one year of operation) and miscellaneous other bodies. In this third round, Audit New Zealand was quite successful. It held half the audits tendered for, and won one from a CA firm.

Early in 1994, another tender round was conducted, covering some Crown-owned ports and a number of other local authority trading enterprises.

Overall:

- 40 per cent of the originally intended 57 per cent of audits by hours have now been contested.
- Audit fees have been lowered by between 12 per cent and 25 per cent.
- Generally, the firms have been positive about the process even though the tender process is costly. Feedback in de-briefing sessions after rounds is helping to both refine the process and retain goodwill.
- The response of those clients involved has been almost universally positive so far, and there has been particular comment on the improvement in Audit New Zealand's performance over the last two years.

The significant unanswered question is whether or not the quality of the audits has been affected. While it is clear that Audit New Zealand is orientated to a concept of client service, there is not yet any significant evidence as to whether audit quality has increased or declined. The performance monitoring regime outlined below must go through another year or two at least before unequivocal evidence can be gathered in this respect.

In terms of monitoring the quality of audits, the first step was to develop standards against which a quality audit could be measured. The Office is now in a position to collect and compare data with the newly established standards to determine whether the quality of audits has improved.

Review of the tender process

In May 1994, the Audit Office reviewed the tender process with the benefit of several years' experience. The first major lesson is that contestability is, to date, a success. Notable positive results included:

- An overall reduction in fees, with what is expected to be no reduction in the quality of audits.
- A significant improvement in the performance of Audit New Zealand. It is now capable of competing with firms in its own territory of expertise, and has affected some remarkable turn-arounds in clients' and others' perceptions.
- Dialogue being initiated between ASPs and the Office, improving both the ASP's understanding of the portfolio and role, and also the OAG's understanding of the issues ASPs face as agents.
- The tendering process itself becoming less burdensome – although it still represents a significant effort for tendering firms.

However, a number of negative factors also became apparent within the first two years. These included:

- A number of audits exhibiting difficult issues in auditing both the Crown's ownership and purchase interests in some entities – highlighting larger risks for the OAG.

- Potential misunderstanding by clients of their role in the process. The OAG consciously wanted to prevent a situation where the clients considered that since they pay the fees, they have the determining voice in who is appointed as agent of the Office.
- Some indications that audit firms see the audit entity as the primary client, rather than the Audit Office. This seemed to arise from a combination of circumstances, such as history, culture, and a lack of a clear understanding of the actual, formal relationship.
- Professional risk faced by the Office in contracting firms to audit more political clients without full and adequate briefings on the auditor's role. The Office had a lot of work to do in developing and articulating standards and guidelines about the role of the legislative auditor.
- That the market shifted towards the bigger firms. The smaller firms had as a general rule acted from adequately to very well on behalf of the Office. However, they were not seeing that improved performance reflected in their success in tender rounds. This may partly be a result of their inability to apply the amount of overhead that the bigger firms have to the development of proposals. It may also be a real professional gap, or a perception gap.
- A question about how level the playing field was between the firms and Audit New Zealand, and how level it would be as more political audits were tendered. Audit New Zealand has the natural advantages of being the incumbent and of having a culture more attuned to the requirements of the Auditor-General; the firms have the natural advantages of the wider services they offer through their international connections and being able to offer their services to both the private and public sectors.

These issues gave the Office some ideas for further improving the tendering process. The review was well timed in that it enabled the Audit Office to amend its tender process before moving to full contestability.

In making the transition to full contestability, it was important to ensure that the following risks were minimised:

- Political – that matters of legality, probity, financial control and management effectiveness or efficiency that the primary client (including Members of Parliament, Ministers, and Councillors) expects the Auditor-General to bring to its attention are not reported on. As an Officer of Parliament it is essential that Parliament has confidence in the Auditor-General.
- Financial – that financial information in audited accountability statements is materially mis-stated.
- Performance information – that performance information in audited accountability statements is mis-stated or inappropriate.
- Service quality – that a secondary client's expectations of the Auditor-General and the individual auditor are not met.
- Provider capture – that the integrity of the process is compromised either by:
 - in-house “provider capture” by Audit New Zealand as a result of its historically dominant position; or
 - another single audit service provider, or a cartel of providers, achieving a dominant position and dictating the price paid for audit services.
- Culture transfer – that the culture of being an agent of the Auditor-General is not satisfactorily transferred to chartered accounting firms in a sustainable manner.
- Secondary client capture – that the Audit Service Providers mistake their role, and forget that their prime responsibility is to the Auditor-General.

The review of the tender process was conducted between October 1994 and March 1995. It focused on the key weaknesses perceived in the tender process and on minimising the risks outlined above. In particular, the tender process had to be amended to:

- place greater emphasis on Parliament's (or taxpayers') needs rather than those of the audited entity;

- further test its fairness between large and medium-sized firms, and public and private sector firms; and
- minimise process costs for all involved.

The review resulted in a number of notable changes to the tender process. In selecting the successful tenderer, more attention is now focused on audit quality and the ability of the tendering firm – especially with core audits. The OAG also changed the level of control over the management of the tender process by delegating the task to small entities only where there is a high level of confidence that the entities are administratively competent to manage the process. Finally, to promote fairness between tenderers and Audit New Zealand, the OAG takes account of the tenderers' level of investment in the OAG's standards and guidelines rather than focusing solely on their experience in public sector auditing.

The introduction of the contestable provision of audit services necessitated the expansion of the existing standards and guidelines of the New Zealand Society of Accountants for the conduct of public sector audits.

The Guidelines contain material on the role of the legislative auditor, the necessary competencies, quality assurance systems and reporting to the Auditor-General. The ASPs were involved in the development of the standards and guidelines, although final policy approval was given by the Auditor-General. The OAG held workshop sessions for ASPs to explain the content of the standards and guidelines.

Monitoring performance

An essential part of any contracting out environment is mechanisms to allow effective monitoring. There are a number of mechanisms used to monitor performance; some are quite mature while others are more developmental.

- Quality assurance begins with the registration of potential ASPs. Only those assessed as having sufficient capability and capacity are registered. The evaluations conducted as part of the tender process also ensures that the AA has had sufficient public sector and sector experience to be able to do the audit.
- Early in the audit cycle, a small number of entities that are considered to be of particularly high risk are scheduled for pre-signing reviews. Examples include entities that are likely to be sold. Audit plans will, in most cases, be discussed by the OAG with the auditors, and certain elements of the accounts will be reviewed before the opinion is signed.
- When auditors seriously consider the issue of a fundamental opinion (disagreement, disclaimer, or going concern qualification), they must consult with the OAG before issuing their opinion. This is a formal process, which needs to be conducted on average about once a week.
- Auditors are required to provide the audit opinion, financial statements, and audit highlights memorandum to the OAG within 24 hours of issuing their opinion. This is primarily designed to give the OAG timely advice on the issue, and it also enables immediate follow-up where contract or statutory deadlines are not being met.
- Within six weeks of audit completion, auditors are required to file a return, including the management letter, a report on the state of the entity and a report on the conduct of the audit, including fees and hours. A six-week period is allowed for management reporting. OAG staff review the quality of this material.
- The OAG has conducted about 70 site visits and file reviews so far, to assess ASP compliance with its standards. The general approach to these site visits is to take an overview of the systems of control and quality assurance within the firm, supplemented by some file reviews. A significant minority of smaller firms (doing smaller audits) are not performing well on the OAG's behalf, and it was quite clear from reviewing the one auditor outside Audit New Zealand who audits a government department that there is a large knowledge gap to be filled if private sector auditors

are to be effective in auditing core government departments. It is intended that each Approved Auditor will be reviewed at least once every contract period (three years).

- The Audit Office has experimented with bringing in senior partners and directors to do file reviews, while OAG staff concentrated on system reviews. This aims to give a more in-depth assessment of the quality of work, and also spread the knowledge and issues further.
- The Auditor-General has a programme of client visits that is strong in some sectors but not yet developed in others. On these visits, the Auditor-General seeks the entity's view on the auditor. Two mail surveys of client attitudes, covering certain sectors where the annual cycle has recently been completed, have also been undertaken.
- Still to be fully developed is the co-ordinated and systematic analysis of all of this information, plus the informal information coming from file notes of various contacts made with the ASPs and audit entities. Currently, the Office keeps a file for each AA and a semi-automated system for summarising it. More recently, the Office has begun pulling the information together with a view to more rigorous assessment of, and feedback on, auditor performance.
- A thorough review of how the quality assurance work is being targeted is also well under way, and its likely result will be a re-focusing of quality assurance work to concentrate solely on the features of audits unique to the public sector.

In the long term, the OAG aims to take a risk-based approach to monitoring. This would target reviews in areas where there is high risk in order to minimise the costs of administering the contracting environment.

To date, the costs of running the contracting process have been far outweighed by the savings made thus far. The Office has a contracting unit of four dedicated staff. The time taken for a specific tender depends on the complexity of the audit in question. On average, the Office estimates a tender takes 30 hours in contract management.

Scale of contracting out

As mentioned above, 40 per cent of auditing services previously handled by the Audit Office are now contracted to third parties. This has clearly affected both the Audit Office as a whole and Audit New Zealand as its operational arm.

The main impact on management within the Office was the splitting of Audit New Zealand from the policy and contract management functions of the OAG. This focused management attention on “busting” the monopoly previously enjoyed by Audit New Zealand. The process of letting tenders became “bureaucratised”. The more formal tender process was an intentional strategy to change management's focus towards the new contestable environment.

In addition, new management skills were required – particularly within the contract management function. OAG staff are largely self-trained in the areas of contract management and dispute resolution. Relationship management both with audit entities and the auditors themselves became highly important for management.

The communication of the decision to restructure the Audit Office and to contract audits out to the private sector was handled as a corporate affair. The decision was justified in terms of the new environment faced by the Office and the need to improve efficiency through competition with the private sector.

The imposition of the contracting environment encompassed more than just redundancies at the Audit Office. The Audit Office also embarked on a restructuring programme, which included splitting the OAG and Audit New Zealand and closing several district offices. The Crown, as owner of the Audit Office, was requested to fund these costs. The Crown agreed, subject to a number of provisos.

Conclusions

New Zealand's decentralised public sector management system and its drive for efficiency has encouraged an increasing use of private sector partners over the past 10 years. The Audit Office provides a good example of a "white collar" activity which has been successfully contracted out with beneficial results.

Through the use of competitive tendering, the Audit Office has developed an efficient process of selecting private sector auditors to perform public sector audits. It is clear from the Audit Office example, however, that contracting out is an activity that must be approached with care.

For example, contracting out required the development of more robust processes for contract management. The implementation of the Audit Office's contracting out strategy was conducted on a step-wise basis. Before moving to full contestability, the Office reviewed its tendering and monitoring processes in light of several years' experience. This provided the information to improve and streamline these processes and to minimise the risks involved with contracting out. The resulting tendering and monitoring process provides a basis for careful examination of prospective auditors and *ex post* review of the work performed.

Organisational culture is also an important aspect in the successful implementation of a competitive tendering philosophy. In this case, a shift in management's focus from the business of performing audits to meeting the needs and expectations of the primary client (Parliament) was required. This shift focused management attention on the requirement for quality auditing services, regardless of who performs the audits.

NOTES

1. We acknowledge the assistance of Bruce Anderson of the Office of the Controller and Auditor-General in the preparation of this paper.
2. The Approved Auditor is a partner in a chartered accounting firm or a director in Audit New Zealand.

CONTRACTING OUT CATERING SERVICES IN TURKEY

by

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I. INTRODUCTION¹

Since the early 1980s, privatisation has been one of the most important issues for the Turkish economy. Privatisation need not only involve the sale of public sector assets; other forms of privatisation can also provide sufficient conditions for competition. For example, contracting out is commonly used in OECD Member countries although it has been only used to a limited extent in Turkey.

This case study will elaborate on the advantages and disadvantages of contracting out catering services in Turkish government organisations. According to the Government Personnel Act 1965, subsidised meals can be provided to government employees as detailed in government decrees. Additionally, the Turkish Ministry of Finance issues annual circulars concerning the practical matters of providing subsidised meals such as the minimum contributions of users, etc. Currently, if there are a minimum of 50 employees in a government office and an appropriate dining area exists, a subsidised lunch service is provided. Interestingly, if the number of employees is fewer than 50, then neither the lunch nor the cash value of it is granted.

The rest of this paper consists of four sections. In Section II, we will explain the details of subsidised meals with regard to the fiscal procedures in the Turkish public sector. In Section III, we will elaborate on the Ministry of Finance's contracting out practices for catering services. In Section IV, we will discuss the experiences of other government organisations with contracting out catering operations. We will conclude in Section V with the main lessons learned from the Turkish case.

II. FISCAL ASPECTS OF CATERING IN THE TURKISH PUBLIC SECTOR

Whether contracted out or not, lunch is served if the number of employees exceeds 50 in a ministerial unit, both at ministries and in municipalities. According to legislation, the cost of providing the lunch must be shared equally between the users and the government. The necessary cost analysis is usually performed monthly or quarterly, according to rough estimates of revenues from users and appropriations from the budget.

During the budget preparation process, provisional appropriation for subsidised meals are calculated as follows: 60 per cent of the number of employees at a ministry, multiplied by 250 days, multiplied by the price.

Until this study, no detailed statistical data had been collected on subsidised meals, so this lump-sum estimation method was used. The total number of employees nationwide that are likely to be eligible for subsidised meals is around 1 million out of a total of 1.3 million employees. It is often claimed that this causes biased distribution of budget appropriations among ministries. Suppose a ministry has many small offices with fewer than 50 employees per office. It will receive an appropriation as if it provided lunch to 60 per cent of its employees, whereas it may only serve to offices in which the number of employees is more than 50. Thus, if there are catering services in only a few locations at a ministry, the budget appropriation will be higher per person than for ministries that have more offices with 50 or more employees. Consequently, if the appropriation is relatively high per person, there can be higher spending for catering, which can result in government dissaving.

The above estimation method for budget appropriation for subsidised meals is not changed if catering is contracted out. This study shows that we need more accurate ways of estimating the number of people that are eligible for subsidised meals. Moreover, although it can create economies of scale in serving, the number 50 is quite arbitrary and can cause unequal earnings between employees in large offices and small offices. It may also create incentives for overemployment in order to exceed the number 50 and for the unnecessary construction of dining rooms.

Therefore, the system of providing subsidised meals should be remodelled. Despite these inefficiencies, some features of the system are well designed. For instance, the prices are set with respect to the income level of employees.

Each government organisation decides itself whether catering will be produced in-house or contracted out. This initiative is not limited by any means. Public procurement legislation allows them to contract out either by negotiation or sealed bid, or similar.

Although there are no barriers to contracting out catering services, it has been very rare. According to a survey conducted for this study, only three out of *circa* 40 ministries and annexed budget organisations (excluding public universities) have contracted out their catering services. As for the Ministry of Finance, only 53 of 79 municipal offices, plus the central office of the ministry, serve lunch. Only at the central office of the Ministry of Finance is the catering service contracted out. This does, however, allow us to draw some lessons from contracting out catering services.

III. THE EXPERIENCE OF THE MINISTRY OF FINANCE

The rationale for contracting out catering

After a long period of in-house provision, catering services have been contracted out at the central office of the Ministry of Finance since February 1994. Before contracting out, all meals were prepared in the Ministry's kitchen. The cooks who were employed by the Ministry were subject to the regular personnel act. Since their wages were not high, skilled cooks were usually contracted in and paid more. This, however, caused other employees to complain. Various other interventions caused overemployment and inefficiencies in the catering operations. For instance, as can be seen from Table 1, while the total number of personnel served is the same for 1992 and 1994-95, the number of personnel employed for catering is higher in 1992 than in 1994-95.

As can also be seen from Table 1, real total expenditure for catering increased gradually until the end of the 1993. The data for 1994 and 1995 show clearly that the real total expenditure is decreasing

Table 1. **Cost of catering in Ministry of Finance (as for District of Ankara)**

(1 000 Turkish Lira)

Catering			Total number of personnel			Real total expenditure for catering 1987 prices [(1) + (2)]/(5)	Exchange rate (TL per US\$) Nominal (4)	Inflation (CPI) 1987 = 100 (5)
Appropriation from budget (1)	Revenues from the users (2)	Employed in catering by Firm and MOF	Served lunch (Daily) (3)					
1990	4 500 000	525 000	n.a.	75	1 500	1 104 000	2 606	455
1991	7 000 000	900 000	n.a.	90	2 000	1 048 000	4 168	754
1992	13 850 000	1 990 000	n.a.	110	2 500	1 235 000	6 864	1 283
1993	23 700 000	3 479 000	n.a.	125	3 000	1 275 411	10 965	2 131
1994	34 760 000	11 603 000	75	15	2 500	1 054 663	29 670	4 396
1995	59 465 000	23 453 000	75	15	2 500	974 130	58 000	8 512

1. n.a. = not applicable.

2. CPI = Consumer Price Index (Annual average, 1987 = 100).

3. TL = Turkish lira.

4. Exchange rate is as of annual average (Buying rate of Turkish Central Bank).

Source: Turkish Ministry of Finance, General Directorate of Budget and Fiscal Control, The Census of Department of Economic and Social Services, 1995, and State Institute of Statistics, *Monthly Statistical Bulletins* and Central Bank of Turkey, *Monthly Bulletins*.

after having been contracted out. At the same time, revenues (contributions) from users are increasing. Therefore, the Ministry of Finance has saved considerable funds by contracting out catering.

Content of the contract

The catering services were contracted out through a sealed bid auction. Six companies participated in the auction and the lowest bidder was awarded the contract. The auction was conducted with respect to the procurement legislation.

As before, a four-course lunch is served. The employees are charged on a daily basis. The lunch is served in four different dining rooms. The rooms and the quality of the services are different according to the seniority of employees. Essentially, all employees have the same dishes at the same quality but the level of service differs slightly. For instance, two rooms are self-service. In the other two, the lunch is served by waiters. The prices are higher in the dining rooms reserved for senior staff.

The contract also covers the following terms:

- Dining rooms, kitchens, utensils and other facilities can be used free of charge by the firm.
- The contract covers a period of one year and the delivery price of the firm is reviewed biannually. The contract can be extended with the same conditions if both parties agree. However, extending the contract without reviewing the terms can eliminate the incentives for competition and efficiency. If there is no new bidding for a long period, the terms of the existing contract cannot be tested with regard to new market structures.
- The cost of gas is paid by the firm; water and electricity are provided by the Ministry of Finance. Since the meals are already subsidised at the production level by supplying free water, electricity, kitchens, etc., the selling of surplus food to third parties is forbidden by the contract. Thus, the firm should be very careful about the forecasted demand for food.
- The quantity and quality of the meals is inspected by a committee² at the Ministry of Finance. Both quality and quantity standards are listed and attached to the contract. If either is not followed, the firm is warned and fined in the first two instances. If this is repeated for the third time, the contract is terminated and the guarantee fee of the firm is not returned.
- Cleaning is done by the firm. If the rules are violated, the firm is first warned and then fined.
- Periodic hygienic check-ups of cooks and waiters is provided by the firm. Fines are imposed for violations of the hygienic rules.
- Courts are the authority for dispute resolution. However, there are no arrangements if the contract is interrupted in order to change the contractor.
- The firm's delivery price for lunch is decided biannually between the Ministry of Finance and the firm. Since there is high inflation in Turkey, a six-month period might be too long for the contractor.

These rules have never been violated and fines have never been imposed. In fact, both the employees and the administrators seem happy with contracting out the catering services. Employees often express that the quality of the catering has improved.

The four dining rooms are arranged for different groups of employees, which allows the Ministry to charge higher-income staff higher prices. In Table 2, Group A includes lower-income employees, Group B includes middle-level staff (chiefs and heads of sections) and Group C includes higher-level staff (under-secretaries, deputy under-secretaries, general directors, etc.) The group "others" includes visitors and others. Table 2 shows that Group C always pays higher prices. Therefore, there is more money transferred to the lower-income employees from the budget. For example, the amount of transfer to a low-income employee is:

$$\begin{aligned}\text{The amount of the transfer per lunch} &= 66\,000 - 20\,000 \\ &= 46\,000 \text{ TL}^3\end{aligned}$$

whereas for a high-earning staff the amount of transfer is 16 000 TL (66 000-50 000).

Table 2. **Prices of the Ministry of Finance and of the firm**
(TL)

	Prices per meal				The firm's price	Inflation rate (CPI) 1987 = 100	Real prices for Group A ('87 prices)
	Group A	Group B	Group C	Others			
1990 January	250	375	500	750	n.a.	362	69.1
1990 July	250	375	500	750	n.a.	440	56.8
1991 January	500	750	1 000	1 250	n.a.	586	85.3
1991 July	500	750	1 000	1 250	n.a.	741	67.5
1992 January	650	1 000	1 500	2 000	n.a.	1 047	62.1
1992 July	650	1 000	1 500	2 000	n.a.	1 229	52.9
1993 January	750	2 500	4 000	5 000	n.a.	1 672	44.9
1993 July	750	2 500	4 000	5 000	n.a.	2 127	35.3
1994 February	2 500	7 000	10 000	25 000	21 250	2 837	88.1
1994 July	5 000	15 000	20 000	35 000	36 500	4 453	112.3
1995 January	15 000	30 000	40 000	45 000	51 500	6 542	229.3
1995 July	20 000	40 000	50 000	75 000	66 000	8 305	240.8

1. The prices are valid for six-month period.

2. CPI = Consumer Price Index, cumulative, base year is 1987.

3. TL = Turkish lira.

4. n.a. = not applicable.

Source: Turkish Ministry of Finance, General Directorate of Budget and Fiscal Control, The Census of Department of Economic and Social Services, 1995. CPI is taken from State Institute of Statistics, *Monthly Statistical Bulletins*.

Close investigation of Table 2 (last column) reveals that lunch prices for Group A employees began to increase considerably in 1994. In fact, this shows that the Ministry of Finance began to implement a policy of fewer transfers for subsidised meals.

On the other hand, the contracted price follows the inflation rate closely. For example, the real contracted price for February-July 1994 is:

$$\begin{aligned}\text{Real contracted price} &= 21\,250/2\,837 \text{ per cent} \\ &= 749 \text{ TL}\end{aligned}$$

while the real contracted price for July-December 1995 is $66\,000/8\,305$ per cent = 795 TL.

Effects on the private sector of contracting out catering

The firm contracted by the Ministry of Finance is a foreign firm. The cooks and other workers are, however, employed locally. Supplies are purchased locally as well. In this respect, it is no different from a domestic firm.

In-house catering can be a barrier to the development of private restaurants, because restaurants around government organisations will not receive enough demand. Therefore, the public sector production of food can "crowd out" the private sector. Yet, contracting out public catering services will develop private catering firms and may improve competition in this sector and leverage quality.

As stated above, there has been a saving in labour after contracting out. The firm began to employ fewer workers for the same amount of service. This means that labour is more productive in private catering services. However, the number of employees at the Ministry of Finance has not been reduced. For various reasons, the cooks and other workers were deployed to other offices at the Ministry.

IV. THE EXPERIENCES OF OTHER GOVERNMENT ORGANISATIONS

Experiences with in-house production

Table 3 shows the cost of catering within the public sector for 12 ministries and annexed budget organisations.⁴ This table is organised so as to be comparable with Table 2 where the price of meals is indicated.

Table 3. **Catering in the Turkish Public Sector**

	Number of users (Daily average) (1)	Government subsidised meals (000 000) TL (2)	Revenues from user (000 000) TL (3)	Cost per meal a person nominal TL (2 + 3)/(1)	Cost per meal a person real TL 1987 prices
1992	65 849	29 214	22 775	3 290	256
1993	61 580	46 320	38 284	5 725	269
1994	56 991	74 955	73 929	10 885	248
1995	45 304	60 999	52 563	20 889	279

1. The figures are nominal unless otherwise indicated.

2. CPI = Consumer Price Index, cumulative, base year is 1987.

3. TL = Turkish lira.

4. The data are from 12 line ministries.

Source: Turkish Ministry of Finance, General Directorate of Budget and Fiscal Control, The Census of Department of Economic and Social Services, 1995. CPI is taken from State Institute of Statistics, *Monthly Statistical Bulletins*.

The last column in Table 3 indicates that where contracting out is not practised, the cost per meal averages between 248 TL and 279 TL in 1987 prices, whereas Table 2 shows that in the second half of 1995 the real prices is 240, 480 and 600 TL for Group A, B, and C employees, respectively. The contracted biannual prices in 1995 are 51 250 and 66 000 TL in nominal terms. On average it is $[(51\,500 + 66\,000)/2 =] 58\,750$ TL in nominal terms and 783 TL in real terms. (58 750 deflated by provisional CPI of 1995 that is 7 500 with the base year 1987).

These figures show that meals in the Ministry of Finance are more expensive than the average price in the public sector. However, as shown in Table 1, the Ministry of Finance saved a great deal of money from contracting out catering compared to the years prior to contracting out.

Experiences with contracting out

As stated earlier, there are two other public organisations that have contracted out catering services (excluding hospitals, universities, the army and schools).⁵ Both contracted out their catering operations in 1995. These cases do not provide sufficient data for lessons to be drawn. However, the contracts and the prices can be adjusted and compared with each other.

In both cases, the contracts were signed after public bids. There were five firms competing in the first, three firms in the second. In the first, the lowest bid was 70 000 TL and the highest was 108 500 TL. The firm that offered 74 000 TL was accepted as the contractor. The contract was designed to serve lunch to around one thousand employees. However, the data indicates that currently only about 300 employees use this service. Such a discrepancy between planned and actual numbers presumably stems from the high prices and existence of alternative restaurants around the organisation. The firm can, however, sell surplus food to other parties without the prior consent of the public administration.

In the other case, the lowest bid of 35 000 TL was awarded. Around 150 employees have lunch in this case. The contract is similar to the Ministry of Finance's and there have been no problems between the firm and the organisation.

The first contract shows that contracting out does not always result in the lowest price whereas the second one is a good example of getting a low price. However, all bids depend on the terms for quality as well as the quantity.

V. CONCLUSION

Only three of forty government organisations in Turkey contract out their catering services. The first contract has been in place for only two years. For this reason, there is not enough data to tackle the case in a complete manner.

The data shows that contracting out the catering services of the Ministry of Finance has been a success from the viewpoint of the Ministry, the firm and also of the employees. There are some lessons that can be drawn from this experience.

First, there must be a balance among price, quality and quantity. By segmenting the dining rooms, higher-earning staff can be charged a higher price. This is one of the many ways for government to achieve savings. Data shows that after contracting out, more effective use is made of food supplies and efficiency improves. Also, the terms of the contract and the quality of the food must be observed by a committee at which all groups of employees should be represented.

Second, there must be an incentive for the firm to maintain quality. This may be done by not compensating the firm when demand is less than planned and by restricting the firm from selling surplus food to third parties.

Third, the subsidised meals system of the Turkish government should be remodelled. The system is not a sophisticated one. It creates dissaving and biased income distribution. Moreover, in order to make use of economies of scale, catering operations should be researched further, and instead of 50 a more accurate figure for the optimum number of employees served should be established.

Fourth, in case of interruption of the contract, the continuity of the services should be provided for in the terms of contract.

Although contracting out can serve to develop the catering sector, both in-house production and contracted out catering can crowd out restaurants located in government areas. This problem may be overcome with “*ticket restaurants*”. That is, arrangements whereby existing restaurants near to government offices accept vouchers issued to the employees in order to share the cost.

NOTES

1. I would like to thank Erdogan Öner, Dogan Cansizlar and Fikret Demir for their valuable comments.
2. The committee consists of five senior-level staff and does not represent the users of all four rooms. Therefore, it is hard to detect all violations of the terms of the contracts.
3. The cost of water, electricity, the depreciation rate of the service rooms, kitchens, utensils, chairs and tables, etc., is not included in this figure.
4. These ministries and organisations are as follows: General Directorate (GD) of Foundations, Ministry (M) of Labour and Social Security, M of Tourism, GD of Youth and Sport, M of Culture, M of Domestic Affairs, GD of Agricultural Reform, M of Agriculture and Rural Affairs, M of Construction and Accommodation, GD of Meteorology, and M of Energy and Natural Resources.
5. These organisations are Undersecretariat of Treasury and GD of Health at Borders and Coasts.

CONTRACTING OUT INFORMATION TECHNOLOGY SERVICES AT THE UK INLAND REVENUE

by

David Jayes, Inland Revenue

I. INTRODUCTION

The Inland Revenue is responsible, under the overall direction of Ministers, for the efficient administration of income tax, corporation tax, capital gains tax, petroleum revenue tax, inheritance tax and stamp duties; for advice on tax policy; for advice on valuation policy; and for valuation services for revenue, rating, council tax and certain other purposes. The department also collects National Insurance contributions on behalf of the Department of Social Security. In fiscal year 1994/95, total Inland Revenue receipts were £87.3 billion.

Most staff are engaged in day-to-day operations of assessing and collecting tax and providing internal support services. These are organised into a number of separately accountable "Executive Offices". One of those Executive Offices, the Information Technology Office (ITO), is the subject of this case study.

In the 1980s, the ITO earned a reputation for successfully developing and running large computer systems. It was responsible for procuring, developing, maintaining and operating these systems, and in 1992/93 had a budget of £268 million. Over 51 000 workstations and terminals, mostly networked, connected some 67 000 staff to the Inland Revenue's computing architectures.

The ITO had three main software development sites at Telford, Worthing and Basingstoke, employing some 2 300 staff. Telford developed the Inland Revenue's major tax systems, Worthing the Department's administrative systems, while Basingstoke developed smaller distributed and PC-based systems, often using leading edge technology.

In addition, the ITO was responsible for 13 Regional Processing Centres housing powerful mainframes connected to the Inland Revenue's network of local offices. These mainframes supported:

- the computerised assessment of both employed and self-employed taxpayers;
- the collection of tax.

On 23 May 1994, the Inland Revenue signed a 10-year contract with Electronic Data Systems Limited (EDS) for the supply of information technology (IT) services previously provided by the Department's own in-house Information Technology Office. The contract value is an estimated £1 billion over 10 years at 1994-95 prices.

II. GOVERNMENT POLICY ON CONTRACTING OUT

In November 1991, the government published its "Competing for Quality" White Paper, which set out their programme to improve public services. The aim was to make public services respond better to the wishes of their users – primarily by expanding choice and competition.

Principles of market testing were set out in that White Paper, whereby all government departments were required to launch substantial programmes to compare cost and quality of work done in-house with what the private sector could offer, with the aim of delivering a high-quality service at the best possible value for money.

Before considering activities as candidates for a market test, departments were asked to consider a series of prior options:

- whether the activity needs to be performed at all;
- whether it is a suitable candidate for privatisation;
- where government wishes to retain responsibility, whether competition for its provision should be introduced, including the possibility of setting up a Next Steps Agency rather than continuing with the more conventional government department;
- consider whether for policy or management reasons the work should be done by the private sector (strategic contracting out without an in-house bid) or whether to have an in-house bid as part of a market test.

III. IMPLEMENTATION ISSUES

On either side of the publication of the White Paper, two external assessments of the ITO separately indicated that the organisation had some way to go to achieve standards of performance comparable with the private sector. Scope to improve arose on three fronts:

- manpower levels;
- productivity;
- the rationalisation of existing physical resources.

The first assessment (by CSC-Index, in September 1991) examined how the ITO should be positioned to operate cost-effectively in a “multi-project environment” – the handling and development of a multiplicity of projects at any one time. The assessment recommended that the ITO’s senior management team should be strengthened, and offered a judgement that the ITO could achieve significant efficiency savings, including eventual reductions in manpower, offset by some additional and focused new skills.

The second assessment, in March 1992, was made by consultants (Lucidus) who were engaged to help the ITO determine an appropriate response to the “Competing for Quality” initiative. Their report offered a number of possibilities for enabling private sector standards of performance to be achieved in the Inland Revenue’s computing services. These ranged from a wholly in-house programme of performance improvement, requiring substantial investment (including capital, subsequently estimated as some £50 million between 1992/93 and 1997/98) through various degrees of outsourcing up to what amounted to complete privatisation. The report pointed to potential cost-efficiency savings in the range of £18-£25 million per annum.

The Inland Revenue was attracted to an approach that balanced risk and return by outsourcing, potentially, the bulk of ITO activity, but in increments, beginning with computer operations.

Some commentators expressed concern about the ability of the private sector to maintain taxpayer confidentiality and security. The Department’s requirement in this area is underpinned by legal safeguards, and any contract entered into would be (and is) subject to stringent specific obligations on both the confidentiality and security aspects.

On 23 December 1992, the outsourcing of the Inland Revenue’s IT services was advertised in the Official Journal of the European Communities.

IV. IN-HOUSE COSTINGS

The baseline costs of performing the activity in-house were calculated by projecting the 1992/93 actual spending incurred in the running of the ITO and its computer systems (after taking account of non-recurring payments, known future capital expenditure and any planned internal productivity improvements).

V. PRIVATE SECTOR POSITION

The private sector market specialising in providing information technology services already included numerous world-class companies competing in an expanding environment. Firms responding to the advertisement with a formal Expression of Interest were:

- Cap Gemini Sogeti;
- Computer Sciences Corporation Europe in alliance with IBM UK;
- Digital Equipment in alliance with Logica and Barclays Bank;
- EDS;
- ICL in alliance with Andersen Consulting; and
- The Sema Group.

A more traditional market testing approach would have involved the dividing up of the ITO's business areas into segments and inviting bids – possibly in-house as well as from the private sector – for them in a series of competitive tenders.

The task of running a series of competitive tenders over a period of a year or two, involving in-house bids, for perhaps three or four segments of the ITO's business, while at the same time maintaining current operations and development schedules, was considered of questionable feasibility. Moreover, it could well have led to the fragmentation of the Department's IT supply to the extent that it would become costly and inefficient to manage and poorly positioned to respond to the demands placed upon it as the Department moved to build the new Inland Revenue over the rest of the decade.

VI. IN-HOUSE BID

The Department did not invite or encourage an in-house bid.

A main aim of market testing is to take a fresh look at the way public sector work is carried out and to be innovative in proposing new ways of improving value for money. Although an in-house bid is the means by which existing staff can take part in this important process, the Department judged that a strategic partnership – involving the transfer of most of the ITO to one company, subject to a market test against in-house costs (but no in-house bid) – was the route most likely to provide the flexibility and resources needed to achieve the market test objectives. In making their decision, the Department judged that an in-house team would not deliver the desired objectives because:

- It would continue to be constrained by Civil Service rules – for example, the inability to redeploy surplus capacity to work for non-Revenue third parties, or obtain all the necessary skills and expertise needed at Civil Service pay rates.
- It would be in competition with world-class companies specialising in providing information technology services. The earlier consultants' reports had clearly indicated that the performance of the in-house organisation fell some way short of private sector standards.
- It would be unable to ensure the availability of the significant investment, some £50 million in the first five years, that would be needed to buy in new skills and technologies.

Furthermore, if fewer staff were to be needed on information technology work for Inland Revenue, a private sector employer would be much more likely to provide new employment opportunities than the Department, where staff numbers in general were decreasing.

VII. STAFF ISSUES

Under the contract, some 1 900 Inland Revenue staff and their work transferred to EDS in two stages: the first transfer, involving around 1 100 people, occurred on 1 July 1994; the second transfer took place on 1 January 1996. As part of the arrangements, the Department sold their mainframe computers and other equipment to EDS, and this also transferred in two stages. The company will occupy under leases or licences the buildings formerly used by the Information Technology Office.

The staff of the ITO were told in July 1992 that a strategic partnership, which would take around 2 000 of them to the private sector, was the leading option. Over the two years to contract signature and implementation, the Department recognised staff worries about their future, and adopted a number of approaches to keeping them informed and responding to their concerns including:

- establishing a confidential telephone enquiry line;
- issuing newsletters and information bulletins;
- providing question-and-answer booklets;
- setting up Focus Groups at which senior managers discussed staff concerns.
- once EDS were selected as the proposed supplier arranging:
 - joint presentations to staff by ITO and EDS management;
 - one-to-one meetings between staff and EDS management.

Protecting terms and conditions

The Department's lawyers advised that TUPE – the Transfer of Undertakings (Protection of Employment) Regulations 1981 – would apply to the strategic partnership, and this meant that staff were entitled to transfer to the company with their current terms and conditions of employment. Following extensive discussions with the Department and the trade union side, EDS produced an "Image" package that adequately replicated existing Civil Service employment terms.

TUPE, however, does not preclude the supplier seeking to negotiate changes to the transferred terms and conditions, and, after transfer, staff were given the opportunity to change to the company's standard terms and conditions. However, the company has re-affirmed that the terms and conditions will not be varied substantially without the consent of staff and their representatives.

Protecting pension rights

On transfer to EDS, Inland Revenue staff ceased to be members of the Principal Civil Service Pension Scheme. As part of its Image package, EDS produced a new pension scheme, and the Government Actuary's Department has certified that this scheme provides transferred staff with benefits that are broadly comparable to those of the Civil Service Scheme.

The Department has agreed transfer arrangements with EDS so that Revenue staff can receive a service credit in the company's pension scheme equal to their pensionable service in the Principal Civil Service Pension Scheme. Participation in this arrangement is voluntary, and, if they so wish, staff can instead preserve their benefits in the Civil Service Scheme.

Severance payments

The successful supplier would be liable for severance payments to any transferred staff made redundant after the transfer. As part of the bid process, the Department required the tenderers to show separately that proportion of their bid price that related to their provision for severances. Thereafter, the successful bidder would not be allowed to include any additional redundancy costs in the price charged to the Department for the contract. The Department, on the other hand, would not seek to reduce the contract price if the supplier did not make redundancies at the level anticipated. The Department considered this approach had three main advantages:

- it provided competition between the tenderers to keep severance costs down;
- it provided the Department with certainty on redundancy costs; and

- it provided the supplier with an incentive to minimise the number of redundancies since, if they succeed in keeping the number of redundancies below the level assumed in the contract price, it should mean additional profits for them.

The extent to which the provision will be used will depend on the suitable employment opportunities EDS can offer in other parts of the company and the extent to which EDS enforces the mobility obligation on staff to whom it applies.

Monitoring transferred staff

The Department required tenderers to demonstrate that they had in place a well-established career development scheme and to show how transferred staff would participate. EDS fully satisfied this criterion and has undertaken to provide all transferred staff with training as part of their induction course and individual development plans.

The Department tracks the progress of transferred staff by requiring EDS to provide up-to-date reports on personnel issues (promotions, transfers, resignations, training, etc.) involving former Inland Revenue staff.

The trade union position

At an early date, consultations were opened with the trade unions: there were five with an interest. Although civil service unions are, as a matter of policy, implacably opposed to the idea of market testing and outsourcing, the main union involved – the Inland Revenue Staff Federation – with its own professional advisers, came at the nuts and bolts aspects of the implications for their members in a wholly professional and constructive way. There was plenty of tough talking, but at the working level they did not allow their antipathy to the policy of market testing to get in the way of their professional duty to their members to secure the best deal that they could.

The Inland Revenue Staff Federation's Executive Committee recommended acceptance of the Image package. They believed the package was as good as could be obtained; it met many elements of their original claim but fell short of others. They also believed that job security would be no worse than in the Civil Service – so long as EDS made the contract work and continued to grow. Members subsequently voted to accept the Image package by a substantial majority. EDS has recognised the Inland Revenue Staff Federation for collective bargaining on pay and terms and conditions.

VIII. IMPACT ON THE ROLE OF MANAGEMENT

The main issues faced by management were:

- Cultural change: the impact of dealing with people with different objectives and different ways of doing business.
- Once the deal was signed, the need to accept different approaches to the delivery of IT.
- The difficulty of marrying public sector accountability for public money and the reasons why it has been spent with the private sector ethos of finding the most pragmatic way of meeting the bottom line objective without too much concern about how that is done.
- Getting the Department as a whole to sign up to the practical implications of partnership where both sides should work to support each other's objectives, not just their own.
- Getting the Department to understand that completion of the procurement represents the end of the beginning, *not* the end of the process. And, that making it work is even more difficult than the procurement.
- Acting as the intelligent customer for the business, and *not* as the IT supplier.

IX. CONTRACT ARRANGEMENTS

Although referred to as the strategic partnership contract, there are well over 100 different agreements covering the deal. These embrace the commercial terms, the transfer of assets, terms and conditions including pension arrangements for staff, the assignment of third-party agreements to EDS, and numerous leases and licences covering the 15 properties that EDS occupied from Day 1 to deliver the IT services.

Service level agreements

The Department entered into the contract with EDS before updating the Information Technology Office's existing service level agreements which defined the services to be provided and associated measures of performance.

Under the terms of the contract, the Department ensured that, prior to the introduction of the detailed new contractual arrangements, EDS was to deliver the *de facto* levels of service being achieved by the Information Technology Office in the period immediately before transfer.

Within the first six months of the contract, the Department aimed to agree a Master Service Level Agreement with EDS setting out the framework within which EDS would provide service to the Inland Revenue: this included how they would be defined, measured, reported and actively managed over the life of the contract.

The Master Service Level Agreement is underpinned by Scopes of Work, the detailed service agreements, which are agreed between EDS and the individual Departmental customers. These include the detailed descriptions of delivered service, their characteristics, standards, key performance criteria, etc. These Scopes of Work are intended to be evergreen documents which can be updated at any time during the course of the contract to reflect changing business needs.

Price competitiveness

The Department's philosophy in negotiating this contract was one of incentives backed up by protection rather than sanctions.

For each year of the contract, EDS has agreed a fixed standing charge for providing the base workload and related manpower resources transferred to the company. This reduces over the life of the contract. The fixed charge has the effect of reducing our IT costs by about 50 per cent for the volume of services in Year 1.

The formula for calculating the fixed standing charges remains unchanged for the life of the contract, but the actual charge will vary to take account of, for example, changes in the volume of work ordered, the resources required and any indexation of labour costs.

There are three charge bands:

- SCR – Standard Consulting Rate: this rate applies where little or no notice can be given to EDS for the supply of a resource type.
- ASC – Additional Services Charge: this charge band applies when at least 3 months' notice is given to EDS.
- FSC – Fixed Standing Charge: this is the cheapest charge rate and applies when at least 12 months' notice is given to EDS.

Provided the Department can plan ahead and give EDS 12 months' notice of its resource needs, it can get the benefit of the Fixed Standing Charge. Inland Revenue expects the great bulk of its spending with EDS to be at that rate.

By agreeing to a fixed standing charge, which delivers around a 50 per cent reduction in charges to the Department for the defined workload, EDS has taken a considerable business risk. However, it expects to reduce its underlying costs by increased efficiency and productivity, thus releasing staff on Inland Revenue business for productive work elsewhere in the company.

The contract also provides a profit-sharing mechanism. At the end of the financial year, where the gross margin exceeds a percentage target level calculated in accordance with the contract formula, the Department and EDS share the excess equally.

The Department has also put in place arrangements that should, if required, ensure the orderly transfer of service provision from EDS, either back to the Department or, more likely, to an alternative supplier.

X. DRAWING UP THE CONTRACT

- two teams of in-house personnel focused on commercial aspects and human resources/communications aspects;
- outsourcing consultants provided specialist project management and commercial expertise;
- the Government's Central Computer & Telecommunications Agency provided support of strategy and procurement aspects;
- Inland Revenue Internal Audit Division worked on the project alongside the ITO teams;
- legal advice was provided by:
 - the Inland Revenue's internal Solicitor's office on employment issues;
 - external Solicitors in respect of commercial and contractual issues;
- an external firm of consultants conducted Quality Assurance (QA) reviews at various stages during the Procurement.

Apart from the QA consultants, all the other teams worked as part of the global "Implementation Team" with joint responsibility for success/failure.

XI. THE BIDDING PROCESS

A procurement in line with the EC Services Directive was started in December 1992. Six formal Expressions of Interest were received and reduced after careful deliberations to a shortlist of two suppliers in May 1993. An Invitation to Tender, running to nearly 20 000 pages, was sent to each of the two organisations on the shortlist and a considerable time was spent evaluating their responses.

This evaluation was conducted in an extremely structured way, testing such different matters as the commercial stability of these organisations; the track record they had with other customers in long-term relationships (The Inland Revenue took 30 references from around the world and visited nearly a dozen reference sites); their technical capacity; their ability to keep taxpayer information confidential and secure – all these companies had experience of dealing with sensitive data in the defence field – and, of course, the financial value to the Department of their bids was evaluated.

The Inland Revenue was looking for the best value for money, not just the lowest price.

At the end of November 1993, EDS was declared a preferred supplier and the Inland Revenue spent the next four months in contract negotiation until contracts were signed on 23 May.

The size of this contract made it more appropriate to a large supplier so it was not considered helpful to encourage small businesses to bid.

XII. PERFORMANCE MONITORING

The Director of the Department's Business Services Office has overall responsibility for the contract, supported by a contract management team headed by the contract manager. The team includes specialists in performance monitoring and financial and resource planning, all of whom have received training in contract management. The team work closely with the Department's Internal Audit Office and each year they jointly agree an audit programme of the strategic partnership arrangement.

The Department have given considerable thought to the need to manage the contract successfully and ensure that the financial and other benefits of the strategic partnership are realised. In particular, processes have been initiated to ensure that:

- EDS delivers the quantity and quality of services in accordance with the Master Service Level Agreement and the individual service agreements;
- changes in the level of services are clearly defined in the agreements, including appropriate performance measures;
- EDS rectifies failures in the delivery of services promptly and, where appropriate, financial remedies are imposed;
- the Department plans its work properly so that IT can be obtained at the most economic rate by ordering resources from EDS 12 months in advance;
- EDS' prices, costs and profit figures are reasonable;
- the Department closely monitors changes in industry prices, and can, where appropriate, renegotiate prices with EDS or carry out further market testing;
- EDS maintains the Inland Revenue's contingency and disaster recovery arrangements.

In addition, the contract provides:

- an "open book" approach so that the Inland Revenue can check EDS's commercial position;
- profit sharing arrangements so that additional gains made by EDS are shared by both parties;
- dispute resolving procedures if the Department and EDS are unable to settle differences between themselves.

XIII. OVERALL ASSESSMENT

The Department estimate that the arrangements with EDS could result in savings of between 15 and 20 per cent over the projected baseline (in-house) costs – in cash terms somewhere in the region of £225m at 1994/95 prices over 10 years.

The market testing exercise cost the Department £4 million.

The Inland Revenue strategic partnership with EDS has been in place for eighteen months and has proved very successful, although it is too early to measure the extent to which long-term objectives have been met. This public/private sector initiative is a major contributor to modernising the Inland Revenue and achieves good value for money. EDS are:

- providing high levels of IT service to the Inland Revenue;
- managing the key project which will deliver IT support for the new self assessment programme;
- delivering significant cost savings to the Department.

XIV. LESSONS LEARNT

The Department has identified the following elements of the procurement that proved to be particularly effective:

1. the setting of clear objectives for the procurement that could be translated into quantifiable targets;
2. initial contact with potential suppliers to explain the objectives and stimulate vendor interest in the procurement – *i.e.* promote a competition;
3. the creation of a small, high-quality procurement team with a wide range of relevant experience;
4. rigorous project planning allowing sufficient time to anticipate and manage each phase of the procurement;
5. risk management through formal risk assessment and a commitment to procedural integrity through rigorous quality assurance; and
6. a structured communications strategy covering all interested parties.

A contract of this size and complexity requires continuing management commitment not only for procurement, but also for implementation and day-to-day running.

XV. CRITICAL SUCCESS FACTORS

The specific major critical success factors for the Inland Revenue's IT strategic partnership were as follows:

- to gain access to 1990s skills, tools and technologies;
- to realise substantial improvements in cost effectiveness;
- to achieve significant improvement in speed or response in development and enhancement of systems;
- to maximise career opportunities for existing staff.

On a more general note, the following factors may be considered as "key" for an outsourcing contract of similar size:

- understand your organisation – its strengths and weaknesses – and the future demands to be made of it;
- research in depth your options for change;
- convince yourself and all other stakeholders that the route you choose is in fact the best way to go;
- keep those stakeholders up to speed with every major twist and turn in progress;
- secure ownership and oversight of the chosen route at the very top of the organisation;
- put together a high-powered, highly motivated team encompassing all the necessary skills;
- take great care of how you prepare the market and then how you run your competition;
- keep the staff informed of what is happening throughout the process;
- ensure that on your side of the partnership, particularly in contract management, you have sufficient residual skills to be able to talk to your partner on level terms;
- understand that there will be a far-reaching impact on your whole organisation not just on the way IT services are delivered.

CONTRACTING OUT THE OPERATIONS OF INDIANAPOLIS INTERNATIONAL AIRPORT

by

David A. Lips, Mayor's Office, City of Indianapolis

I. INTRODUCTION

Traditionally, the Indianapolis International Airport (IIA) has been one of the most well-run airports in the United States. Run by a municipal corporation, the IIA had lower costs than most other airports and had enjoyed the reputation of being well maintained and efficient.

Indianapolis's experience, however, with contracting out governmental services had been so positive that when members of the Indianapolis Airport Authority board of directors first discussed the prospect of private management of the airport in late 1992, they considered the idea seriously and refused to let it lie fallow. Three years later, the IIA is under private management in one of the largest and most complex examples of managed competition in the United States.

IIA is the largest airport in the nation, in terms of passenger traffic, to be privately managed. The contract between IIA and the vendor chosen to manage the airport guarantees savings of \$32 million over ten years. The arrangement has been hailed as a precedent for how airports should and will be run and as showing how competition can make even efficient public operations more efficient.

These comments are fairly accurate descriptions of both the novelty of this particular contract and its likely effect in inspiring other jurisdictions to consider doing the same thing. It might surprise Indianapolis residents, however, to hear the amazement of those who note that competition created savings even of this magnitude. Through the leadership of its mayor, Stephen Goldsmith, Indianapolis has become a model for contracting out city services, and the community is well acquainted with the savings and benefits associated with competition. While other governments throughout the world are viewing the IIA contract as a dramatic departure from the norm, people in Indianapolis view it as one more extension of Mayor Goldsmith's efforts to make Indianapolis government competitive, efficient, and cost-effective.

II. THE INDIANAPOLIS COMPETITION MODEL

Mayor Goldsmith was elected in 1991 on a platform that included reducing the size and burden of government. Several problems needed rapid and substantial governmental attention. Earlier in 1991, the Indianapolis Chamber of Commerce had issued a report indicating that it would cost \$1.1 billion to repair the city's infrastructure over the next decade. The city's police force also needed to be strengthened and modernised. Yet the city was beset by the flight of wealth. Raising taxes would merely chase more businesses and residents across the city line into one of the lower-tax suburbs.

The chief problem the mayor faced when he took office was how to pay for improvements to infrastructure and public safety – core municipal services – without increasing tax rates. Part of the answer lay in competition.

Starting in early 1992, the mayor embarked on a sweeping initiative to apply the principles of competition to the provision of municipal services. The programme has involved injecting competition into nearly 70 areas of city government. The savings (excluding the savings from the airport contract)

total \$135 million. They have helped make possible the largest infrastructure rebuilding programme in the city's history, the expansion and updating of the police force, and an enormous increase in the City's financial reserves – all without raising taxes.

The administration uses a “core service” analysis in determining the need for and probable success of competition. Services that relate to government's core mission (such as police protection) are distinguished from those services that are ancillary to government's central policy concerns (microfilming, for example). Competition is more desirable and more likely to be successful when the service is not part of government's core mission.

III. APPLYING THE COMPETITION MODEL TO THE IIA

In the case of the airport, the Airport Authority board determined – and the administration agreed – that managing the terminal (parking, concessions, landscaping and interior housekeeping) and overseeing the airfield (cutting grass and removing snow) are not inherently governmental activities. They could be adequately and perhaps more efficiently done through the private sector. In addition, the IIA was already a free-standing entity that had its own financial statements. The board therefore had a benchmark by which to compare costs from private bidders.

The board was also aware that private corporations already managed several smaller airports nationwide. These airports are almost exclusively for general aviation rather than for commercial passenger service, but the board found no reason to restrict airport management to non-commercial settings. The market for airport management may have been undeveloped in the United States, but the board knew of several prominent airports throughout the world that were owned and/or operated by private corporations.

The board was convinced that opening the management of the airport to competition could bring about unimagined savings and efficiencies. After all, Indianapolis had learned through prior experience not to underestimate the benefits of competition.

Much like the IIA, the Indianapolis wastewater treatment plants were models of public-sector efficiency. They had won several national awards and were considered among the most well-run public facilities in the country. Nevertheless, Mayor Goldsmith hired a consulting firm to assess whether contracting out the management of the plants would create savings. The firm made a detailed review and concluded that private management might save the city 5 per cent over its most effective city operational costs in running the plants. Mayor Goldsmith decided to see what the market could do through competition. He solicited bids from around the world for managing the plants. The result was a bid that saves the city 44 per cent of its operating costs, nearly \$65 million in savings over 5 years.

One profound difference between the other competitions within city government and the IIA competition is that the savings from the airport competition would not accrue to the City of Indianapolis. The benefits to the city from outsourcing the management at IIA are therefore not as obvious.

Unlike the city's other competitive ventures, the IIA competition over the short term is designed to make Indianapolis more attractive for economic development. Over time, the transactions should save city taxpayers money through lower ticket prices and also improve airport service.

As at many other airports in the United States, the lease between the Indianapolis Airport Authority and the airlines charges the airlines for airport costs not covered by airport revenue (from concessions, rents and parking). This arrangement created an adversarial relationship between the airlines and the Airport Authority and offered the Authority no incentive to lower airport costs or increase airport revenue. In fact, IIA concession revenue per passenger in 1994 was only half of what it was in 1984.

Nationally, airport charges have been the fastest-growing part of airline operating costs and account for 5 per cent of those costs. From 1984 to 1994, airport costs per IIA passenger rose 38 per cent. Yet in a good year, airline industry profits are only 2 per cent.

Mayor Goldsmith urged the Airport Authority board to solicit proposals for managing the Indianapolis airport system (consisting of the IIA, four general aviation airports and a downtown heliport). The goals were to cut airport operating costs, provide more revenue both to the airport and the airlines,

improve customer service, position IIA to be one of the leading airports in the country, and in the long term, hold down ticket costs through increased competition and service. The lower costs would make Indianapolis a more attractive place for distribution hubs and passengers, and would therefore create jobs and spur economic development.

IV. BIDDING OUT THE CONTRACT

The Airport Authority decided to bid out the entire airport management rather than split up the contract among several firms. Two factors were critical in this decision. First, given the unusual nature of this contract, at least by American standards, it was imperative to have only one entity to deal with if problems arose. If multiple firms were involved, it might be difficult to determine each party's separate responsibility in the event of problems concerning contract performance. Accountability is essential. Second, given the importance of the services to be rendered in managing the airport, the Airport Authority wanted to have a single entity that would have clear financial liability in case there was a contract default. If several companies were involved in providing the contract services, it was foreseeable that they would make cross claims against each other and delay the payment of damages until after the resolution of complex litigation.

The bidding was open to all qualified proposers. The requests for proposals required information in the bids that enabled the Airport Authority and its consultants to assess the technical and financial capabilities of the bidders. No special provisions were made to help small businesses bid, since the financial resources required of the vendor would naturally exclude small businesses from being awarded the contract. Nevertheless, as will be shown below, the contract itself requires using minority- and women-owned businesses in providing the services under the contract.

In late 1994, four private companies submitted proposals to manage the airport. An in-house team from the Airport Authority staff also submitted a proposal. All proposals were evaluated according to the same criteria. The Airport Authority board hired a consulting firm to review the proposals in depth.

In early 1995, the Airport Authority selected a private vendor. The company chosen to manage the airport system is BAA USA, Inc. BAA is a subsidiary of the privatised British Airports Authority, which owns and operates London's Heathrow (the largest airport in the world) and six other airports in Great Britain.

BAA had not submitted the most aggressive initial proposal. But in negotiations, BAA showed itself to be the most flexible, the most accommodating, the most creative, and the most experienced vendor to perform the services required for managing the airport.

V. THE CONTRACT PROVISIONS

The Airport Authority continues to exist, although its role has narrowed under the contract. Long-range planning and strategic decision-making will continue to be the exclusive domain of the Airport Authority. The Authority will also make decisions on capital expenditures, oversee IIA debt, assure compliance with federal regulations, and monitor BAA's performance under the contract.

The contract is for ten years. Excluding schedules and attachments, the contract is 64 pages long and consists of twenty-two articles. Six of the articles are especially salient.

Article III of the contract lists BAA's responsibilities. BAA's primary responsibilities are running the terminal, overseeing the airfield and providing administrative services.

Article VI sets forth BAA's compensation. Under the Article, BAA gets paid only after it has generated savings above a defined "baseline". In 1994 dollars, BAA guarantees \$25 million in cost reduction and revenue increases over the decade that the contract is in effect. (This figure will be inflation-adjusted each year.) Once the baseline is reached, BAA and the Airport Authority share the savings in varying amounts depending on the year of the contract. In the first year, BAA's percentage of savings above the baseline is 40 per cent. It drops to 35 per cent in the second year. Thereafter, BAA is entitled to only 30 per cent of savings above the baseline, the rest of the savings going to the Airport Authority. During the second and subsequent years, BAA is eligible for a 5 per cent bonus for meeting

mutually agreed upon quality targets. If BAA fails to meet the baseline, BAA gets no compensation. In addition, BAA has put up a \$50 million letter of credit to seal its guaranties.

Article IX describes BAA's covenants under the contract. Three of these promises are particularly noteworthy. First, BAA is to develop a Quality Service Monitor programme to assess the attitude and helpfulness of the staff, airport cleanliness, crowding and other features important to the travelling public. BAA is to submit to the Airport Authority a proposed schedule for monitoring and to improve service levels as warranted. The Airport Authority may conduct its own customer surveys to assure that BAA is adequately monitoring and improving the quality of airport services. Second, BAA is to use best efforts to use minority – and women-owned businesses in connection with providing services under the contract. The contract specifies the goal of reserving at least 10 per cent of all purchases and relevant contracts for minority-owned businesses and another 2 per cent for women-owned businesses. Third, BAA is to ensure “street pricing” for concessions. The prices of goods foods and beverages at the airport will on average not exceed the prices for the same goods in greater Indianapolis.

Article XIV requires BAA to “use it best efforts to employ all interested and qualified employees” of the Airport Authority. In practice, this Article means that unless an employee fails a drug test or otherwise is found to be unsuitable, all 300 former employees of the Airport Authority are now employees of BAA. Indeed, BAA foresees the need eventually to hire more staff. The Article also requires BAA to hire the staff at “essentially similar” levels of compensation and benefits that they were receiving from the Airport Authority. In summary, while some employees may be reassigned at IIA, most of them will see little change, at least immediately, from IIA's going under private management. The staff was non-union before the management was privatised and has remained so.

Article XVII provides that the contractor co-operate in transferring the responsibilities of managing the airport to a new vendor at the end of the contract.

Finally, Article XVIII permits the contract to be modified if legal requirements or changes to the terminal so necessitate. No such modifications in the contract have been made to date.

The contract terms were negotiated, on the City side, by the Airport Authority with the assistance of the City's Department of Public Works. A local law firm hired by the City drafted the contract.

VI. BENEFITS AND COSTS

The contract went into effect on 1 October 1995. At this early date, the decision to contract out appears to have been wise and foresightful.

Although under the contract BAA guarantees savings of \$32 million, BAA actually projects savings in airport management costs of \$105 million, thereby slicing airport operating costs by 25 per cent. The contract is a clear winner for the Airport Authority, BAA, and the airlines.

The consumer also wins under the contract. Services will be monitored more closely with an eye toward constant improvement, new shops will be put into the terminal, and the price for goods and meals purchased at the airport are considerably lower than they were thanks to the contract's “street pricing” provision. The consumer may reap another important benefit in time. BAA predicts that in 10 years the cost per passenger at the IIA will fall by 30 per cent. BAA guarantees a reduction of over 9 per cent. This reduction may well lead to lower ticket prices for Indianapolis customers. Michael Boyd, president of Aviation Systems Research Corp., notes, “Where you have lower airport costs, you'll have lower fares.”

The other party to benefit from the contract is the city of Indianapolis. This contract puts Indianapolis on the cutting edge of municipal reforms and makes the city one of the most attractive venues in the United States for airlines. Betty Johnson, a member of the Airport Authority board, observes, “By having an outside firm manage our airport, we are setting the trend in the airline industry.”

There were, however, costs associated with contracting out IIA's management. It is estimated that the costs from drafting the RFPs and the contract and other consulting and legal costs amount to around \$500 000, approximately 2 per cent of guaranteed savings.

VII. KEY LESSONS

This experience with privatising airport management demonstrates once again the benefits of competition. The main positive lesson confirmed that competition works. We also found out that the key success factor is having a fair deal for both sides. Our attitude was to be as helpful as possible to BAA, and BAA reciprocated. Having the same goals was the key.

At the same time, we also employed a strategy that we had used before and that worked again. Although we received five bids, two were clearly superior. By playing the corporations that made those two bids off each other, we arrived at a contract that was superior to the arrangement proposed in either bid.

The main negative lesson is not to spend too much money studying the deal before the RFPs are issued. Let the marketplace provide the answer about whether contracting out is feasible and desirable.

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